TRANSMISSION CAPITAL PARTNERS

For the attention of:

Stephen Beel
Associate Partner
Electricity Transmission
Ofgem
9 Millbank
London SW1P 3GE

8th December 2015

Dear Stephen,

Re: views on moving from RPI to CPI as an index applicable to future OFTO and interconnector licences.

Transmission Capital Partners ("TCP") has been responsible for delivering 5 of the 13 OFTOs to reach financial close and is named as the Preferred Bidder on another OFTO, Westermost Rough.

TCP welcomes the opportunity to provide its views on the indexation for future OFTO and interconnector projects.

1. Would moving to CPI affect investor appetite for projects going forward and if so explain why and how these obstacles might be addressed?

An assessment of the potential impact of a shift from RPI to CPI as the applicable index for transmission licences on equity investor appetite for future projects should consider the full range of consequences for their financing and risk profiles. In the isolated context of the transmission licence, it is TCP's opinion that such a shift would negatively impact the attractiveness of UK transmission investments, bringing a range of adverse changes and unnecessary hurdles for future financings. From the investor perspective, we set out below our consideration of the primary consequences:

(i) Lower Returns

Due to their computational differences, RPI indexation delivers a higher nominal return than that of CPI – this is widely documented and commonly referred to as 'the Formula Effect', and currently represents c. 1 percentage point of premium. An immediate impact of switching to CPI indexation for transmission licences would be to reduce nominal investor return by approximately 1 percentage point on an annual running basis (we note that recent measures of CPI have recorded deflation). Over the course of the long-term initial revenue entitlement periods of transmission licences, this difference is compounded such that the reduction in nominal equity returns can be substantial even at low rates.

A likely consequence of any change to CPI is that future potential investors will simply require an equivalent increase in real return to make-up for the reduced nominal return. We suggest that this outcome would be unlikely to represent better value to the consumer.

(ii) Asset / Liability Matching (ALM)

The liability profiles of investors are, as a majority, generally linked to changes in the RPI Index or derivatives of (which are widely considered to better represent the cost of living), although we do recognise that some public and private sector deferred pension plans refer to CPI for calculating increases in payments and revaluations. A move to CPI is, therefore, likely to create a degree of ALM 'mismatch' between CPI-linked assets and RPI-linked liabilities, which must be aligned in some other way, thereby naturally reducing the allocation of capital to transmission projects delivering CPI-linked returns. This is likely to result in a reduction in investor appetite for CPI-linked revenue compared to equivalent projects which offer RPI linkage.

(iii) Illiquid and Inaccurate Hedging Instruments

The availability of a liquid and transparent swaps market is a core investor requirement for any transmission asset investment, or indeed infrastructure assets more broadly, to allow risk to be accurately hedged out. The substantial depth in the RPI-linked Gilt (discussed below) and GBP RPI swap markets allows investors to hedge out RPI risk with confidence and at efficient cost, which benefits the consumer: LCH.Clearnet's SwapClearing OTC interest swap clearing platform has recorded over £10bn of GBP RPI swap notional volumes in 2015 YTD[1].

In stark contrast, there is currently no market for CPI-linked Gilts. Similarly, the CPI swap market is highly illiquid with no-to-very-limited price transparency and transactions executed on a bespoke basis (reflective of the fact that EU Central Counterparty Clearing Houses (CCPs) are currently authorised to clear only UK RPI OTC swaps[2]). The consumer savings obtained through RPI swaps executed under Tender Rounds 1, 2 and 3 of the OFTO regime would have been substantially lower with CPI indexation due to the lack of liquidity in hedging instruments.

(iv) Higher Cost of Debt

If appropriately structured, OFTO and interconnector assets are capable of supporting significant levels of leverage, bringing cost advantages to the consumer. Given the proportion of debt financing, the cost of debt is able to significantly alter the overall project economics. With a fully developed RPI-linked Gilt curve in existence (as at the date of this letter, over £280bn[3] of notional outstanding debt is outstanding across 25 RPI-linked Gilts with maturities extending out to 2068), RPI-linked debt can be readily and accurately priced across a range of different tenors. Without a reference CPI-linked Gilt curve to provide an accurate pricing reference point, CPI-linked debt pricing is challenging and uncertain, and inefficiencies of this kind are likely to result in increased debt costs. Accordingly, the reduced flexibility and expected higher cost of debt funding options under a CPI-linked transmission licence, particularly when combined with the restrictions described above in (iii), would likely reduce the attractiveness of the sector to investors.

