

DRAFT DETERMINATION FOR WESTERN POWER DISTRIBUTION LTD

RESPONSE FROM NORTHERN POWERGRID

20 January 2014

Contents page

INTRODUCTION	1
THE SCOPE OF OFGEM'S CONSULTATION.....	1
NORTHERN POWERGRID'S VIEW ON THE SUBSTANTIVE ISSUE ON WHICH OFGEM IS INVITING COMMENTS	2
THE BASIS ON WHICH WPD SHOULD BE FAST-TRACKED.....	3
CONCLUSIONS.....	11

INTRODUCTION

1. On 22 November 2013 Ofgem published a *Draft Determination for Western Power Distribution Ltd* (the *Draft Determination*) and invited views on the proposal of the Gas and Electricity Markets Authority (the Authority) to fast-track the four distribution licensees of Western Power Distribution Ltd (WPD).
2. This response sets out the views of Northern Powergrid Holdings Company and its two distribution licensees Northern Powergrid (Northeast) Ltd and Northern Powergrid (Yorkshire) plc (together referred to as Northern Powergrid).

THE SCOPE OF OFGEM'S CONSULTATION

3. The *Draft Determination* is concerned only with the Authority's intention to fast-track the WPD licensees. Ofgem has made it clear that it is not seeking views on whether the decision of the Authority not to fast-track any other licensees was correct. That decision has been made and Ofgem has made clear that it is not now consulting on whether the Authority has made the right judgement about the non-fast tracked companies.
4. Paragraph 1.23 of the *RHIO-ED1 business plan expenditure assessment – methodology and results: Supplementary Annex* goes further and, with respect to the possible identification of more errors in the Ofgem efficiency modelling, it states that:

‘we have completed our cost assessment for fast-tracking and we do not intend to make any further corrections to this assessment for any points that may be subsequently identified by the DNOs.’
5. Of course such a position could not be maintained if Ofgem became aware of errors that, if corrected, would make a material difference to its assessment. With that caveat, however, we acknowledge that the Authority has made its assessment that no other licensees should be fast-tracked and this response from Northern Powergrid will therefore focus on the question that Ofgem is asking, namely, should the WPD licensees be fast-tracked?
6. For completeness, we should add that Ofgem has confirmed to us that the assessment that it has made of Northern Powergrid's efficiency for the purposes of the fast-track decision is *not* that the costs put forward in our business plan are inefficient; only that Ofgem is not yet

satisfied that these costs are efficient. In particular, we should state now that we do not agree with the weighting that Ofgem chose to give to the disaggregated activity-level assessment as opposed to the top-down assessment. However, we accept that, for the purposes of the fast-track decision, the Authority has chosen to weight the assessment in this way. In the slow-track process we shall make representations to Ofgem that will demonstrate that its method of cost assessment is not sufficiently robust to cast doubt on the efficiency of the costs proposed in our plan.

NORTHERN POWERGRID'S VIEW ON THE SUBSTANTIVE ISSUE ON WHICH OFGEM IS INVITING COMMENTS

7. If Ofgem remains satisfied (as we presume to be the case) that there were no material substantive or procedural errors in its assessment of WPD's well-justified business plan, we believe that it is important for the credibility of the RIIO regime that all of the WPD licensees should now proceed to be fast-tracked. Any other decision would cast doubt upon the incentive properties of the RIIO process. We note that Ofgem has issued a consultation on the methodology for assessing the equity market return for the purpose of setting the RIIO-ED1 price controls. We have responded to that consultation indicating why we believe that the cost of equity proposed by WPD was, and remains, appropriate. That cost of equity should not be an obstacle to the fast-track treatment of WPD.
8. If the Authority remains satisfied that its cost assessment methodology was fit for the purpose of making the fast-track assessment – which of course differs from the requirements of the forthcoming slow-track assessment – we see no basis (other than a material substantive or procedural error) on which to withhold fast-track treatment from WPD. Moreover, if WPD is to be fast-tracked (as we think it probably should be), it must be fast-tracked on the basis of the plan that it submitted without any adjustments for the cost of equity.
9. With respect to process, we note that Ofgem has treated the WPD quality of supply proposals as being in place of the CI and CML targets that would result from the application of the methodology specified in Ofgem's Strategy decision of March 2013. We presume that Ofgem has satisfied itself that this approach was indeed proposed by WPD in its well-justified business plan, as our own reading of the WPD plan (and we think that of some other stakeholders who commented upon this aspect of the RIIO-ED1 consultation) was that

