electricity north west

Bringing energy to your door

Appendix 2: response to Finance questions

March 2019

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1 Overview

Electricity North West Limited (ENWL) is an electricity Distribution Network Operator (DNO). We recognise that Ofgem is "*not consulting on proposals for the next electricity distribution price control at this stage*" (paragraph 2.30), however, we are mindful that Ofgem has also indicated that measures with the current consultation "*may be capable, in principle, of application for ED2*" (paragraph 2.31).

Whilst we support many of the proposals in the Cross-Sector Methodology as described in Appendix 1 of our response, we remain extremely concerned that there are a number of areas in the Finance Annex where Ofgem's proposals are inappropriate or suffer from a lack of detail. We address these issues in detail within this Appendix.

Our interest stems from our understanding that the same broad design principles that inform the methodology for these sectors could apply to ED2 and that the starting point for considerations of ED2 could be the decisions made for these sectors.

This Appendix should be read in conjunction with the RIIO-2 sector specific cover letter, response to the cross sector document and in light of previous correspondence in relation to RIIO-2.

The independent consultant reports referenced within our response are being provided alongside the Energy Networks Association's (ENA) response to this consultation and are therefore not appended to our individual response.

2 Cost of debt questions

FQ1. Do you support our proposal to retain full indexation as the methodology for setting cost of debt allowances?

We do not support the proposal to retain full indexation as the methodology for setting cost of debt allowances.

The methodology is unsophisticated and does not respond well to sharp changes in capital markets rates. Complexity should not be a barrier to ensuring a fair and reasonable regulatory framework.

Any calibration based on sector average is likely to result in a wide dispersion of performance across licensees. Careful review would then need to be carried out to increase the allowance for efficient, but underperforming companies in accordance with Ofgem's duty to ensure each licensee is financeable. Overall, customers would therefore pay more than is necessary.

A sector average approach, absent specific adjustments, will establish winners and losers at the outset of the determination, leaving companies with no real options to change the outcome over the regulatory period. These winners or losers may be the result of size or merely the luck of timing of refinancing, rather than any actual inefficiency of financing arrangements.

Small companies have a structural disadvantage to meeting any trombone or roller mechanism, with 1/10th to 1/20th of debt being well below benchmark size. Small companies face the choice of incurring additional transaction costs and issuance premiums on frequent issuances, or the additional costs of carry associated with grouping financing needs into above benchmark size. This latter option also increases the exposure of small companies to fortunes of timing.

Any assessment of company debt costs needs to incorporate all financing costs which include appropriate estimates of transaction, liquidity and carry costs for each company. It is likely that these costs are higher overall for small companies or more frequent issuances (if companies choose to try to reduce risk by matching the index).

Financing costs should also explicitly include the cost or benefit of derivatives. Derivatives are entered into primarily for risk management purposes and it is unreasonable to view their impact in isolation. It is unfair on consumers to treat outperformance on direct borrowing, which is effectively shared through calibration each regulatory cycle, any different to that gained through derivatives, which would be excluded from calibration if they were ignored during assessment. Derivatives used to correct nominal to RPI debt, together with its underlying nominal debt should be treated consistently with index linked debt.

We do not believe any adjustment for Halo costs is necessary. The analysis provided by Nera in its 'Cost of Debt at RIIO-2' report (*March 2019*) would support this view. Should Ofgem decide to undertake further analysis, it is important that any assessment of the Halo effect should make all necessary adjustments for credit rating of issuer, tenor and concavity of bonds.

FQ2. Do you agree with our proposal to not share debt out-or-under performance within each year?

We consider it appropriate that debt under/out performance is shared each year, in line with other aspects of regulatory performance, on a cumulative basis.

Debt under/out performance should be treated in a similar way to Totex and Ofgem should provide evidence and support as to why it should be treated any differently to other areas of under/out performance within the price control.

If companies successfully outperform the debt allowance, for instance through securing private placement financing below iBoXX rates, it is fair that customers should benefit during the regulatory period.

A framework that does not adequately remunerate networks may lead to short-termism, negatively impacting customers.

FQ3. Do you have any views on the next steps outlined in Finance annex paragraphs 2.22 to 2.25 for assessing the appropriateness of expected cost of debt allowances for full indexation?

The setting of the cost of debt allowances needs to be based on Ofgem's financeability duty to ensure that each licensee is financeable, based on its particular circumstances subject to an efficiency test. Averaging across sectors is too wide a starting point, particularly now that Ofgem has full details of each company's specific circumstances through the RFPR data collection.

We do not support the proposal to retain full indexation as the methodology for setting cost of debt allowance, or that calibration of the allowance should be based on sector averages. Sector averages will give rise to winners or losers, which may then require adjustment to losses as a result of Ofgem's financeability duty. Overall this approach would result in customers paying more than would be justified on a licensee by licensee approach.

Table 1 below illustrates the issue. The data is extracted from Ofgem's Regulatory Financial Performance annex to RIIO-1 annual reports 2017-18 and shows the ED1 sector having a debt allowance matching its costs, but with significant winners and losers.

Table 1 – Annual Performance

Annual financing performance		ENWL	NPg	SP	SSE	UKPN	WPD	ED1
Financing performance (notional)	£m 12/13	(16.1)	(1.4)	19.1	5.8	13.0	(17.3)	**3.0**
Financing performance (actual)	£m 12/13	(12.9)	6.6	19.7	5.4	12.5	(14.7)	**16.6**
Equity (notional)	£m 12/13	545.1	960.5	1,123.8	1,051.3	1,815.6	2,260.4	**7,756.8**
Equity (actual)	£m 12/13	642.2	1,432.4	1,201.5	1,052.5	1,774.5	2,415.6	**8,518.7**
RoRE % (notional)	%	(3.0)%	(0.2)%	1.7 %	0.6 %	0.7 %	(0.8)%	**0.0 %**
RoRE % (actual)	%	(2.0)%	0.5 %	1.6 %	0.5 %	0.7 %	(0.6)%	**0.2 %**

Source: Ofgem Annual Report 2017-18

While overall sector performance for ED1 is 0.0% (notional) there is wide dispersion of network performance.

There are limited practical opportunities for companies to 'match' existing debt portfolios to any roller or trombone mechanism, particularly for smaller companies, and we believe that there will continue to be a wide level of dispersion of financing performance in RIIO-2 under full indexation.

