

Doc Type: Response to RIIO-2 Framework Consultation 2018
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National Grid – Price Control Consultation ((brackets denote the answer))

Capital Investment Requirements (use actual not forecast)

The very first price control was not based on any forecast of future capex but was a pure RPI-X formulae agreed by Regulator and NG Chairman during an evening meal and exchange of letters.

Every price control since has been largely based upon forecasts of capital expenditure. In every case National Grid has over estimated such capital forecasts with replacement capex in particular being some third of its forecast over the price control period for each of the last four controls.

Currently NG are not incentivised to only spend capital efficiently indeed the converse is true because all capital expenditure earns a rate of return no matter whether it was necessary or not and over forecast but allowed and then unspent capex earns even more.

In order to prevent any recurrence the regulator should simply assume no replacement capex at all and then adjust the control retrospectively for any actual expenditure justifiably incurred.

Rate of Return – Debt (use a 20 year rolling average on Nominal – forward RPI sale price)

I agree with ALL the Policy Objectives set out but do not think your options address these well.

Some of the proposed methods, in particular those used by Ofwat/CAA fail completely in providing any form of incentive to the licensee to obtain lower costs. This is particularly the case when interest rates are falling or have volatility and/or a changing slope across the yield curve.

In addition NG's relatively reduced use, in practice, of indexed linked debt implies that it is no longer necessary to fully index the income provided to them. This aspect fails to be addressed at all. Instead it's better to assume use of nominal debt and immediate sale of index linked RPI costs as this has already been proved cheaper for OFTO's from their competitive tendering process.

Similarly instead of assuming a forecast capex and fixed debt percentage instead use the actual percentage of nominal debt to a reassessment of retained equity at year end as if dividends paid to the group were at the proportion expected.

Rate of Return – Equity (6% real x 0.5 for lower risk = 3%)

Unfortunately despite the theoretical merits for CAPM the evidence in practice is not good. Regrettably past data on creating and keeping portfolios based on just company betas do not yield either better returns nor lower risk. This was a question unfortunately not put to the academics. All that can be said is what the market average return was in the past over different time frames. It is also fairly clear that there is not a single measure of risk.

However if regulated utilities had some of the attributes of bonds eg a low likelihood of a loss together with some of the attributes of shares eg real dividend growth whatever inflation occurs. Then they ought to be provided a lower rate of return than the market as a whole. Furthermore a consistent approach by the Regulators over time should enable this. Thus an overall return somewhere (eg halfway) between government bonds and shares as a whole ought to be adequate. The proof would be seen whenever they needed to raise additional equity because of a need to meet higher levels of capital expenditure on future regulated capital investment eg the rights issue by NG.

Unfortunately the needs for this rights issue was more because from paying excessive dividends (at least relative to their regulatory capital base of the dividend level implicit in the regulators model). Thus a beta of 0.5 and a real dividend (eg RPI'd) ought to be sufficient. To assure investors the level of dividend for NG if this model had been used since privatisation could be illustrated for comment.