British Gas
Looking after your world

Legal & Regulatory
1st Floor, Lakeside West
30 The Causeway
Staines
Middlesex
TW18 3BY

Anna Rossington
Head of RIIO-ED1
Ofgem
9 Millbank
LONDON
SW1P 3GE

12th May 2014

Dear Anna,

Open Letter on RIIO-ED1: Electricity Distribution Networks Operators' resubmitted business plans

1. Thank you for the opportunity to respond to Ofgem's open letter regarding the resubmitted RIIO-ED1 business plans. This is a non confidential response on behalf of the Centrica Group, excluding Centrica Storage.

2. As you will be aware we are fully engaged in the RIIO-ED1 process, and our goal remains to ensure all elements of the electricity supply chain offer our customers value for money. Since electricity distribution charges are over £1bn per annum for British Gas and we have no network ownership, we feel we are well placed to offer our thoughts on the Distribution Network Owners' (DNOs') resubmitted business plans. Our response here builds on our other letters in relation to RIIO ED1.

3. In general, we consider that the resubmitted plans fail to adequately justify the level of allowances being sought by the networks. Our key areas of concern are:

    - **Fast-tracked vs Slow-tracked DNOs:** The fast tracked decision for WPD contains many very generous elements. This was accepted as a package by Ofgem and these elements should not be read across to other DNOs.
    - **Financing:** we believe the DNOs proposals are not justified and we would encourage Ofgem to instead adopt a cost of equity below (or at worst at) its central reference point of 6.0%, as supported by both market evidence and regulatory precedent.
    - **Transition to 45yr asset life:** Transitional relief for the increase in asset lives to 45 years should not be viewed as a given, but rather only provided if fully justified and only to the minimum extent necessary.

- **Efficiency:** Given the insulated position DNOs have enjoyed from the pressures on the wider economy, far more challenging efficient targets should be set.
- **Incentive Framework:** The returns being made by network companies indicate that networks have been able to outperform against target consistently. It is therefore vital that targets are set more robustly and reflect the performance level improvements that customers have funded through base revenues.
- **Lack of transparency and engagement on key material issues**: There are a number of areas where we are concerned with Ofgem's proposed policy, and consider that these issues have not been explained adequately to stakeholders.

Fast-tracked vs Slow-tracked DNOs

4. The fast tracked decision for WPD contains a number of very generous elements. Whilst we are not convinced evidence has been provided to do so, Ofgem may possibly justify this in terms of an overall 'package'. It is vitally important that slow-tracked DNOs are not now able to justify individual elements of their own plans by cherry picking comparisons with the fast-tracked DNO, as some attempt to do in the resubmitted plans. The generosity provided to WPD cannot be read across to the slow-tracked DNOs and we expect Ofgem to deliver on their comment in their fast tracking decision letter "*We have made clear to the slow-tracked DNOs that elements of the WPD settlement do not set a precedent for slow-track*".

Financing

5. Ofgem has published clear guidance for the DNOs on what it considers to be an efficient cost of equity allowance (6.0%) and the calibration of the cost of debt indexation mechanism through its decision on assessing the equity market return in RIIO ED1 and previously in its RIIO ED1 strategy decision. In order to allow a level of or approach to cost of capital that differs from this guidance, any proposal from the DNOs must be well justified for all stakeholders and supported through the presentation of evidence. We discuss whether this is the case in more detail in Annex A.

6. Based on our review of the DNOs revised business plans, it appears all the companies, except UK Power Networks (UKPN), have proposed a cost of equity that is above the 6.0% central reference point established by Ofgem. This is set within a general context of dissatisfaction with the proposed debt indexation mechanism (as adopted for RIIO GD1) and a proposal by a number of DNOs that they should be rewarded on similar terms as Western Power Distribution (even though they have not been fast-tracked) given the quality of their business plans, and the package of risks and opportunities that they face.

7. From our review of the revised business plans, we believe the DNOs proposals are not justified and we would encourage Ofgem to instead adopt a cost of equity

below, or at worst at, its central reference point, as supported by both market evidence and regulatory precedent. DNOs proposals on cost of debt indexation are not justified and would not provide value for money for GB customers compared to the mechanism applied successfully in RIIO GD1 to date. Ofgem should adopt a financial package for slow track companies that is consistent with its previous regulatory guidance.

8. As Annex A shows:
   - Recent decisions by the Competition Commission (now the Competition and Markets Authority) and Ofwat in PR14, illustrate how a 6.0% cost of equity would be at the top end of what can be justified for RIIO-ED1 based on consistency with recent regulatory precedent. As noted in our response to the equity market returns consultation, market evidence - especially on the equity beta - points to a figure below 6.0% and this continues to hold since the decision.
   - The revised business plans also provide insufficient new evidence on relative risk in the electricity distribution sector to justify a cost of equity any greater than 6%. Risks which are stated to increase, including the length of the price control, higher capex to RAB ratios and longer asset lives, Ofgem has considered or rejected previously. If Ofgem didn't accept similar company proposals as part of previous assessments – including in RIIO GD1 - it should not be accepting them now. These risks have also already been accepted by debt and equity markets.
   - The DNOs arguments also sometimes run in contradiction to one another. For example, a number of the business plans propose a higher proportion of embedded debt but then also argue that high capex to RAB ratios increase risk and justify a higher cost of equity. There is also limited evidence to suggest that proposed changes to the cost of debt indexation mechanism (for example, a lower credit rating, longer tenor or longer averaging period being used) would provide better value for money for consumers compared to the mechanism used in RIIO GD1.
   - Looking at some of the more specific arguments raised in the revised business plans, one proposal that we have highlighted in particular, is Northern Power Grid (NPG's) proposal to receive consistent rewards for proportionate business plan treatment as WPD. This proposal would be inconsistent with the established RIIO fast-track process and incentive package and would send the wrong regulatory signals to companies in future of what fast-tracking is intended to reward. The cost of capital should also be calculated based on the standalone company and the risks that are faced by that company. It should be considered separately from the financial rewards that may be made available elsewhere in the price control package, a distinction that a number of DNOs blur in their business plans.