With Ofgem guiding towards a 50% reduction in equity returns, we believe that a full indexation approach could lead to financeability issues for companies in RIIO-2.

When assessing the appropriateness of any debt allowances, it is critical that Ofgem include all relevant costs in any estimates for future financing, including:

(1) Derivatives. These are primarily risk management tools to protect against inflation risk.
(2) Direct and indirect issuance costs, including legal, advisory and rating agency fees.
(3) Liquidity costs, including carry costs on operational cash.
(4) Appropriate refinancing assumptions, including periods of pre-financing and/or commitment fees.
(5) Financing rates based on current credit ratings, not simple sector average. The Halo effect should be evaluated and incorporated if appropriate. As we explain in our response to FQ1 we do not currently believe an adjustment for Halo costs is justified.
(6) Any appropriate non-issuance costs, including adjustments for premiums or discounts on issuance or redemption. For the avoidance of doubt, we do not believe it is appropriate to adjust interest costs to reflect current Yield To Maturity on public debt, only the actual cash impact on issuance or redemption.

Ofgem states that it will consider whether a smaller company allowance is appropriate, and we would therefore raise the following points for consideration by Ofgem:

- **Legitimacy.** It is not in the interests of customers to set a debt allowance in line with weighted-average debt costs for the sector as a whole, and then to offer small companies extra allowances. Absent adjustments for “larger companies”, customers would then end up paying more than they would do if allowances were set fairly on a licensee (or group) by licensee basis.
- **Additional financing costs for smaller companies.** Small companies may face additional costs across all six areas noted above and any assessment must extend outside of simple differences in coupon and relative transaction costs. Larger groups often have central Treasury functions that benefit from the portfolio effect of several companies, accessing markets frequently and aligning debt profiles with any roller/trombone mechanism.

Regarding assessment of company financing costs, providing that RFPR data incorporates all costs noted 1-6 above and that methodology is aligned between companies (but still allowing for company-specific variations), then we would support RFPR data being used to assess costs.

We strongly disagree with Ofgem’s proposal for sector average calibration however, should it be implemented, we believe it should be in the context of the following objectives:

- Limit the dispersion in performance between licensees
- Limit the performance impact arising on sharp changes in financing rates (gilts, credit spreads, inflation)

Ofgem should tailor its methodology to achieve this, including the introduction of company specific adjustments where appropriate, such as adjustments for both smaller and for larger companies, or indexation weighted according to issuance.

Ofgem should state how it will apply a sector specific average approach when certain larger groups dominate a sector (such as transmission), and how, in that case, the policy does not mathematically result in quasi company specific allowances for the largest group.

We do not believe that simplicity should take precedence over these objectives and it is far more important that financeability and fairness are achieved.

As an alternative to the methodology proposed by Ofgem we would support an indexation methodology that reflected an individual company's profile of issuance. This would eliminate the windfall gains and losses derived from fortunes of timing and remove the motivation for companies to conform financing structures to unrealistic roller or trombone mechanisms. In addition, by retaining external benchmarks for financing costs, it would continue to incentivise companies to outperform without being unduly complex.

An appropriate debt allowance is a cornerstone of individual company financeability, therefore it is imperative that Ofgem give the methodology and calibration due consideration, including the impact of derivatives.

It is essential that Ofgem undertake a full, stress tested impact assessment on how the debt allowance will impact individual company financeability. The RIIO-ED1 debt performance figures provide a basis for this. An impact assessment for all licensees should be carried out before RIIO-2 methodologies are finalised in order to ensure that the methodology results in conformity with Ofgem's financeability duty.

FQ4. Do you have a preference, or any relevant evidence, regarding the options for deflating the nominal iBoxx as discussed in Finance annex paragraph 2.14? Are there other options that you think we should consider?

There should be consistency between the RAV indexation and the deflation of the nominal-WACC. Breakeven inflation, measured as the difference between nominal and RPI-linked Gilts, is not an accurate method of predicting RPI inflation across a regulatory period. RPI estimates using this method are impacted by market distortion, particularly given that demand for RPI linked debt is outstripping supply.

Long term breakeven inflation does not accurately reflect the inflation expectations across a five year regulatory period.

Providing there is no conflict with the overriding principles noted above, we would support using OBR or HMT CPI(H) inflation forecasts for deflating nominal iBoxx indices.

3 Cost of equity

3.1 Risk-free rate

FQ5. Do you agree with our proposal to index the cost of equity to the risk-free rate only (the first option presented in the March consultation)?

We believe it is largely unnecessary to index the risk-free rate component of the CAPM model given other proposed regulatory framework changes. The existing RIIO toolkit, if applied appropriately, contains all the controls necessary to maintain an appropriate return to shareholders. Furthermore, shortening the price control period from eight to five years will limit opportunities for unchecked material movement in the risk-free rate.

Equity investors deliver patient capital for the long-term, basing their investment decisions on long-term averages. Regulatory stability and decision-making are crucial components in attracting such capital.

While we consider indexation unnecessary, rating agencies have suggested that equity indexation may be marginally credit positive, because it constrains a regulator from setting an inappropriate equity allowance. Given the material financeability pressures inherent in the RIIO-2 package as proposed we feel it necessary to support indexation for this reason.

If Ofgem is to use trailing indexation, it should ensure that the underlying data sets are robustly accurate and not subject to presumptions to make up for gaps in data or research. To maintain legitimacy and fairness, the introduction of such a mechanism will require a long term commitment from Ofgem, well beyond RIIO-2 price controls to apply the mechanism throughout all market conditions in the future.

Care needs to be taken to ensure that returns remain sufficient to attract the capital needs of an asset intensive business, particularly during periods of market distress or significant market change. NERA's paper for the ENA, "Cost of Equity Indexation Using RFR" (*March 2019*), recommends using 20 year nominal gilts based on 12 month averaging prior to the charging year. We support NERA's position and recommendations on using nominal gilts.

Finally, we note the current RIIO-1 framework disjoint between (i) long-term inflation expectations being used to deflate the nominal WACC and (ii) RAV and revenue growth being inflated based on actual outturn inflation. This disjoint results in cash flow risk for networks, particularly in periods where short term inflation expectations deviate from long run average. Ofgem should seek to address this disjoint for RIIO-2.

