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10th January 2014

Dear Hannah,

Consultation on the methodology for assessing the equity market return for the purpose of setting RIIO price controls

Thank you for the opportunity to respond to this consultation. This is a non-confidential response on behalf of the Centrica Group excluding Centrica Storage.

We remain committed to engaging in the RIIO:ED1 process to ensure our customers receive value for money. It is particularly clear at the current time how important it is that networks are not over-rewarded and so customers do not overpay. We support the view of Cost of Equity suggested by the Competition Commission (CC) and welcome the extra £2 per customer it will avoid customers having to fund each year.

Our key conclusions are as following:

- The analysis we have commissioned from CEPA supports the range for Cost of Equity proposed by the CC. It also demonstrates that if the Ofgem methodology is applied consistently with how it has been applied historically, this would provide a result within the CC range. CEPA's report containing this analysis is attached as an annex to our letter.
- The adoption of a Total Market Return of 6.85% by Ofgem would represent a change in methodology by Ofgem and is not consistent with the recent determinations made by other regulatory bodies, notably the CC, Civil Aviation Authority, Office of Rail Regulation and Ofcom.
- We disagree that the CC has placed too great an emphasis on contemporaneous information or spot rates. The case for a lower Total Market Return is supported by analysis of Market Asset Ratios and broader market evidence.
- For RIIO ED1, we continue to support the use of debt indexation and the DNO business plans also supported this position. There is evidence that the indices used in the cost of debt are overly generous, although with less headroom than we see in the cost of equity estimate, but we remain of the view that debt indexation is beneficial for customers relative to the alternatives.

If you have any questions in relation to any part of our response please do not hesitate to get in touch with me.

Kind regards,

Andy Manning
Head of Network Regulation, Forecasting and Settlements
British Gas
[via e-mail]

Appendix: Answers to consultation questions

A direct translation of the Competition Commission's estimates to DNO cost of equity allowances

- Do you agree with our direct translation of the CC's equity market return estimate to DNO cost of equity allowances?

Ofgem's direct translation of the CC equity market return includes a risk-free rate of 1.25% and a total equity market return of 6.0%. We agree with this translation of the CC provisional determination for NIE, although not with the Ofgem interpretation of the CC approach.

Implications for risk

- Can you provide evidence on the impact of giving greater weight to contemporary market evidence on perceived systematic and regulatory risk?

We favour analysing longer-term averages of market evidence in setting a cost of equity, which will reduce systematic and regulatory risk. However Ofgem does not need to place a greater weight on contemporary market evidence to arrive at a lower total equity market return figure. CEPA discusses the impacts of the choice of methodology extensively in Section 1 of its report.

Financing issues

- Do you think changing our methodology for the equity market return would impact on interest costs for DNOs? If so, how would this need to be accommodated in our approach to the financial package or the regulatory package more widely?

A lower total equity market return would not require Ofgem to change its methodology and we find that a 6.85% TMR is inconsistent with Ofgem's approach and interpretation in previous price controls (see Section 1 of CEPA Report). CEPA discusses the interaction with the cost of debt and its interaction with financeability in Section 2 of its report, stating that it does not believe the selection of a lower cost of equity warrants revisiting how the cost of debt is determined. Additionally, the assessment of the RIIO ED1 business plans found at least three networks to have comfortable credit metrics and the issue has been discussed as part of the RIIO Financeability Study.

Investment incentives

- How do you consider that the choice of methodology for determining the appropriate equity market return impacts on investment incentives? Is there any evidence that you can provide?

In terms of attracting investment, the perception of risk is a determinant for both the supply and cost of capital. As such, a consistent methodological approach that involves examining market evidence and interpreting this market evidence, should reduce risk. The equity market return chosen by Ofgem is above the range selected by the Competition Commission (CC), Civil Aviation Authority (CAA) and Office of Rail Regulation (ORR). Ofwat have also indicated that the cost of capital will be reduced significantly since 2009. This would suggest that the Ofgem decision would not be consistent with other regulators, which could mean that the equity investors in electricity distribution receive windfall gains at the expense of the consumer.

Looking at previous network decisions, we do not believe a change in the methodological approach to setting the cost of equity is required to achieve consistency with the regulatory bodies noted above and note that Ofgem's own position on Interest During Construction for offshore transmission would point to a lower cost of equity. Excluding the impact of inflation, a rise in the total equity market return from DPCR5 is not well justified or supported by market evidence. We believe that RIIO GD1 and T1 decisions on the cost of equity represented a change in interpretation relative to previous Ofgem price controls which was unwarranted and inconsistent with their previous approach. The issue of consistency is discussed in depth in Section 1 of the CEPA report.

Eight-year RIIO price control period

- To what extent do you think the merits of the alternative approaches to the assessment of the equity market return are affected by the eight-year RIIO control period?

The intention behind Ofgem's move to an eight year price control was to allow companies to more effectively manage investment uncertainty. In the RIIO ED1 strategy decision, Ofgem reviewed analysis from Oxera, on behalf of the Energy Networks Association (ENA) that pointed to an increase in risk from lengthening the price control period, however Ofgem state that the evidence presented does not indicate that RIIO ED1 is riskier than previous price controls. The starting point must therefore be that there is no reason to adopt an alternative approach, although note that the equity beta decisions by Ofgem remain significantly elevated compared to available market evidence, going against the views of its own advisers. We believe that the long-term evidence examined by the regulator, such as averages of index-linked gilts and both DMS and Barclays evidence for the Total Market Returns, remain valid considerations for price controls of five years or of eight years, whilst it is important that cross-checks, including on the equity beta, (see Section 2 of the CEPA report) are used to ensure that the cost of equity assumption is valid based on an assessment of all available evidence.