Transition to 45-year asset life

9. Transitional relief for the increase in asset lives to 45 years should not be viewed as a given, but rather only provided if fully justified and only to the minimum extent necessary. All DNOs seek to transition to the 45 year asset life over the course of RIIO ED1, however we do not consider that a one size fits all approach to transition is

necessarily the right approach. The transitional arrangements proposed by DNOs will add on average c. £3/yr to the average domestic bill over RIIO ED1 and must be fully justified.

10. It is possible that the DNOs have been encouraged to do so by the granting of transitional arrangements to Western Power despite Ofgem noting that credit metrics *'by WPD's own assessment, already look comfortable without transition. The one credit metric which looks stretched in WPD's assessment – PMICR – is specifically calibrated to be neutral to changes in depreciation profile.'*[1]

11. The resubmitted business plans do not contain compelling evidence that transitional arrangements are required or to the extent that they are required. The move to a longer asset life was a welcome policy decision from Ofgem which has the potential to give benefit to customers at a time when household incomes continue to be under pressure. This should not be undermined by claims of financeability when not supported by hard evidence in the business plans.

12. At RIIO:GD1, Ofgem gave assurances about transitional measures*: 'Companies who propose transition arrangements will need to satisfy us that the transition is as short as possible, necessary to secure the financeability of the company and in the interest of existing and future consumers.'*[2] However, in practice all companies were given the same transition measures. Whilst it may be the case that those transition measures were necessary for the network with the most strain on financeability, they clearly must be overstated for all remaining networks. It is important to learn from experience and we would expect Ofgem to not apply a 'one size fits all' approach and assess each network separately, in the interest of existing and future customers.

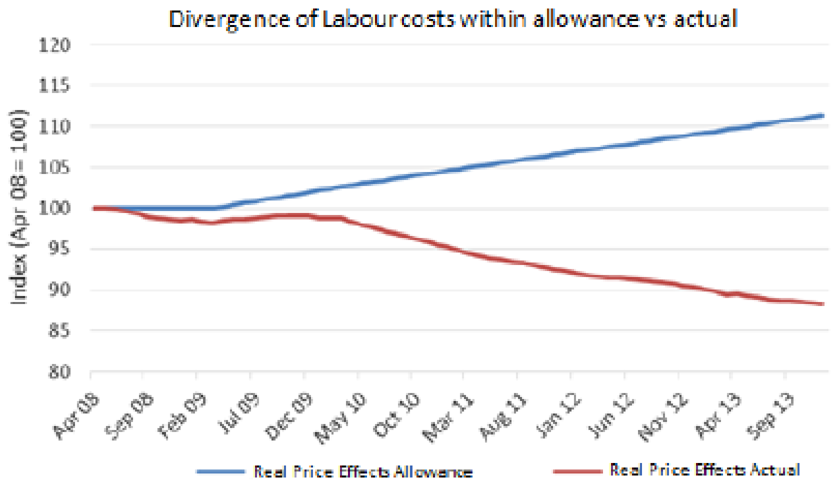
Efficiency

13. Current regulatory arrangements appear to insulate networks against the pressures that have affected the wider economy. Over recent years, across both the public and private sectors, there has been pressure to reduce costs in *nominal* terms and yet there appears to a continuing acceptance that costs will rise for network companies broadly in line with inflation.

14. All networks seek additional allowances for Real Price Effects (RPEs) for labour and materials. We do not believe there is a case for allowing positive RPEs and believe that networks should be challenged to significantly outperform inflation and potentially deliver cost reductions in nominal terms.

15. Consumers have historically borne the cost of allowances in this area that have proved overly generous. The chart below demonstrates that networks have benefited significantly from previous ex-ante allowances for labour RPEs.

[1] Ofgem (2013) Assessment of the RIIO ED1 business plans, p58.
[2] RIIO:GD1 – Strategy Decision pg 49



Source: ONS

16. The difference between the allowance and true cost is a windfall loss to consumers. The converse of this, the windfall gain, is shared between staff and investors. If the staff is given increases in line with the allowances, the cost base for the next price control will be artificially higher than it would have been should this have been dictated by market conditions.

17. If networks have agreed wage settlements over the course of DPCR5 which are not justified by reference to wider economy settlements then we believe this simply represents an inefficiency which DNOs have chosen to incur. We have not seen any justification of the labour cost increases during DPCR5 in the DNOs plans and therefore we expect Ofgem, in setting labour allowances for RIIO ED1, to now take account of any relative inefficiency in labour costs which has crept in during DPCR5.

18. If we assume that half of the excess labour RPE allowance for DPCR5 has manifested itself in wage settlements above those experienced by the wider economy, then our analysis suggests that base level labour costs will have increased by c. 10% more than justified by the wider economy settlements. Removing any such inefficiency for RIIO ED1 would not represent a clawback since any DNO which held wage settlements in line with the wider economy settlements will have received the full additional return from the excess DPCR5 RPE allowances and would also now be shown to be efficient relative to the wider economy.