The current use of RPI breakeven as a proxy for long term inflation expectations is flawed due to supply-demand imbalance for RPI linked debt. The supply-demand balance for long-dated index-linked government debt is currently unequal. Demand far outstrips supply, increasing prices and suppressing inflation linked yields. Pension funds and life companies have unfulfilled demand for index-linked income and, most importantly, for the inherent liquidity risk protection that is actively encouraged by the Government and Pension Regulator. This has implications for the use of gilt spreads when estimating market expectations of inflation.

FQ6. Do you agree with using the 20-year real zero coupon gilt rate (Bank of England database series IUDLRZC) for the risk-free rate?

As noted in the response to FQ5, we believe that real gilt yields are frequently distorted due to a supply-demand imbalance for RPI-linked debt. Pension funds and life companies have unfulfilled demand for index-linked income and, most importantly, for the inherent liquidity risk protection that is actively encouraged by the Government and Pension Regulator.

In normal market conditions, the use of long-term nominal gilt yields is considered an appropriate proxy for the nominal risk free rate. While so, we do not believe rational investors without any specific hedging requirements would accept a negative real return on risk free investments.

A negative real Risk Free Rate (RFR) is both unsustainable and counter-intuitive to the investment strategy of pension funds, which are looking to invest to receive RPI+ returns. We note that there are significant pension fund liabilities that have RPI inflation written into their trust deeds, hence them seeking returns above RPI and not merely above inflation. It would imply that such funds are

investing to lose money, long-term, on a real basis. Ofgem should be mindful that the cost of equity determination needs to be defensible to the life and pension funds that are significant long term investors into UK infrastructure. As such we consider it appropriate that any approximation to the Risk Free Rate should be subject to a floor.

As noted in FQ5, NERA's recommendation in its paper "Cost of Equity Indexation Using RFR" (*March 2019*) is to use nominal rather than real gilt yields. The evidence they present in the Appendix from Schroders supports this position.

Regarding any inflation adjustment to calculate a real risk free rate, we again highlight the current framework disjoint between the long-term inflation expectations being used to deflate the nominal WACC; and RAV and revenue growth being inflated based on actual outturn inflation. Ofgem should seek to address this disjoint for RIIO-2.

FQ7. Do you agree with using the October month average of the Bank of England database series IUDLRZC to set the risk-free rate ahead of each financial year?

Point in time estimates are subject to a greater risk of distortion. Also noting concerns with the indexation approach (FQ5), and using the series in isolation (FQ6), we would favour some period of averaging when setting the Risk Free Rate.

We support NERA's proposal ("Cost of Equity Indexation Using RFR", *March 2019*) to base any calculation on a twelve month average prior to the charging year. NERA's work indicates that twelve months provides for more stable estimates and is likely to be more reflective of the interest rate variations over the year.

FQ8. Do you agree with our proposal to derive CPIH real from RPI-linked gilts by adding an expected RPI-CPIH wedge?

We do not agree with Ofgem's proposal to derive CPIH real from RPI-linked gilts by adding an expected RPI-CPIH wedge. This principally reflects the concerns noted in FQ4-7 regarding the potential distortion in RPI-linked gilt yields.

Subject to an appropriate floor in the measure of Risk Free Rate, it is considered more appropriate to derive an appropriate CPIH real from the nominal rate, using an estimate of inflation that is aligned to the inflation expectations over the regulatory period.

Again, we support NERA's ("Cost of Equity Indexation Using RFR", *March 2019*) recommendation to use nominal gilts and deflate using an appropriate CPI forecast derived from HMT or OBR forecasts.

3.2 TMR

FQ9. Do you have any views on our assessment of the issues stakeholders raised with us regarding outturn inflation, expected inflation, and the calculation of arithmetic uplift (from geometric returns)?

We agree with the broad stakeholder issues summarised by Ofgem in the consultation document, but do not agree that the information adequately represents the underlying arguments and considerable weight of the evidence as provided by both academics and consultants on this issue.

We share NERA's concerns about some of the UKRN conclusions and Ofgem's interpretation of the UKRN study, particularly its interpretation of historical data. We support NERA's conclusions ("Review of UKRN Report Recommendations on TMR", *December 2018*), highlighting the flawed nature of the UKRN report on this matter; and therefore the TMR ranges in the Ofgem consultation document on which this judgement relies:

1) "NERA's analysis shows that the Millennium CPI dataset does not provide a reliable measure of historical CPI inflation. This has been clearly acknowledged by the ONS and academic research. We conclude that the historical TMR back to 1900 must instead be calculated relative to the "official" RPI inflation." ("Review of UKRN Report Recommendations on TMR", p4).

2) "The UKRN's assertions on the issue of the "predictability" of returns do not appear to be well founded. NERA conclude that the CMA's (NIE, 2014) position on this issue is much more robust." ("Review of UKRN Report Recommendations on TMR", p4).

3) "A Real TMR deflated by RPI cannot be used in a CPI framework without adjustment" ("Review of UKRN Report Recommendations on TMR", p5).

It is our belief that, to the extent that matters are subjective Ofgem should also consider the alternative views advanced by NERA and others to gain a consensus in approach. In order to maintain a balanced and fair approach to the underlying arguments, we believe Ofgem should instruct a third party academic review to independently assess the UKRN approach and stakeholder issues.

We are aligned with Oxera's position ("The cost of equity for RIIO-2", *February 2018*) on arithmetic vs. geometric averaging and consider that arithmetic means are more appropriate than geometric means as an averaging method in this context. Use of arithmetic means is more broadly supported by regulatory precedent and academic research in estimating equity market returns. Any departure from existing regulatory precedent would need compelling justification.

FQ10. Do you have any views on our interpretation of the UKRN Study regarding the TMR of 6-7% in CPI terms and our 6.25% to 6.75% CPIH real working assumption range based on the range of evidence?

We believe it is important for Ofgem to consider the full weight of evidence in respect of the TMR, to enable a fair, reasonable and objective conclusion to be drawn. Singular reliance on the UKRN report conclusions that have been shown to be subjective, does not in our opinion, demonstrate a reasonable regulatory assessment.

We refer to the response to FQ9 above, and in particular the first point extracted from the NERA ("Review of UKRN Report Recommendations on TMR", *December 2018*). In our opinion this confirms the subjective nature of interpreting historic data measurement, and the range of TMR conclusions this can deliver.

NERA conclude that the data labelled as CPI inflation taken from the Millennium dataset for years prior to 1987, does not represent a reliable measure of CPI inflation. This is supported by similar conclusions by the ONS. Furthermore, the Millennium dataset, utilised by the UKRN TMR analysis

for the period 1915 -1949, equates a CPI index with a RPI index. This cannot be correct, and should not be overlooked by Ofgem, particularly when relying on such evidence to justify the TMR ranges in their RIIO-2 proposal.