WPD's plan did not unambiguously propose this treatment.¹ If there was ambiguity in the plan proposed by WPD, Ofgem should consider whether the treatment outlined in the *Assessment of the RIIO-ED1 business plans*² is consistent with Ofgem's previous insistence that no iteration of plans would be permitted after submission and with its subsequent confirmation that no such iteration has occurred. We are not in a position to offer a view on this, and we therefore presume that Ofgem has satisfied itself that it has not, inadvertently, facilitated iteration.

10. If for any reason the Authority is persuaded that the fast-track assessment needs to be carried out again, we would expect any new assessment to be applied to Northern Powergrid and for us to be given the same consideration as any other licensee in any reassessment.
11. Chapter 2 of the *Draft Determination* sets out some components of the proposed price control settlement for WPD. Some other components are set out in Ofgem's informal consultation on the fast-track licence drafting issued on 10 January 2014.³ Assuming that the Authority proceeds to fast-track WPD, we recommend that Ofgem sets out how each of these components have been derived, where appropriate showing the source of the numbers that have been used to derive the component and detailing the calculations. This will enable all stakeholders to reconcile the fast-track settlement with WPD's well-justified business plan and with Ofem's Strategy decision and its published cost assessment.

THE BASIS ON WHICH WPD SHOULD BE FAST-TRACKED

12. We shall now turn to the question of the basis on which the WPD licensees should be fast-tracked.

¹ In this connection we note from the *Draft Determination* the description of the way that the targets (Ofgem's or WPD's) were 'selected' (paragraph 2.2). The passage does not say who, or more importantly, *when* this selection occurred. It is important that it did not occur after submission of the well-justified business plan as a result of any interaction between Ofgem and WPD, because the valuation of these tougher targets played an important part in the cost assessment process. We trust that Ofgem will be able to confirm that any ambiguity in WPD's well-justified business plan has not enabled it to iterate its plan.

² Ofgem Supplementary annex, 22 November 2013.

³ Ofgem, RIIO-ED1: Informal consultation on fast-track licence drafting – Charge Restriction Conditions (Part 1).

13. It has always been recognised that the fast-track process involves the acceptance (or rejection) of a plan *in its entirety*. In the *Draft Determination* Ofgem states that ‘the fast-track process involves us accepting a DNO’s business plan in full’.⁴
14. The RIIO principle that a company’s plan should be fast-tracked in its entirety, or not all, is hard to reconcile with Ofgem’s proposed approach to the question of equity market returns.
15. Ofgem has been clear that to be fast-tracked a company’s plan had to ‘score green against all five criteria’.⁵ WPD’s plan was judged to be worthy of a green award in the ‘Resources-efficient finance’ criterion (as it was against all the other criteria). If the CC’s provisional findings, or Ofgem’s consideration of whether the cost of equity should be adjusted downwards on account of changes in the RPI formula effect, are sufficient to cast doubt on its proposed cost of equity, then WPD should not have been scored green against that criterion.
16. Since WPD’s financial package was the same as the package put forward by four other DNO groups it follows that there is no reason why WPD’s plan could be judged acceptable against this parameter without conferring the same judgement on the others. We note that this is what the Authority also decided.
17. Ofgem should avoid artificial contrivances that would allow it to adjust its approach to the cost of equity, in the light of the CC’s approach, whilst still allowing the WPD plan to proceed through the fast-track process. Licensees and other stakeholders will become very wary of any process that is distorted in this way to achieve a particular outcome. We come back to the same point: either WPD’s proposed business plan, inclusive of its financial package, is acceptable, or it is not. If it is not, WPD must return to the slow-track process. If it is acceptable, it should proceed to be fast-tracked.
18. The Authority’s Strategy decision of March 2013 made clear that the only items of a fast-tracked company’s plan that would be determined separately from its well-justified business plan would be:
 - the allowed cost of debt (through the application of the index);

⁴ Draft Determination, page 5.