19. With regards to ongoing RPEs, we consider that the current approach to setting an ex-ante allowance for RPE has proven to provide poor value for consumers. When the underlying costs of running the networks change, there should be greater ability for value for money changes to be made to price control agreements. Rather than locking in up-front allowances, a method of indexing labour costs to average earnings would seem more appropriate.

Incentive Framework

20. Ofgem places a large reliance on network companies responding to incentives in its price control agreements; however history has shown that whilst this incentive structure may encourage investment, in our view, it is overly generous, with insufficient penalties for under performance. The table below summarises the Return on Equity achieved by networks in the most recent price control settlements across the industry. We do not consider it credible that in 38 out of 40 instances networks are genuinely high or good performers. We would expect a far more symmetric outcome to well-set settlements and this indicates targets tend to be too easy to achieve.

Summary of Return on Equity: existing and recent Price Control agreements

Price control	Control Years	Allowed Return on Equity	Average actual Return on Equity (and range)	Companies at or above allowed Return on Equity	Companies underperforming allowed Return of Equity
DPCR4 **Electricity Distribution**	2005-10	7.50%	8.4% (5.5% - 10%)	12	2
DPCR5* **Electricity Distribution**	2010-15	6.70%	11.2% (6.8% - 14.4%)	14	-
GDPCR1 **Gas Distribution**	2008-13	7.25%	9.47% (8.2% - 11.2%)	8	-
TPCR4 **Gas and Electricity Transmission**	2007-12	7.00%	9.15% (7.4% - 10.1%)	4	-

*in first two years of price control

21. British Gas believes that the RIIO (Revenue = Incentives + Innovation + Outputs) framework is appropriate and applies carrot and stick in the right areas of the work of the network operators. However, we believe that within this framework the levels to which incentives and targets are set do not provide the right level of pressures to ensure that costs passed through to consumers are minimised. Allowances and targets set at overly generous levels see consumers paying more than necessary regardless of efficiency savings.

22. In addition to overly generous upfront allowances and targets, we note that learning from LCNF projects (and subsequently NIA/NIC projects) can be used to improve

performance against incentive schemes and, indeed, could easily be targeted to do so. Whilst this is inherently a positive thing, as incentive schemes will be focussed on areas customers' value, the customer should not be paying for the development of innovative methods through innovation allowances and then paying again for the performance improvement resulting from the innovation. Some adjustment is required to the relevant incentive scheme to ensure the DNO is only rewarded appropriately, and not for investment already funded by customers through either the NIA/NIC or the IQI mechanism.

23. We are also concerned that the DNO business plans are not transparent enough with regards to whether costs of improving performance in areas subject to separate incentive schemes have been included in base revenue requests. Consumers should not be required to pay for service improvements twice – through base revenues and also through incentive rewards and if all networks include funding requests for improving performance in areas such as customer service and quality of supply then relative benchmarking will not identify the additional cost and the result could be consumers paying twice. Ofgem needs to be fully aware to this risk.

Lack of transparency and engagement on key material issues

24. Whilst DNOs have held many stakeholder workshops we consider that there has been a lack of transparency available to stakeholders in the more contentious areas of the RIIO ED1 framework. This lack of engagement raises serious risk of a structural imbalance in the process.

25. There is a greater reliance on stakeholder engagement and stakeholder views under RIIO, which is to be welcomed. However, if stakeholders are not presented with all the information necessary to make an informed decision and then stakeholder views are used to support a decision, this is unsatisfactory and risky. Networks are, rightly, expected to take the lead in engaging stakeholders but will, quite naturally, wish to portray themselves in as positive a light as possible. This brings an inherent bias to the process which Ofgem should be looking to counter-balance.

26. For example, we have repeatedly highlighted the significant rewards we expect WPD to receive through the Quality of Supply incentive due to the setting of inappropriate up front targets which do not adequately take into account current levels of performance. We now estimate that WPD will receive £200m in additional income through RIIO ED1, simply by maintaining performance levels at 2012/13 levels. This level of reward is material and we are not aware has not been shared with stakeholders by either Ofgem or WPD. It is doubtful that any consumer research would agree that a £200m reward for no improvement in performance is justified.

27. Indeed, we note that in their recent submission to the Energy & Climate Change Select Committee WPD stated: "*31. WPD has received significant IIS rewards for the operational improvement, but the targets are reset from 2015/16 and customers will receive substantially all of the benefit of the improvement from that point onwards.*"

28. It is difficult to see how a £200m reward for holding performance at 2012/13 represents customers receiving "*substantially all of the benefit of the improvement"* from 2015/16 and this statement certainly does not reflect the full situation.

29. This issue is not restricted to WPD alone. As we have also previously highlighted, UKPN have made step change improvements in their quality of supply performance during DPCR5, for which they have been considerably rewarded. However they also will continue to receive significant rewards for no improvement on 2012/13 performance – we estimate c. £100m during RIIO ED1. Indeed if UKPN perform in line with the expectations they have included in their business plan, we estimate they will receive even higher rewards, c. £180m. All DNOs include quotes about how much they will improve performance, but without including the expected incentive rewards they will receive for this improvement. This is poor in terms of transparency and potentially prevents stakeholders from making a fair assessment.

30. We continue to urge Ofgem to revisit their overly generous approach to the setting of the Quality of Supply targets for RIIO ED1. Even if Ofgem now feels unable to revisit the WPD fast-track decision, we do not believe Ofgem should feel compelled to offer the same generosity to UKPN.

31. We also refer Ofgem to our recent response to their consultation on the Stakeholder Engagement reward in which we highlight the importance of Ofgem ensuring that incentives which they have presented to stakeholders as symmetrical remain symmetrical after Ofgem have calibrated targets.