We note that the small selection of Sub-sovereign borrowers that have issued CPI-linked bonds to date (Greater London Authority/Northern Line Extension, the Church of England and Warrington Borough Council) have priced their bond financings off the RPI-linked Gilt curve by applying a 'wedge' to account for the difference between RPI and CPI. This mechanism is problematic as it relies on the accuracy of long-term inflation forecasts, which are generally accepted to be, at best, imprecise and do not take into account volatility in the RPI-CPI relationship.

For the reasons above, it is our opinion that a change in the licence index reference should only follow a market-wide shift to CPI, including the issuance of CPI-linked Gilts and the development of a liquid and accessible GBP CPI swaps market.

2. *Would a change to CPI affect the financeability of projects? Please indicate which project types you are considering and what the impacts may be*.

We have considered above the deficiencies that would surround the financeability of future transmission projects following a shift to CPI indexation for future transmission licences in isolation. While future projects could still be privately financed, we would generally expect the cost of both equity and debt financing to rise in the current market, resulting in higher end costs to the consumer. The consequences on financeability can be summarised as:

- High real cost of equity required to offset the 'Formula Effect' and lower nominal returns;
- Higher cost of nominal and inflation-linked debt expected due to the illiquidity of CPI swap and CPI-linked bond markets, respectively, exacerbated by the leveraged nature of transmission assets;
- Higher hedging costs due to the need to enter into complex additional hedging arrangements to address the divergence between CPI-linked revenue and RPI-linked costs and a greater potential for ALM mismatching (which itself could have knock-on consequences for the cost of capital)

[1] Source: LCH.Clearnet
[2] https://www.esma.europa.eu/system/files/public_register_for_the_clearing_obligation_under_emir.pdf
[3] Source: Bloomberg

3. Please comment on whether CPI is in your view an appropriate index to move to or whether you have a preference for another measure of indexation (e.g. an alternative CPI-based measure) and why?

Without making comment on the suitability of CPI as a measure of inflation, we do not believe it is currently an appropriate index to move to given the immaturity of the GBP CPI-linked derivative and bond markets and lack of precedent for CPI-linked project financings. We would argue that no other measure of inflation should be considered as a replacement until the associated financial markets relating to that measure (i.e. swaps and debt) have sufficiently matured to allow for efficient and competitive risk management, which would likely only a follow a market-wide shift to an alternative measure (including the index-linked Gilt market). It is clear that the liquidity of markets for RPI-linked securities have created substantial efficiencies in financing structures and delivered value for money to consumers. We recommend, therefore, that revenue allowed under the OFTO and interconnector licences remain linked to RPI.

4. In your view what effect on the consumer or other industry participants (such as offshore windfarm generators) do you think a move to CPI would have?

For the reasons expressed above, in relation to debt costs if the move from RPI to CPI were implemented before the CPI swap and gilt markets were firmly established, we would anticipate that the consumer would likely experience higher costs than would be the case if RPI was retained. In relation to investor costs, at best there would be no change (as the investor's real returns would simply be increased to compensate for the reduced nominal returns). The more likely result however would be an increased cost to the consumer with reduced competition, as all things being equal, investors are more likely to pursue RPI-indexed opportunities, which greater match the requirements of the underlying investor.

5. For OFTO projects, would a change to CPI impact on your strategy for biddable indexation, and if so what are the impacts. In your view would this result in a benefit or additional cost to the consumer?

A comparison between the CPI swap rate and the Bank of England zero coupon rate would be required before making a decision on the biddable level of indexation for any future project. As these rates move over time, it is not possible to comment definitively on how the biddable indexation would change and/or its impact on the consumer.

6. Are there any other challenges you foresee a change of index may bring? How could these be resolved?

Apart from those considered above, it would of course be important for Ofgem to maintain its earned reputation for providing a stable and transparent regulatory framework, which is integral to maintaining existing, and attracting future, investors.

7. Are there any consequences to timing we should be aware of regarding a move to CPI (or another index) and how should we manage these?

In the event of a move to any different index, it would naturally be important to give all potential investors as much notice as possible ahead of any future project tender exercise in order to gauge the impact and if necessary, re-assess the attractiveness of the tender opportunities.

We are of course available for any further conversations on this topic should it assist.

Yours sincerely,

Gavin Tait

Gavin Tait
for and on behalf of Transmission Capital Partners