⁵ Letter from Hannah Nixon, 22 November 2013.

- the allocation to tax pools;
- the allowance for pension deficit recovery; and
- legacy adjustments from the DPCR5 period.⁶

19. Since the cost of equity was not identified as an item that would be determined after submission of the well-justified business plan, it would not be consistent with the Strategy decision and the RIIO principles for this to be varied in a fast-track decision.

20. Ofgem was very clear about the requirement to meet the requirements in all categories of the assessment. At paragraph 3.9 of the *Strategy decision for the RIIO-ED1 electricity distribution price control: Business plans and proportionate treatment* supplementary annex⁷ Ofgem confirmed that:

‘In order to be fast-tracked, the DNOs must demonstrate that their plan sufficiently meets the criteria in all of the sections listed below.’

21. Under the heading ‘Resources (efficient financing)’ Ofgem sets out three questions that would determine whether ‘the proposed financing arrangements are efficient’. There was no suggestion in any of these passages that it may be appropriate to treat one part of the financial package under a special arrangement that would allow Ofgem to ‘offer’ a fast-tracked licensee a different package. This proposed approach was devised by Ofgem after the RIIO rules had been clearly delineated.

22. We understand that Ofgem could not disregard the provisional findings of the Competition Commission (CC) in the case of Northern Ireland Electricity (NIE) that were published on 12 November 2013. However, the suggestion that the cost of equity proposed in WPD’s well-justified business plan could now be varied by Ofgem and ‘offered’ to WPD cannot be reconciled with the RIIO approach.

23. While the CC’s provisional judgement may have been published after business plans were submitted, the information on which it was based was in the public domain significantly

⁶ *Strategy decision for the RIIO-ED1 electricity distribution price control : Financial issues*, (26/d13), pp 10-15, pp 33-35, pp 37-38 and p50.

⁷ Ofgem, 4 March 2013, 26b/13.

earlier. No new evidence has emerged, only a different view of the cost of equity based on that view. WPD was free to submit a plan that took a different view if it had wished, but it chose not to. We can only conclude that WPD took the view that the cost of equity was 6.7%, in full knowledge of the body of evidence on which the CC based its provisional findings for NIE.

24. The same is also true of Ofgem's consideration of whether there should be any reduction in the cost of equity because of the formula effect associated with the retail prices index (RPI). This issue, and the relevant evidence, was in the public domain when WPD submitted its business plan. It was even referred to in one of the reports that WPD commissioned to support its business plan. We conclude that WPD took the view that the cost of equity was 6.7% in full knowledge of the issue that Ofgem is now contemplating as being a possible basis for a reduction in the cost of equity.
25. We believe that the cost of equity of 6.7% that WPD proposed it in its well-justified business plan was justified at the time the plan was prepared and that it remains justified today. As we explain in our response to the Ofgem consultation on the cost of equity, there is no case for any reduction in the cost of equity for British electricity distributors: the RIIO-ED1 price control period will last for eight years and will carry considerably more risk than the price control that is being contemplated by the CC for NIE. Movements in short-run data should not alter Ofgem's approach to the determination of the cost of equity. We also demonstrate in our response to that consultation that the formula effect associated with the RPI has been exaggerated and is offset by other countervailing factors.
26. There is also an important point of principle here. The number proposed by WPD for the cost of equity is either justified or it is not. If it is justified (as we believe is the case) it should be allowed in full in the determination of WPD's RIIO-ED1 price control. If Ofgem considers that the cost of equity proposed by WPD is too high, WPD must be returned to the slow-track process because one important aspect of its plan has been found by the Authority to be unsatisfactory. Any other treatment would undermine the RIIO approach because it would amount to being a clear statement that, contrary to everything that Ofgem has said about the basis on which the well-justified business plans would be assessed, there is after all scope to vary the proposals set out in the plan in discussion (or negotiation) with Ofgem.

27. For the avoidance of doubt, we believe that the 6.7% cost of equity proposed in WPD's business plan is well-justified, and by corollary that this aspect of WPD's proposals provides no reason for WPD to be returned to the slow-track.