32. There are a number of other areas where we are concerned with Ofgem's proposed policy as well as areas where we believe transparency needs to be improved.

- **Rail Electrification Allowances**: In their assessment of the RIIO ED1 business plans, Ofgem raised the issue of the diversion costs associated with Network Rail's electrification programme. In that document Ofgem stated "*We consider that, from a public policy perspective, these costs should not be borne by energy consumers, but should be recovered from rail customers.*" However they then go on to say, "*We have concluded that we will allow the costs (which we assess to be efficient) in WPD's business plans, but, should it be decided that another party will fund them, we will include a facility in WPD's licence to remove them from the settlement.*"

  This uncertainty mechanism might appear to protect consumers, however we believe in fact that this is simply a further area of a lack of transparency in a contentious area. We were alarmed by subsequent confirmation from Ofgem that they will only remove allowed costs from WPD settlement in the event of another party funding these costs, and not in the event that the costs do not materialise in the first place. In this case WPD would retain 70% of the allowed £96m without doing any activity or realising any efficiency.

Ofgem mention the discussions that have been held between DNOs, government and Network Rail, which raised the questions as to which entity would bear these costs. We find it hard to understand how, as Ofgem's stated view is that they believe rail customers should fund these costs, they have proposed an uncertainty mechanism by which electricity customers will have to pay for 70% of the costs even if they do not occur. We seriously doubt that this is the type of solution that DNOs, government and Network Rail contemplated in their discussions and we urge Ofgem to remedy what must be a mistake in their policy in this area. This, as an uncertainty mechanism, is clearly a discrete issue, and not part of the 'package', and so should be able to be rectified straight-forwardly to protect customers.

We note that many DNOs agree with our view here, however we are disappointed that Northern Powergrid has now decided to include £61m for their own uncertain rail electrification costs and are requesting the same, inappropriate, uncertainty mechanism as WPD. This would mean Northern Powergrid retaining the significant portion of this allowance if the work is not requested. We note that Northern Powergrid have not received any actual notices of a diversion request from Network Rail and are not estimating any costs for the Northeast region until 2019/20.

We understand the need to protect DNOs from a potential uncertain cost however it appears irrational to us to implement a solution which provides an ex-ante allowances for costs which Ofgem have stated they believe rail customers should fund, with no way for such an allowance to be returned to electricity customers should the work not materialise. This places a completely unnecessary risk on customers.

- **New Transmission Connection Point Charges**: We have identified a similar area of potentially inappropriate ex-ante allowances with regards to new transmission connection point charges. We are concerned with the policy to incentivise these costs through the Totex Incentive Mechanism, especially in relation to UKPN and SSE. Both of these networks include significant additional forecast costs in this area for RIIO ED1 (£78m for UKPN and £57m for SSE), however both of these networks have a history of significantly over forecasting such highly uncertain costs. UKPN were provided with allowances of £70m in nominal terms over DPCR5, representing an over forecast of c. 290% on our estimate of their outturn costs for new transmission connection points (of just £18m) – providing UKPN with a significant reward through the DPCR5 incentive for transmission connection point charges. SSE, although to a less material extent, also over forecast their new transmission connection point charges during DPCR5 by c. 190%.

  We believe that the reduced costs during DPCR5 are more likely to be a result of lower than expected levels of demand growth, operational delays and unit cost forecast error rather than any underlying efficiency on the part of the DNO. Given the significant increased strength of the incentive on these costs for RIIO ED1, Ofgem must scrutinise very carefully any network which has included significant costs in this area, especially if those networks have benefitted substantially through DPCR5 from an over forecast of these costs. We do not consider it appropriate to allow significant ex-ante allowances in areas where DNOs will gain significant financial reward from lower outturn levels of cost when they have demonstrated a history of over forecasting these costs.

We also consider that any allowances should be accompanied with specific output requirements so that if new Grid Supply Points are delayed or cancelled due to operational issues or lower demand growth, then allowances can be returned to consumers.

We also would question UKPNs forecast of transmission connection point charges which are subject to the pass-through mechanism. UKPN are forecasting an average annual cost increase of 65% through ED1 compared to DCPR5 and we can find no justification for this increase in their plan. This average annual increase represents an additional £320m over RIIO ED1 which consumers will have to provide upfront funding for. We note that all other DNOs forecast of pass-through transmission connection point costs remain reasonably in line with DPCR5 levels and would question the UKPN forecast in this area.

- **Excluded Services:** We have highlighted our concerns in this area to Ofgem on a number of occasions. DNOs continue to appear be claiming for ES4 excluded services revenue within their business plans whilst showing no associated costs. We consider that the situation regarding the treatment of ES4 has been clear since the start of DPCR5 and has not changed for RIIO-ED1. Revenues received should only recover the reasonable costs of providing the service (and potentially a reasonable rate of return to account for the timing difference between the DNO expenditure and the customer payment). It is clear that if there have been no costs incurred then there should be no revenue recovered. Therefore an explanation is required for the anomalous revenues associated with ES4 during DPCR5. If any network has erroneously treated revenues as excluded which should not have been, then the practice needs to be ended immediately and all revenues need to be returned to customers as soon as possible. We remain disappointed at the lack of transparency in this area.

33. We hope you find our comments helpful and we look forward to discussing with you in the future.

Yours sincerely,

Andy Manning
[Via email]
Head of Network Regulation, Forecasting and Settlements

Annex A: Financing issues for RIIO-ED1

Introduction

In this annex we review the DNOs business plan proposals on financing issues, with a particular focus on the allowed cost of equity.