FQ11. Do you have any views on our reconciliation of the UKRN Study to previous advice received on TMR as outlined at Finance annex appendix 2?

Our key concern with Ofgem's approach to the reconciliation is that it omits a significant step relating to the change in inflation basis in arriving at a "real" number. The 2003 and 2006 studies were presented and interpreted as being on a real-RPI basis. The 2018 report is on a CPI basis.

We believe any reconciliation such as that presented in Figure 8, needs to expressly reconcile the 2006 TMR figure (RPI) to 2018 report (CPI), by first reconciling to the 2006 TMR figure in CPI.

Apart from this important point we have no further comment on the reconciliation as presented except that we have fundamental concerns about UKRN's construction of the endpoint.

Our understanding is that the construction of the reconciliation is Ofgem's work and would suggest that Ofgem ask UKRN to verify this approach, or present an alternative in order that all UK regulators are aligned?

3.3 Equity beta

FQ12. Do you have any views on our assessment of the issues that stakeholders raised regarding beta estimation, including the consideration of: all UK outturn data, different data frequencies, long-run sample periods, advanced econometric techniques, de-gearing and re-gearing, and the focus on UK companies?

Ofgem has taken a fundamentally different approach to beta estimation than used in previous determinations, namely placing significant weight on the use of GARCH modelling techniques, thereby breaking with established regulatory and CMA precedent. We do not believe that this is appropriate given the degree of subjectivity involved in the assessment and difficulties with modelling assumptions and specification. We believe that with the lack of compelling evidence of a consistently superior modelling approach (see responses to FQ13 and FQ14 below), any starting point for beta analysis should be established regulatory precedent (i.e. the use of OLS and daily data over a time period no greater than five years) to avoid the problem of including data points that may not be representative of the current systematic risk of the business.

Our view is consistent with approaches and arguments outlined in Oxera's February 2018 ("The cost of equity for RIIO-2") and May 2018 ("Review of Ofgem's initial cost of equity proposals for RIIO-2") reports.

For the reasons outlined by Oxera, GARCH techniques employing long term data at a reduced frequency level have their own drawbacks. Utilising such datasets introduces complications regarding structural breaks, use of data from very unusual economic circumstances and the disregard of data points by moving away from the use of daily data. Issues arise from specifying the correct model. None of this leads to superior, clear, consistent and reasonable answers - quite the contrary, it complicates the picture.

We believe it is unreasonable to place significant weighting to the GARCH techniques without firm justification. A forthcoming Oxera report for the ENA examines in further detail why use of GARCH over OLS is problematic.

We also have concerns about Ofgem's 'adjusted' gearing ratio approach and believe each company should be separately de-geared using its own gearing ratio rather than apply a blanket and subjective EV/RAV (1.1x) approach. We believe this is necessary to control for individual company circumstances such as their capital structure and financial risk. Applying the proposed 'adjusted' gearing approach potentially ignores the spread of raw equity betas and gearing across UK utilities. It is also a departure from established practice without adequate justification.

With regard to the use of UK data, we remain supportive of Oxera's stance in their report ("The cost of equity for RIIO-2", February 2018) that, given the small sample set of relevant comparator companies, it is desirable to include relevant international data. Given the international nature of infrastructure investors we believe this approach is justified. It is difficult to understand why arguments are advanced by Ofgem to limit the use of such data, when there are also compelling reasons for disregarding the UK utility comparison data actually used, such as differing regulatory jurisdictions within the same groups, use of water companies as proxies for energy companies, etc. There will always be limitations of any given data set, which is the reason to use all relevant datasets.

FQ13. What is your view on Dr Robertson's report?

We consider Dr Robertson's report to be technical in nature. It highlights how sensitive the model results are to the assumptions used, many of which are highly subjective in nature. Conclusions about the recommended use of a model (OLS or one of a number of variants of GARCH) under a clear set of assumptions are hard to discern. This is unsurprising, as there appear to be no clear "correct" answers to this analysis; rather a spectrum of subjective "possibilities" that may or may not deliver a reasonable answer. It appears that outcomes are very dependent on model specification.

As noted in FQ12 above, our view on the approach that should be taken to estimate equity beta is fully aligned with the approaches and arguments outlined in Oxera's February 2018 ("The cost of equity for RIIO-2") and May 2018 ("Review of Ofgem's initial cost of equity proposals for RIIO-2") reports. These advocate the use of daily data over a time period no greater than five years to avoid the problem of including data points that may not be representative of the current systematic risk of the business.

We would suggest that in order to justify the departure from established regulatory precedent, i.e. using OLS, a timeframe no greater than five years and high frequency data, requires clear demonstration of a superior method that delivers consistently more accurate results. We do not believe that the technical detail presented by either UKRN, or similar from Dr Robertson, meet the necessary hurdle to show GARCH (or one of its many variants) is superior to established regulatory assessment techniques using OLS.

A forthcoming Oxera report for the ENA examines in further detail why use of GARCH over OLS is problematic.

FQ14. What is your view on Indepen's report?

Indepen's report demonstrates that there is no clear cut "correct" way of undertaking the equity beta assessment.

Not unlike Dr Robertson's report, Indepen finds that precise model specification is subjective and can result in a number of different outcomes:

> "*The characteristics of the data series are such that making a statistical estimate of a company's/sector's β at a point in time entails a process that is complex and sensitive to several assumptions and potentially subject to bias and inaccuracy*." (Indepen, December 2018, "Beta Study – RIIO-2", section 5.2, p42)

Indepen then go on to say that:

> "*none of the specific approaches we have considered is without significant failings*". (Indepen, December 2018, "Beta Study – RIIO-2", section 5.2, p42)

Furthermore the range of outcomes reported under section 5 of the report is broad, and appears to disregard the British Telecommunications (BT) evidence in its entirety, offering no further justification for removal apart from the fact that Indepen regard it as "significantly" different. Again this appears to be subjective treatment of an upwardly biased beta estimate; an approach that could no doubt be taken to disregard other pieces of downwardly biased evidence.

Of most concern is Indepen's conclusion not to re-gear to the notional company level. This is contrary to the regulatory concept of assessing financial returns at a notional company level, and is clearly inconsistent with other parts of the regulatory assessment process, most notably for the cost of debt.