28. However, if the Authority disagrees with our assessment of the cost of equity, then the process set out in the strategy decision seems to leave no possibility that WPD's plan could be amended while WPD is also fast-tracked. Ofgem could not have been clearer that none of the aspects of the well-justified business plans could be iterated after submission. We had suggested in our November 2012 response to Ofgem's strategy consultation that the plans should be capable of limited iteration after submission, so that Ofgem could eventually accept a revised plan provided the big picture was right.⁸ Ofgem's response to that suggestion was very clear; no revisions would be permitted:

'Consultation responses broadly supported our proposals, although in their responses to views on proportionate treatment (Chapter 6) some DNOs expressed concerns that they would not have the opportunity to fine tune their business plans after submission to make changes in response to Ofgem feedback. As we set out in the consultation, we have intentionally removed any opportunity for iteration after business plan submissions, in order to ensure that DNOs provide their best view in the business plan, and do not include elements that they would be willing to change.'⁹

29. We surmise that Ofgem considers that if it were to adopt the approach of the CC to the cost of equity (or to make a reduction to recognise the formula effect within the RPI), this would amount to a change of policy on the part of the Authority. Presumably Ofgem considers that a change of regulatory policy made after the business plans were prepared gives rise to special circumstances that justify iteration of one component in the plan.

30. If that is Ofgem's rationale for supposing that it is free to 'offer' WPD a variation in one of the key parameters in its well-justified business plan, we must respectfully disagree.

⁸ Northern Powergrid, November 2012, Consultation on the strategy for RIIO-ED1: The response from Northern Powergrid, page 32, paragraph 121.

⁹ Ofgem, *Strategy decision for the RIIO-ED1 electricity distribution price control: Overview* (26/13), 4 March 2013, paragraph 4.11.

31. The important point that must not be overlooked here is that whilst Ofgem gave guidance as to its own view of the range of the cost of capital components, companies were free to propose any financial parameters that they thought were appropriate and that they could justify. Nowhere had Ofgem said that financial parameters that fell within what the *Strategy Decision* called merely ‘our initial range for the cost of equity’,¹⁰ would be acceptable in a well-justified business plan. The Ofgem ‘range’ was not in any sense a mandatory requirement. Distribution Network Operators (DNOs) were simply required:

‘... to set out in their business plans what they think is an appropriate cost of equity consistent with the cash flow risks.’¹¹

32. There is, therefore, nothing special about the publication of the CC’s provisional findings in the case of NIE that would justify Ofgem in offering (i.e. negotiating with) WPD a variation to WPD’s well-justified business plan. The financial parameters that WPD proposed in its business plan are either acceptable or they are not.

33. Indeed, we should go further. It would be particularly odd if Ofgem were to suppose that it must take on board one aspect of the CC’s provisional findings without recognising any of the other aspects of the CC’s findings that might cast doubt on Ofgem’s approach to the cost of capital.

34. In particular, we note that the CC observed that debt indexation:

‘is a policy decision that requires pre-notification in order that the regulated company can make appropriate financing decisions’¹²

35. The implication is clear – that the application of debt indexation to financing decisions taken before the policy pre-notification is inappropriate. In the case of RIIO-ED1, pre-notification of debt indexation and its specific form was only completed in March 2013, with the publication of Ofgem’s Strategy decision.

¹⁰ Ofgem, *Strategy decision for the RIIO-ED1 electricity distribution price control: Financial issues* (26d/13), 4 March 2013, paragraph 2.42.

¹¹ Ofgem, *Strategy decision for the RIIO-ED1 electricity distribution price control: Overview* (26/13) 4 March 2013, paragraph 9.14.

¹² CC, 2013, NIE provisional findings, paragraph 13.56.