RIIO-ED1 guidance and business plan proposals

Ofgem has published clear guidance for the DNOs on what it considers to be an efficient cost of equity allowance for ED1 both in its recent decision for assessing the equity market return and previously its ED1 strategy decision.

Key aspects of that decision were:

A central reference point for assessing DNOs cost of equity for ED1 set at 6.0 per cent (a 0.3 per cent reduction to the central reference point that was used for the fast-track business plan assessment)[3].

The need for slow-track companies to look into reducing the cost of equity estimates in their business plans, even though Ofgem stated that for the purpose of revising their plans, DNOs should assume that its methodology for the equity market return would remain unchanged.

Although an equity beta range of 0.90 to 0.95 had been adopted in Ofgem's Strategy decision, observed market betas for comparator companies are much lower than this, indicating that the market interprets regulated networks, including the DNOs, as having relatively low systematic risk.

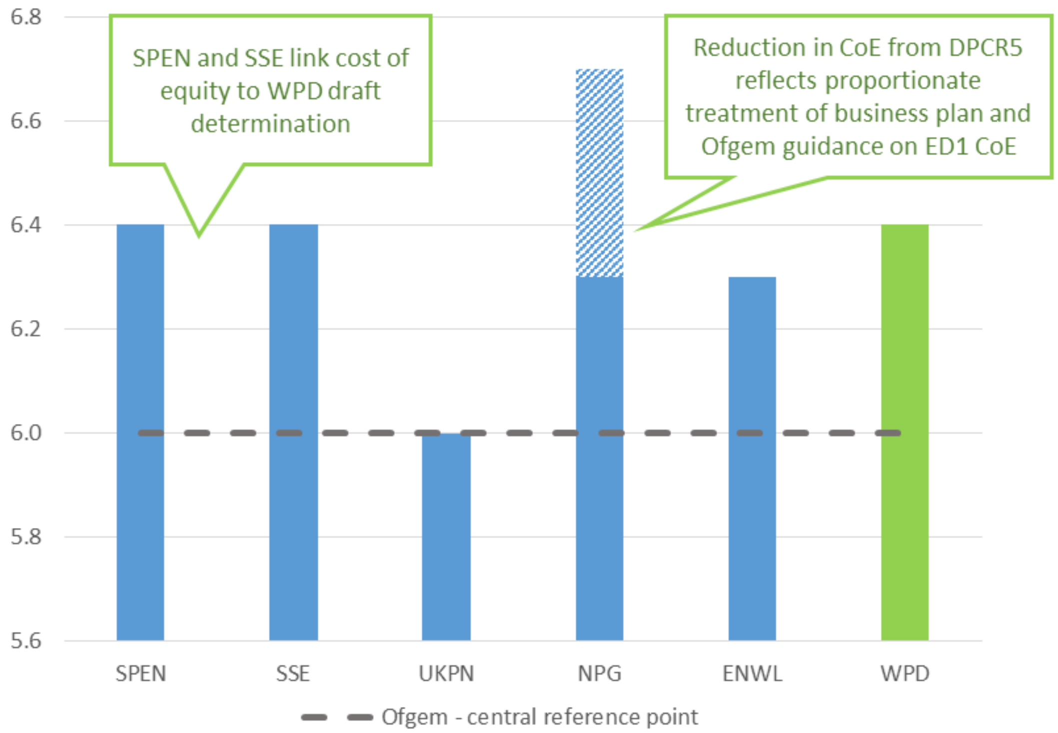
Overall, Ofgem's guidance suggests that there are a number of factors that point towards a lower cost of equity for DNOs in ED1 than previous price controls, in large part reflecting current market conditions as analysed by the Competition Commission (CC)[4] in the referral of NIE's electricity transmission and distribution price controls.

Figure 1 below compares the slow-track DNOs' revised business plan proposals on the cost of equity to Ofgem's central reference point for RIIO-ED1 of 6 per cent. This illustrates that all the companies except UK Power Networks (UKPN) have a proposed a cost of equity that

[3] Western Power Distribution received a 6.4% in their fast tracked draft determination, which was above Ofgem's central reference point due to challenging efficiency targets and an assessment of the overall package being of value to consumers.
[4] The CC has now been incorporated into the Competition and Markets Authority (CMA).

is above the reference point proposed by Ofgem. The DNOs sight a number of reasons for their proposals, including consistently challenging cost targets for ED1 with Western Power Distribution (WPD), evidence that systematic risk is similar or greater for ED1 compared to DPCR5 and their proposals being appropriate within the overall financial package. This is set in the context of dissatisfaction with the mechanism proposed for cost of debt indexation.

Figure 1: Comparison of Ofgem guidance of DNO cost of equity proposals



Northern Power Grid (NPG) proposed an alternative financial package in which they argued that they should be rewarded on similar terms as WPD given the quality of their business plan. They suggest that although they were not fast-tracked, they should still receive an additional reward for proportionate treatment their plan (a 2% of totex reward as opposed to 2.5% award because they weren't fast-tracked) together with an allowed cost of equity of 6.3% (rather than the 6.7% figure proposed by NPG without this additional reward).

In the remainder of the annex we focus on whether the DNOs proposals on the cost of equity (and other aspects of the financial package, including cost of debt indexation) are supported by new evidence in their business plans, regulatory precedent and market evidence.

We conclude that the DNOs proposals are not justified and we would encourage Ofgem to, at the very least, adopt its central point for the cost of equity – with market evidence supporting a figure lower than this – for its ED1 slow-track proposals. Neither do we believe that the DNOs proposals on cost of debt indexation are justified, which again we discuss later within this annex.