Similar to the FQ13 response above, we recommend that established regulatory precedent should be the starting basis for any such analysis, absent any compelling evidence of a consistently superior alternative.

FQ15. What is your view of the proposed Ofgem approach with respect to beta?

As noted in our responses to FQ12 to FQ14 above, we do not support Ofgem's approach in respect of the assessment of equity beta.

In this area we support maintaining established regulatory and CMA precedent, consistent with the approach taken by Oxera in their February and May reports.

An important consideration will be raised in a forthcoming ENA Oxera report on asset and debt risk premiums. This report checks that the sum total of the individual building blocks of the CAPM is consistent with a sensible market-based result. Oxera test this based on the relationship between the asset risk premium and debt risk premium of a company and is based on the principle that any financial claim by debt holders has priority over dividend payments to shareholders. As such, the risk premium to equity holders must be greater than that for debt holders.

The results of Oxera's analysis suggest that the premium differential is below market evidence and that the combination of CAPM assumptions is delivering an extreme result. The recommendation is that one or more of these parameters needs revising upwards to provide a more sensible market-based result.

3.4 Cross-checking the CAPM-implied cost of equity questions

FQ16. Do you agree with our proposal to cross-check CAPM in this way?

We support the concept of CAPM cross-checking however there is a great deal of subjectivity involved in the four proposed approaches which give rise to a range of answers and thereby significantly impact their ability to provide objective support to conclusions drawn from the CAPM.

- **Market-to-asset ratios (MARs)**

  The use of MARs as a cross-check of CAPM as applied within the consultation document is subjective, as we explain below. In addition, any cross checking would need to be done in the context of an overall return position based on a realistic RoRE calculation, and an assessment of the whole regulatory framework.

  The observation of MARs by looking at publicly listed shares is likely to be flawed, due to the small sample size (three companies) and limitations to the water sector and therefore is not directly reflective of the electricity and gas sectors. In addition, the conclusion drawn is very subjective, as acknowledged by Ofgem 'this implies investors *may* expect the return on the RAV to be greater than their costs of capital', as there could be a number of reasons for payment of a premium.

  The observation of MARs by looking at privately held shares is a similarly subjective conclusion. Again, there could be a number of reasons for companies trading at a premium, including future expected synergies and cost savings by the winning bidder. In addition, this data only captures the winning bid, and not the range of bids that were put forward as part of the sale process. The buyer of a business in a competitive market is necessarily reflective of the highest bidders and not a sector average.

- **Professional Forecasts**

  We believe more details are required on Ofgem's analysis of discount rates from listed infrastructure funds, before we would be able to agree with how the professional forecasts have been used as cross check for CAPM, including the following points.

  Closed end funds have different investment horizons to typical energy network investors. This may lead to more weight being placed on shorter term interest rates when calculating discount rates, which may not only explain (in the context of an upward sloping yield curve) why discount rates are low, but also why they have fallen over time by more than might be expected if the discount rates were calculated by reference to very long maturity gilt yields.

  Listed infrastructure funds' discount rates will reflect different levels of leverage. They will not necessarily reflect the leverage of the underlying portfolio of assets, but rather the funds themselves which are likely to be low leverage. Adjusting these discount rates to an equivalent basis to Ofgem's CAPM analysis would likely imply a higher overall cost of equity.

  There may be specific accounting rules that need to be followed in the calculation of these discount rates that mean they do not necessarily reflect the true discount rates of the investors.

  These closed end infrastructure funds have a different mix of dividend and capital growth to investments in energy networks (where dividend yield would typically be lower) and this

means that these funds are likely to attract different types of investors (smaller institutional investors) than energy networks and as such may have different discount rates.

These infrastructure funds may hold a more diversified portfolio of investments and as such may not face the same risk profile as energy network investors.

We consider it appropriate that Ofgem validates the analysis by gathering additional data on these discount rates, specifically:

- Gathering discount rates over a longer time series (if the data is available)
- Gathering discount rates for a wider set of funds or investments. To the extent that there are no other listed UK infrastructure funds, data could be gathered for funds listed internationally

- We support Oxera's concern on survey evidence as highlighted in its March 2019 paper ("Rates of return used by investment managers"). It demonstrates that the impact of FCA guidance gives rise to lower advised ranges. In the instances where investment managers have published rates, many caveat their advice and rates by advising that these cannot be used to estimate future performance. Oxera conclude that "if any weight is to be placed on this evidence, the projected growth rates reported therein must be adjusted for the downward bias embedded within such estimates. Academic literature suggests that the adjustment amounts to c. 2%".

- **Bids for Offshore Electricity Transmission Assets**

  We do not believe that the use of bids for offshore electricity transmission assets as a cross-check for CAPM is valid, due to the significant risk and structural differences between networks and OFTOs. Areas where we perceive there to be significant risk differences include construction and longevity of the network assets, asset maintenance, financing, environmental and safety concerns, competition, and the considerably different regulatory and political challenges facing the different sectors.

  Given the above we expect the risk component of the CAPM model to be different and will, therefore, deliver different results.

- **Infrastructure Fund Discount Rates**

  Using infrastructure fund discount rates requires a significant amount of interpretation, with answers differing significantly between the respondents and the context in which the question was framed to them.

It could be found that evidence acquired from different sources may validate a wider range for CAPM, thus rendering the evidence put forward as inconsistent and therefore unreliable.

FQ17. Do you agree that the cross-checks support the CAPM-implied range and lend support that the range can be narrowed to 4-5% on a CPIH basis?

As mentioned in FQ16 above, there is a great deal of subjectivity involved in all of the four proposed approaches which is enabling the cross-checks to support the proposed range of 4-5% on a CPIH basis, however the same cross-checks could also be used to support a much broader range, thereby minimising their usefulness.

FQ18. Are there other cross-checks that we should consider? If so, do you have a proposed approach?

We believe that the overall CAPM outcomes should also be cross-checked against a sensible market-based result for the differential between the asset and debt risk premiums. Please refer to Oxera's March 2019 ENA paper on this subject, and the answer provided to FQ15 above.

3.5 Expected and allowed return questions

FQ19. Do you agree with our proposal to distinguish between allowed returns and expected returns as proposed in Step 3?

We have fundamental concerns with the proposed adjustment to allowed returns.