36. This observation from the CC has not been cited by Ofgem in its consultation on equity returns. But it is relevant in two ways to the WPD fast-track decision.
37. It is relevant, firstly, because the CC's approach to the cost of equity cannot be translated into the RIIO system of regulation without taking into account other differentiating features such as the extra risk inherent in the Ofgem debt index and the longer duration of the RIIO-ED1 price control period.
38. It is relevant, secondly, because the CC has opined upon the question of the treatment of the cost of debt not only in the case of NIE, but also in the previous Bristol Water case and in several decisions prior to that. In all cases the actual cost of historically issued debt has been explicitly recognised by the CC. In the case of NIE the CC has opined on the circumstances where it would be inappropriate to apply an indexed approach to the cost of debt.
39. If Ofgem considers that it should defer to the views of the CC on the cost of equity, it must also defer to the views of the CC on the treatment of historically issued debt. Indeed, the WPD case is apt because it illustrates the fact that the industry as a whole has financed itself on a significantly longer term basis than the 10 year rolling basis Ofgem assumes (which implies an average outstanding maturity on debt of 5 years). The weighted maturity average of WPD's debt is in fact 20 years.¹³ Most, if not all, of this debt was issued before Ofgem's March 2013 strategy decision.
40. The Ofgem cost of debt index also calculates the same cost of debt for every company in the sector, even though the financing decisions they took before indexation was announced differed. The CC is not indifferent to this matter. Indeed, in the Bristol Water case it stated:

‘Ofwat sets a single rate for all companies of a particular size. This has the advantage of giving companies a strong incentive to reduce the cost of their debt. However, one of the main factors affecting the cost of fixed-rate debt is the time it was taken out, and interest rates fluctuate over time. As debt issuance may be affected by company-specific factors (for instance, the timing of capex) and the cost of fixed-rate debt is affected by unpredictable changes in interest rates, there may be a danger of this approach penalizing companies that need to borrow at

¹³ Based on Northern Powergrid analysis of company accounts.

times of high interest rates. It might prove unsustainable if such companies are unable to finance their functions, or in order to avoid this, it might require headroom over and above the actual average to the detriment of consumers.¹⁴

41. The CC went on to choose a company-specific approach to the cost of debt, something it has an established track record of doing.¹⁵ The implications in the context of RIIO-ED1 are clear: the CC's views in past cases indicate Ofgem should be setting company specific costs of debt, given that the industry put in place the vast majority of its current financing before Ofgem announced (in March 2013) the form of the debt indexation that would apply in the RIIO-ED1 period.
42. Moreover, the CC has not yet had the opportunity to rule on the use of a debt index in any of the sectors regulated by Ofgem (in the same way it has not ruled on the cost of equity in those sectors). Ofgem cannot argue that it has a reason to suppose that the CC's observation on the drawbacks of debt indexation are specific to Northern Ireland or to the water sector.
43. We conclude that it is puzzling to say the least - and perhaps even disingenuous - for Ofgem to say that it must consider the CC's observations on the cost of equity whilst disregarding the observations the CC has consistently made on the cost of debt in several determinations. This is reinforced by the fact that the CC considered, in the Bristol Water case, that the precedent it had previously set on the cost of capital was an important consideration that it needed to take into account, due to the significant benefits that arise from regulatory certainty, whilst the precedent set by sector regulators (including that of the sector where the CC was re-determining the price cap) was stated to be less relevant.¹⁶
44. For completeness, we should add that in setting the cost of equity for NIE, the CC has placed too much weight on short-term evidence, an approach which risks undermining regulatory certainty (and adding to regulatory risk). Such an approach would be even less appropriate in the longer term context of a RIIO price control. The CC is, however, right about the

¹⁴ CC, 2010, Bristol Water final report, appendix N, page 10, paragraph 47.

¹⁵ The Mid Kent Water enquiry (2000), the BAA enquiry (2007) and the Stansted enquiry (2008).

¹⁶ CC, 2010, Bristol Water final report, pages 66-67, paragraph 9.21.

inappropriateness of applying debt indexation to company financing decisions that were taken before debt indexation (and indeed its exact form) was pre-announced. Moreover, it is right that a company specific cost of debt should be set, reflecting the specific circumstances affecting the companies, rather than a single rate for all. We shall consider both these important components of the cost of capital as we prepare our re-submitted business plan.

CONCLUSIONS

45. We conclude that:

- unless Ofgem is aware of any material substantive or procedural errors in its assessment of the WPD well-justified business plan, all four WPD licensees should be fast-tracked. Any other decision would be damaging to the RIIO model;
- the cost of equity of 6.7% proposed by WPD in its well-justified business plan remains fully justified; and
- there is no case to fast-track WPD on any basis that differs from the business plan that it proposed. To make any changes to any component would be inconsistent with Ofgem's declared policy on fast-tracking.