The revised business plan proposals on financing issues are neither justified nor would appear to provide value for money for customers served by the distribution service areas of the remaining slow-track DNOs.

Regulatory precedent from the CC and Ofwat support Ofgem's central reference point for the cost of equity and not the DNOs proposals

For the equity market returns consultation, we (supported by advice by CEPA[5]) noted recent regulatory precedent provided by the CC in their draft determination for NIE, Ofwat's risk and reward guidance presented for PR14 and the Civil Aviation Authority's (CAA) Q6 determination. Since this submission, the CC (as noted above, now incorporated into the CMA) has provided its final determination on the NIE referral and the PR14 price control in the water sector continues to be developed with Ofwat's draft determinations having been published for the enhanced companies.

We believe that there are some points to re-iterate from these two determinations that are relevant in the context of Ofgem's revised business plan assessment for RIIO-ED1. From the NIE final determination, we note the following:

- the use of an inflation estimate of 3.25% supports Ofgem's reduction in the equity market return from the RPI formula effect (this has changed from the 2.7-3.2% inflation estimate used in the CC provisional determination);
- in terms of selection of a risk-free rate, long-run rather than temporary factors are being seen from the market evidence according to the CC, with the effects of monetary policies increasingly well understood and therefore expected to be more effectively included within ILG yields;
- an upper limit on the equity market return should be 6.5% (lower limit 5.0%) further supports Ofgem's decision to reduce the equity market return;
- the CC state that utility businesses in Great Britain are relatively low risk and the asset beta range of 0.35-0.40 for NIE is predicated on a less well established regulatory model than for GB;
- NIE bonds trade at a premium to utility bonds in GB given their size and perceptions of risk; and
- overall despite the additional risk of NIE, re-geared to 65%, the cost of capital would be 3.5-4.2%[6], which given the low risk of the GB DNOs would suggest that a point estimate at the lower end of that range is appropriate.

In terms of where the DNOs should sit at the lower end of the range is dependent on perceptions of riskiness in the sector. This is something that the DNOs have argued in their revised business plans has not reduced since DPCR5 (2010-2015). The DPCR5 price control takes place over the same period as the PR09 price control in water[7], so any differences

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[5] CEPA (2014): 'Response to the equity market return consultation by Ofgem for RIIO-ED1 – report prepared for Centrica'

[6] Assuming a 6.0% cost of equity, 2.72% figure for the latest cost of debt indexation value and 65% gearing would give a vanilla WACC of 3.87%, approximately the mid-point of the re-geared CC range.

[7] April 2010 to March 2015.

between PR09 and DPCR5 will not be due to different market evidence being available to the sector regulators. We therefore expect the water sector to provide useful context in assessing risk and changes in risk since the last price control in electricity distribution. The asset beta used by Ofwat has reduced to 0.3 from 0.4 in PR14 compared to PR09, with the regulator seeking to align closer to market evidence and noting the low relative risk compared to the market for water sector assets (this gives an equity beta of 0.80). Ofwat have also reduced their allowed equity market return in arriving at a cost of equity of 5.65%[8].

In our response to the equity market returns consultation, we noted low current levels of stock market volatility, historic outperformance by the DNOs, the largest MAR premia in regulated infrastructure sectors being observed for DNOs and the views of Ofgem's consultants that the equity beta used by Ofgem is not aligned with market evidence. A move to reduce the equity beta for RIIO-ED1 would mean greater alignment with market evidence and, with Ofwat's recent decisions in PR14 and more general guidance on risk and reward in setting allowed returns, has support in regulatory precedent.

The CC Q6 decision was finalised prior to Ofgem's equity market returns consultation, so there is little additional material to draw upon for this response. Given Ofwat's decision however, we would reference work done for the Q6 price control by NERA that found the electricity distribution sector was the least risky sector within the GB utilities space[9]. This analysis applies to PR09 in water and DPCR5 in electricity distribution, but we do not believe that there have been any significant developments between price controls that would materially change the relative riskiness such that electricity distribution would now be considered more risky than the water sector. As such, this would point to an asset beta of no more than 0.30 for RIIO-ED1. With a 1.25% risk-free rate and 4.75% ERP, this would point to a 4.44% cost of equity[10]. We are not suggesting that Ofgem necessarily adopt this figure, but highlight that a 6.0% central reference point for the cost of equity remains a conservative estimate for RIIO-ED1.

The business plans present limited new evidence on relative risk and if Ofgem didn't accept these proposals previously they should not be accepted now

As noted in our covering letter, we do not think that there have been many new arguments raised in the revised business plans on the cost of capital that have not been considered by Ofgem in making their judgements. For example, the impact from the increased length of the price control in RIIO-ED1 was analysed as part of RIIO-GD1 and RIIO-T1 and can be considered to provide benefits as well as risks for investors in the electricity DNOs, through enhanced regulatory commitment in ED1.

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[8] Based on a market cost of equity of 6.75%.

[9] NERA (2013) Relative risk of London Heathrow, 31 January 2013.

[10] This is based on a 0.1 debt beta and 65% notional gearing.

Given that we have greater insight into the RIIO-ED1 overall package, the regulator is in a position to be more certain around the risks that the DNOs face. However, if Ofgem change their position at this stage on elements of the financial package, we think that this in itself is a risk given that it would be a different judgement based on the same set of evidence.

The DNO revised business plans refer back to a report by Oxera in April 2013 on the risk framework around RIIO-ED1 and how the price control may be more risky than DPCR5. The reasons quoted for this include:

- high capex to RAB ratios;
- the longer length of the price control;
- changing demands of the sector; and
- longer asset lives.