Firstly, it is imperative that Ofgem accurately measures and evaluates the actual equity returns achieved in the industry. This starts with a full RoRE calculation, adjusting for timing and incorporating all items that may impact equity returns, including financing and tax performance, together with capital structure. This will set the correct context on industry performance and financeability.

Secondly, past performance is not a guarantee of future performance. We believe that the only justification for an adjustment to the allowed return is that Ofgem has *designed* the framework to deliver a target level of out/under performance. This would be incredibly complicated to construct and demonstrate. It would also need calibration across the framework, particularly if Ofgem persists with the implementation of the proposed RAMs. For example, if Ofgem expected companies to outperform by two percentage points and reduced allowed returns to compensate, then the RAM centre points would need to be at AR+2%.

Assuming that any measure of past performance will simply 'repeat' in RIIO-2 is inadequate. The RIIO framework contains all the tools necessary for Ofgem to design a neutral determination, without further adjustment to allowed return. Changes proposed already to RIIO-2 are fundamental. To substantiate any adjustment and retain credibility, Ofgem must provide detailed assessment and justification.

Thirdly, CAPM calculates the minimum return that investors would require for a given level of risk. If Ofgem adjusts for a level of expected outperformance that does not materialise, allowed return will be set below minimum level, potentially, breaching the financeability duty in respect of equity investors.

Finally, if Ofgem introduces this mechanism, it will create future expectations about the calibration of a similar mechanism in future price controls, which will inherently lead to long term investment uncertainty.

We support the arguments presented in Frontier's paper ("Adjusting Baseline Returns for Anticipated Outperformance", *March 2019*) advocating:

- the relative societal benefit of aiming up compared to the harm to consumers of underinvestment; and

- the flawed nature of the theoretical foundations of the MPW report on which Ofgem is basing the allowed ‘v’ expected return argument.
- that analysis suggests performance is not a one way bet when looked at over a longer period than just the recent price control.

FQ20. Does Finance annex appendix 4 accurately capture the reported outperformance of price controls?

Within appendix 4, Figure 22 is an extract from the Citizens Advice ‘Many Happy Returns’ 2015 publication. There is no referencing within the document itself as to where the data and performance measures have been sourced, although it is inferred that the data is based on RoRE. Without references such data cannot be relied upon.

The remainder of appendix 4 which relates to the Energy sector using RoRE as a measure of outperformance. These numbers put forward in the remaining data and tables are flawed as they are based on an incomplete RoRE measure which fails to reflect actual company performance at a post financing and tax level as reflected in Ofgem’s Annual report 2018.

The information presented in appendix 4 should be represented to use correct RoRE data, including financing and tax performance now that Ofgem has published this data.

FQ21. Is there any other outperformance information that we should consider? We welcome information from stakeholders in light of any gaps or issues with the reported outperformance as per Finance annex appendix 4.

As we note in our response to FQ20 above, RoRE should be measured on an actual, post financing and tax basis to correctly reflect performance of the Energy Sector, in line with the new RFPR Ofgem have introduced. Analysis conducted to date to arrive at performance conclusions in the consultation should be re-considered in light of this updated performance measure.

There also needs to be clarity when distinguishing between returns. The consultation document is not always clear which returns measures are being referred to.

4 Financeability

FQ22. What is your view on our proposed approach to assessing financeability? How should Ofgem approach quantitative and qualitative aspects of the financeability assessment? In your view, what are the relevant quantitative and qualitative aspects?

Ofgem’s financeability duty was imposed because Parliament recognised that it was in customer’s long term interests to ensure that licensees, absent specific inefficiencies, could attract patient, low priced debt and equity.

While we appreciate the pressure GEMA is under in conducting this review; a course of action that acts to rethink the basis for financing this industry cannot be continued without widening this debate to the whole of Government. Global investment into this sector has been a huge success for

thirty years, and policy departures that change this will need as wide an audience and as strong an evidence-based case for change as possible.

Adopting a simplistic, all sector approach could easily result in efficient companies who may suffer from an accident of timing becoming unfinanceable, thereby increasing the perceived risk by investors of the sector, to the detriment of customers.

Ofgem should consider the financeability of each network company individually, taking into account company specific information, including derivative positions and other extant circumstances.

As the need to attract and retain capital applies equally to debt and equity, the financeability duty and therefore the approach to assessing financeability is applicable to both components.

The cash flow floor mechanism has been designed to give reassurance to one group of capital, to the possible detriment of the other.

In paragraph 4.12, Ofgem states its intention to focus on 'notional companies' in assessing financeability. We note that Ofgem, in its March 2018 RIIO-2 Framework Consultation (7.4), stated that it will set the baseline allowed return in RIIO-2 to ensure that an efficient, notionally geared company is able to finance its regulated activities through both debt and equity. This assessment is potentially very different to a 'notional company', which implies that all aspects of a company's performance and position are average, rather than simply its gearing level. Ofgem should provide clarity on this point.

We believe that considering financeability, based on a notional company, without regard to licensees specific circumstances is likely to result in a worse outcome for customers and regions in the long term. It will either result in customers paying more than would be needed to meet a sector's debt costs, or it will create financeability issues for certain networks, resulting in service delivery instability, higher longer term bills and the negative consequences associated with delayed or reduced investment.

In formulating its methodologies, as we have noted before, Ofgem should carry out impact assessments on each licensee to ensure that its proposed methodologies leave all licensees financeable.

Historic corporate financing decisions were based on the regulatory environment at the time and all networks have ensured financeability to date.

As the financeability duty applies to both debt and equity investors, requiring investors to ensure the financeability of debt investors, without regard to the financeability of equity, is not desirable nor is it in line with Ofgem's financeability duty.

For networks that operate close to notional gearing, considered to be an efficient reflection of competitive market capital structure, financeability issues created by the RIIO-2 regulatory package will be considered by the market to be more reflective of inappropriate economic design or calibration.

Requiring that networks delay dividends, or investors inject more equity is value destructive to equity and therefore to the long term financeability of networks. Pension fund investors in particular, are sensitive to such changes. This would undermine the confidence in the UK regulatory system.

To request that Ofgem should instead set allowances at a sufficient level to ensure company financeability does not equate to asking consumers to compensate companies for poor financing decisions, it only reflects the need for businesses to have sufficient headroom available to be able to withstand periods of uncertainty.

We would reiterate that it is in the long term interests of consumers to ensure licensees are financeable. Ofgem should be clear to ensure that consumers' interest in the long term receive as much attention as their interests in the short term, recognising that its duty is to take consumers' interests as a whole.