In terms of the high capex to RAB ratios noted by some of the DNOs, we note an inconsistency with DNO arguments relating to the cost of debt and the length of any trailing average. If there is higher capex to RAB, then this would suggest RAB growth. Therefore the proportion of new debt raised would need to buy higher and a shorter trailing average might be more appropriate. In our view, the DNOs are seeking to adopt a position that suits them in one respect and ignore this fact when the implication does not work in their favour. We also note that Affinity Water, one of the enhanced water companies in PR14, has a totex-to-RAB ratio of 22% over the PR14 price control and this is set against a 5.65% cost of equity. The ratio is above the slow tracked DNOs, so we do not think this is a credible argument.

We have previously responded with respect to the longer price control and the regulatory commitment that this provides given the changing demands of the sector. Ofgem have not increased the beta for RIIO-GD1 or RIIO-T1 for the length of the price control and it would be inappropriate to do so in this case. In terms of changing demands, such as low carbon networks, we do not feel that in itself this is a reason when the equity beta should be increased. In terms of longer asset lives, we think that this is a financeability issue and will be taken into account in Ofgem's modelling, with any amendment made to notional gearing, not increasing the cost of equity.

When analysing the beta term, it is also important to consider the assumed debt beta such that the asset beta is comparable across sectors. This then provides a comparable equity beta is you assume the same notional gearing ratios across sectors. The equivalent asset beta point estimate for PR14 is 0.36, which is approximately the mid-point of the CC range of 0.31 to 0.40 for GB utilities (of which they use the top half for NIE). With a debt beta of 0.1 and 65% notional gearing, an equity beta of 0.90 gives an asset beta of 0.38. This is above the PR14 decision and would imply that Ofgem would be adopting a point estimate at the top end of the CC range, which based on the above would not seem to be supported by the evidence on relative sector and price regime risk.

There are in our view two new arguments raised in the business plans around the cost of equity that could be considered material in Ofgem's assessment. The first of these refers to the cost of debt indexation mechanism and its interaction with the cost of equity (we note that this is not an entirely new issue due to previous consultations around calibrating the design of this mechanism). The second new issue we consider is the argument put forward by NPG that they should be allowed additional rewards to the baseline assessment of cost and a cost of equity in proportion to the rewards received by WPD through its overall financial package.

We consider each of these issues in turn.

(1) Cost of debt indexation

One argument that the DNOs refer to is that additional equity returns should be given due to the cost of debt indexation mechanism not being sufficiently generous to them. In our view, both the cost of debt and cost of equity should be calculated on a standalone basis and such a move is not appropriate, yet Ofgem have implied in our view that efficiently incurred embedded debt costs are one reason why their central reference point was previously 6.3% rather than 5.5% that would be implied by a direct translation of the CC's methodology on the equity market return.

DNO arguments on this include that the trailing average period should be longer to include efficiently incurred debt, looking at the Ofwat and CC decisions on the PR14 price control and NIE provisional determination respectively. Further criticisms include that indexation is pro-cyclical, there are financeability challenges and there is no "halo" effect[11] to account for additional costs in issuing debt.

Ofgem have been clear that any regulatory settlement should reflect the position of a notional efficiently financed company. In doing this, using a benchmark which is representative of the sector is a better way of setting a common cost of debt allowance than looking at individual debt portfolios within the sector. Such a method avoids potential gaming of the system and is supported by regulatory precedent given Ofwat and CC decisions also relied upon industry benchmarks where available. As noted in the responses of some of the DNOs, the benchmarks also include debt issued by utilities so these are not as disparate as it may have been made out in previous network commentary on the mechanism design.

It is our view that the benchmark indices used in indexation, the iBoxx non-financial corporates ten-year plus maturity for broad A and BBB assets is appropriate for ED1, as is the use of a ten year trailing average. This is also the same benchmark used by Ofwat in their PR14 Risk and Reward Guidance.

[11] The halo effect refers to the ability of network utilities to outperform corporates of a similar credit rating due to protections and reduced risk provided by the regulatory regime.

In the RIIO-T1 and GD1 Financial Issues (Mar 2011) document, Ofgem stated that their approach to setting a fixed rate allowance was to focus upon a ten year trailing average on ten year maturity debt. As such, using a longer tenor of debt (approximately twenty years) and the same trailing average period has increased costs to consumers in the long run. In the table below we show the impact of this in terms of the cost of debt impact and the impact based on current rates of moving to a 15 year trailing average period, as suggested by some of the DNOs in their revised business plans.

Table1: Cost of debt allowances

	10yr debt tenor*	10yr+ debt tenor
10yr trailing average	2.21%	2.61% *[current approach]*
15yr trailing average	2.68%	2.95%

Source: Markit iBoxx (up to 7 May 2014).

**10yr tenor relates to average of 3-5yr, 7-10yr and 15yr+ indices.*

The current ten year trailing average for the Ofgem indices is 2.61%, using the longer debt tenor. Our analysis shows that there is a 40bps increase in the allowance through use of this longer tenor. Given the size of the continued halo effect noted in the response to the equity market returns consultation in January 2014, there would still be some room in this allowance to cover additional debt issuance costs. If the current mechanism is retained, even companies rated at the lower end of Ofgem's target credit rating should be able to make gains versus the mechanism (current difference between A and BBB rated ten year plus debt is just 19bps).

However the DNOs are seeking to increase the trailing average period with the increased tenor, which would increase the current allowance by 34bps. This is not justifiable and in addition to the costs consumers would face, the longer trailing average period removes some of the benefits from indexation as it is less reactive to market conditions.

Our view is that any change at this stage, having fast-tracked WPD with the cost of debt indexation mechanism would be damaging in terms of regulatory certainty and there is no unique case presented by the DNOs to justify this.

The DNOs have presented varying forecasts on their expectations for the cost of debt index over RIIO-ED1 and stated their concerns regarding financeability. This should be captured in Ofgem's modelling, but accounted for by other means if issues do exist rather than any arbitrary increase in the cost of debt for all companies, at the expense of consumers.

(2) Northern Power Grid's proposal to receive increased rewards for proportionate treatment would not provide the right regulatory signals

NPG highlights in its revised business plan that it believes it has addressed all of the questions Ofgem raised in its previous review of its business plan:

"We therefore expect to be found to be similarity cost-efficient to the fast-track company, Western Power Distribution. Our plan was also found to be stronger that Western Power Distribution's in a number of important respects, so there is merit in ensuring that it receives overall rewards which are proportionate to its status."

In this light of this, NPG goes on to propose that:

"An overall package would be justified that sees our plan rewarded to a degree that approaches the fast-track rewards for Western Power Distribution. We therefore believe that a 6.4% cost of equity would be warranted for our plan even if Ofgem concludes that the cost of equity for a less efficient company should be 6.0%. This would be in ***addition*** *to the reward associated with proportionate treatment our plan assumes it will qualify for, which we have assumed will be at a lower level that Western Power Distribution's fast-track reward (****2% as opposed to the 2.5% awarded to Western Power Distribution****)."*

There are a number of reasons why we would consider it inappropriate for Ofgem to accept the proposals NPG raise in their revised business plan on:

- The fast-track vs. slow track process has by design been developed as an "all or nothing" reward to companies for submitting good quality plans. The fact Ofgem will need to review NPG's plans for a second time would suggest customers have not had "best in breed" value from NPG's ED1 business plan process. To adapt the regulatory arrangements ex post[12] for single company would send the wrong regulatory signals of what fast-tracking is intended to reward, particularly given that NPG failed to qualify for the fast-track based on a key efficient cost criterion.
- There is also an interaction with the slow track IQI that NPG's submission fails to emphasis in its submission. Our understanding is the rewards from the fast-track process are meant to replicate the additional income which would be received from companies that are relatively efficient compared to Ofgem's baseline under the final calibration of the IQI menu. NPG will be rewarded (through additional income and a stronger efficiency incentive) provided it can deliver its outputs for a relatively efficient cost relative to Ofgem's ED1 benchmark.
- Ofgem raised concerns at the fast-track assessment stage that NPG's expenditure forecasts were above the ED1 benchmark and its plan demonstrated poor efficiency in network operating costs (without justification). The strong delivery and efficiency incentives that DNOs - including NPG - face through the IQI and its output package should not be diluted by providing any additional rewards that were not intended for the slow-track process.
- Finally, we would also disagree with NPG's proposal that it should receive a 6.4% allowed base equity return, presumably on the basis of consistency with WPD. The WACC should be calculated based on a standalone company and

[12] We are not aware that a "scaled" proportionate assessment award was included in the RIIO Handbook.

the relevant risks that are faced and require a return by equity holders in the company. NPG and other slow-track DNO business plans WACC should be assessed on this basis. An uplift to the WACC is not the correct area of the ED1 control for providing additional rewards that would boost company returns. The WACC should reflect the risks to equity of the company's delivery of its business plan under its incentive arrangements

Overall, the relative positioning of the business plans of the slow-track DNOs compared to WPD and the established regulatory objectives of fast-tracking, all point towards Ofgem adopting its central reference point or lower for the cost of equity and no additional rewards outside of the IQI from proportionate treatment.

Whilst we expect Ofgem will now consider the financial package and its riskiness in detail, it should not forget that market evidence points towards a low cost of equity for networks as defensive stocks

Looking at this evidence, the key question is whether any changes to Ofgem's current position, as discussed in the previous sections, is justified.

We do not know how Ofgem's cost of equity estimate is comprised to be able to consider differences in position with previous decisions, but the following quote from Ofgem's cost of equity decision is suggestive that the current position has been arrived at through at least some change in the equity beta compared to DPCR5:

> *'Our analysis suggests that even if the equity market return is unchanged, placing more weight on current market data implies a lower cost of equity for DNOs given relatively low exposure to systematic risk implied by the observed betas for comparator companies.'*

However, such a position is difficult to square with the CC evidence if that is the case, as it would suggest that Ofgem have either kept a 0.90 equity beta from DPCR5 or adopted a market cost of equity above the CC range. Applying a reduction to the top end of the CC's total market return range of 6.5% through a reduction in the risk-free rate relative to the RIIO-GD1/T1 market cost of equity gives a risk-free rate of 1.25% and equity risk premium (ERP) of 5.25%. Using a 0.90 equity beta as per DPCR5 then gives an overall cost of equity of 6.0%. Using both a market evidence based equity beta and the equity market return range adopted by the CC would lead to a figure below 6.0%.

The table below shows that only UKPN have adopted a position consistent with Ofgem's minded-to position from the equity markets returns decision. These figures compare to the 6.4% cost of equity that was permitted for the fast-tracked WPD, but which was only justified on the other benefits it provided for consumers within an overall package.

Table 2: Proposed Cost of Equity from DNO revised business plans

	ENWL	NPG	SPEN	SSE	UKPN
Cost of equity	6.3%	6.7% *	6.4%	6.4%	6.0%

** NPG also present a revised financial package that involves a cost of equity of 6.3% with the proportional assessment financial reward*