We agree that financeability needs to be assessed in the round, including all aspects of the price control. It should be based primarily on quantitative measures, but it is also correct to consider qualitative measures.

To grant an investment grade rating, agencies typically discount outperformance to reflect uncertainty, while also requiring some performance headroom to protect downside risk. Ofgem should be mindful of these factors when constructing the overall regulatory package.

Key quantitative measures include PMICR (including Fitch's nominal definition), FFO/net debt (including lease-adjusted figures), absolute post-financing and tax returns and variability in those returns.

Key qualitative measures include regulatory confidence, political uncertainty, and RAMs uncertainty.

We do not believe the cash flow floor mechanism as proposed will ensure investment grade ratings for networks. It is not clear that it is in the interests of consumers and other stakeholders particularly in the long term. Financeability should be assessed and ensured without the cash flow floor mechanism.

FQ23. Do you agree with the possible measures companies could take for addressing financeability? Are there any additional measures we should consider?

Ofgem has a duty to ensure financeability for both debt and equity holders. Neither debt nor equity holders should be required to disadvantage themselves for the benefit of the other.

We do not agree that the onus is solely on equity holders to solve financeability concerns, particularly when those concerns arise as a result of the regulatory environment. It was to both avoid (and to assure any equity investor that it would avoid) financeability issues arising from an inadequate regulatory settlement, that the financeability duty was placed on Ofgem by Parliament.

Companies should only be required to take such action when financeability is threatened from elements within the company control (e.g. inefficiencies).

Mechanically, we are in agreement with the ways listed that companies could address financeability, however we disagree on the grounds that it is not in the long term interests of consumers.

Restricting dividends, equity injections and re-financing of existing debt would materially impact overall equity returns. Dividend policies take time to have material impact and there is limited scope for such restrictions to be effective for issues arising on RIIO-2 implementation.

Refinancing expensive debt is, at best, NPV neutral. This is arguably just a variant on adjusting dividends and equity injection. Future returns need to be attractive enough to attract equity for the long term.

If Ofgem place the onus solely on equity holders to address financeability concerns, we believe there is likely to be a very negative impact on the long term attractiveness of the sector for investors. This would be particularly damaging for post-Brexit Britain.

The economic policies underpinning the finance elements of the framework should be reflective of competitive markets and balanced forecasts, not be distorted to reflect short term reduced consumer bills at the expense of their long term impact.

Infrastructure funds and pension investors target stable, RPI linked, positive returns. Pension funds are the long term providers of patient capital which require inflation-linked returns above RPI. This is specifically RPI, and not any other inflation measure, as RPI has been frequently written into UK pension trust deeds as the inflator for pension liabilities.

FQ24. Do you agree with the objectives and principles set out for the design of a cashflow floor?

The price control should ensure financeability without the need for any additional mechanism.

The financeability duty covers both equity and debt, and the cash flow floor, as structured, would protect debt only, while carrying additional risk for equity holders.

It is essential that Ofgem considers the appropriate counter-factual when assessing the benefits of policy decisions. A safety mechanism will always be viewed as a benefit in isolation, but it should never be considered separately from the danger that is otherwise being introduced through other mechanisms. In this instance, the threat to financeability that is being introduced from removing any headroom from the cost of equity determination.

In addition, by defining its financeability duty by the performance of notional companies, Ofgem is seemingly setting a financial framework that will place certain companies in an unavoidable and financially precarious position. It is then requiring equity investors to introduce more capital to rectify, while justifying this approach with the introduction of a bailout mechanism.

Reducing the equity allowance as proposed will result in less headroom to deal with downside scenarios and this will be considered credit negative for the sector, as Moody's states "If a mechanism is eventually devised that successfully removes the need for Ofgem to allow any headroom to financing costs, the credit quality of the sector is likely to be weakened." (Credit quality likely to weaken in RIIO-GD2 regulatory period, *14th February 2019*). We believe a 'fair' price control would be sufficient to ensure financeability.

The effect on customers of a company failure or indeed, the indirect impact of a punitive price control (reduced investment, less innovation) is potentially more significant than the potential benefit gained from short term reduced equity returns.

The cash flow floor is based on actual company projections, not those of the notional company. Ofgem acknowledges here that it needs to consider actual performance of companies, however only intends to assess its own financing duty on a notional basis. This approach would appear to be disjointed.

We encourage Ofgem to define ‘material company underperformance’. If a company were to trigger the cash flow floor based on baseline performance, with no incentive revenue, this would imply Ofgem has failed to comply with its financeability duty, potentially resulting in legal claims from equity holders.

Regarding the definition of Expected Cash Available (ECA), we believe this measure must only include committed facilities, excluding those from related parties. Ofgem should not allow companies to assume that they can simply raise finance in the future to cover shortfalls as periods of market instability can threaten this assumption and undermine the process.

Ofgem also need to provide guidance on how inflation should be considered in any liquidity forecast. Inflation will impact operational and financing costs, including accretion, indexation and cash interest. It will also impact RAV projections and forecast incremental borrowing capacity, however we note that these components may be less important if Ofgem restricts the definition of ECA to committed facilities only.

Electricity North West operates with an internal risk management policy of holding eighteen months liquidity. Ofgem’s proposal for a liquidity forecast supports the view that pre-financing of maturing debt is prudent, effective risk management and that it is reflective of market practice. As such, Ofgem must ensure that pre-financing costs are appropriately and fairly reflected in the debt allowance.

As is currently proposed, the definition of Debt Service Requirement (DSR) requires the consideration of collateral postings in the event of a three notch downgrade in ratings. Our debt facilities contain covenants that are aligned with the regulatory framework. A three notch downgrade would place us below investment grade and in default for all agreements and we are unlikely to be alone in this regard. We therefore propose that any consideration of credit rating downgrades must be restricted to a floor of BBB-/Baa3.

We note that the structure is complex and while this should not be a barrier in itself, we also note Ofgem’s reluctance to introduce more accurate mechanisms elsewhere, including debt indexation, on the basis of complexity.

Tariff increases at short notice are likely to be problematic for energy suppliers and may lead to increased volatility in consumer bills. The proposal needs extensive consultation with other stakeholders before proceeding further.

We also propose Ofgem consults with credit rating agencies to ensure that it would indeed have the intended protection on ratings and that therefore the mechanism is effective.

Dividend restrictions may result in defaults higher up the ownership chain. Ofgem should be cognisant that this mechanism could ultimately lead to bond holders owning and controlling UK infrastructure assets.

FQ25. Do you support our inclusion of and focus on Variant 3 of the cashflow floor as most likely to meet the main objectives?

We agree that variant 3 is most likely to meet Ofgem’s objectives.

5 Corporation tax

FQ26. Do you support our proposal that companies should seek to obtain the "Fair Tax Mark" certification?

Yes, we support this proposal and are currently seeking to obtain this certification.

FQ27. Is there another method to secure tax legitimacy other than the "Fair Tax Mark" certification? Could we build upon the Finance Acts (2016 and 2009) with regards to the requirement for companies to publish a tax strategy and appoint a Senior Accounting Officer?

Tax information has been shared previously during the recent ring-fence study and we are comfortable with repeating this at regular intervals.

Ofgem should consider duties specified in FA (2016 and 2009) in its risk assessment, however we do not consider it necessary to incorporate these items explicitly into the regulatory environment.

FQ28. For Option A, how should a tax re-opener mechanism be triggered? Is there a materiality threshold that we should use when considering the difference between allowances and taxes actually paid to HMRC? If so – what might this be?

Any mechanism needs to be symmetrical, and also needs to be based on amounts payable to HMRC, not physically paid to HMRC.

Electricity North West is part of a tax group, with net amount of tax due across the Group being paid to HMRC.

The key area of difference between allowance and taxes payable to HMRC is timing. It is critical that any assessment is adjusted for time differences. We note that this is highly complicated and the time required by both networks and Ofgem to evaluate and consider this complexity should not be under estimated.

Any threshold to adjust should be based on materiality, with a dead-band mechanism.

6 Indexation of RAV and calculation of allowed returns

FQ29. What is your view on our proposal for an immediate switch to CPIH from the beginning of RIIO-2 for the purposes of RAV indexation and calculation of allowed return?

The energy sector averages less than 30% index-linked debt. We currently operate with close to 65% index-linked debt on a post-derivatives basis. As it is not part of a wider group, we have chosen to hedge the RPI exposures arising from the debt allowance mechanism: the mechanism strips out embedded (fixed) RPI at debt issuance and pays variable RPI through RAV accretion. As a result of this hedging, with the switch from RPI to CPI (H) Electricity North West is among the most exposed network to the proposed change to CPIH without any transition mechanism.

Index-linked debt provides inflation protection in price controls. The UK price control framework has for many years been linked to RPI. Our structure is based on effective risk management, not risk taking.

An immediate switch, without transition arrangements, will result in basis risk for networks especially where a licencee has hedged its inflation risk. While an immediate switch may be considered manageable on a sector basis, Ofgem will need to consider individual company positions and impact.

Ofgem is not convinced the proposed change to CPIH without any transition mechanism will have a material impact. We request that Ofgem share its analysis and impact assessment that arrives at this conclusion.

Pension funds need RPI linked debt and it is held to hedge the pension liabilities frequently written into trust deeds as RPI. The market for CPI(H) debt is in its infancy, and CPI(H) debt will not offer this same protection. Therefore the appetite and/or cost shown by pension schemes for such network company debt will be impacted.

RPI-CPI(H) swaps are available, but are costly. If Ofgem is intent on moving to CPIH without a transition arrangement, Ofgem should factor these additional swap costs in to any debt allowance assessment.

We note potential complications elsewhere in price control (e.g. absence of breakeven CPI inflation). These are not inconsequential and should be given due consideration by Ofgem before finalising a decision.

FQ30. Is there a better way to secure NPV-neutrality in light of the difficulties we identify with a true-up?

It is critical that Ofgem deliver NPV neutrality. Any assessment of NPV neutrality needs to consider the actual equity investor perspective. It is imperative that this is based on dividend NPV to ensure that no value leakage has occurred. Ofgem needs to share its methodology to enable proper consultation.

While true-up approaches may indirectly link the price-control to RPI, this is not necessarily undesirable and could benefit transition. Basis risk would also be reduced.

We do not believe that a transition arrangement for the move to CPI(H) should be disregarded.

Value neutrality should be measured at outset and, as a minimum, end of regulatory period. We agree that any true-up mechanism should only remain in-force for one regulatory period.

7 Other finance issues

7.1 Regulatory depreciation question

FQ31. Do you have any specific views or evidence relating to useful economic lives of network assets that may impact the assessment of appropriate depreciation rates?

We welcome the fact that Ofgem are open to exploring further changes in depreciation policy, subject to the economic principal of intergenerational fairness.

Depreciation policy and asset lives are levers that can impact key ratios, including FFO to net debt. To the extent that other changes to the framework for RIIO-2, once seen together as a complete package, may negatively impact the future financeability of the network companies, changes to asset lives and depreciation should be considered.

7.2 Capitalisation rates question

FQ32. Do you agree with our proposed approach to consider capitalisation rates following receipt of company business plans?

We cautiously support the proposed approach by Ofgem to tailor capitalisation rates to individual company requirements following receipt of business plans. It should remain an option, but used only in limited circumstances, as it could undermine intergenerational equity. However, capitalisation rate adjustment can only be of limited value, as significant variation in rates will affect the market view of cash flow.

We recognise that adjustment of capitalisation rates can affect cash flows and financeability and our preferred solution to the prospect of financeabilty problems is to correctly assess and calibrate the regulatory framework in the first instance.

7.3 Notional gearing question

FQ33. Do you have any comments on the working assumption for notional gearing of 60%, or on the underlying issues we identify above?

We note that the consultation document was silent on the subject of notional gearing for Electricity Distribution for both RIIO-1 and RIIO-2, combined with the current ED-1 assumption of notional gearing at 65%. We expect that a separate ED assessment will be taking place in future consultations.

In terms of a separate ED2 assessment of notional gearing, we strongly believe that this should remain at 65% as per the current ED1 assumption.

Consequently, this requires Ofgem to re-gear the value of Beta accordingly.

Electricity North West's current financing structure is based upon a gearing level of 65%, which is designed to align with this long term Ofgem assumption. We have issued long-term debt to match the long life of our assets with varying maturities. If Ofgem were to change the gearing assumption for ED2 we would incur substantial costs aligning our debt portfolio.

7.4 Notional equity issuance costs question

FQ34. Do you agree with our proposed approach to consider notional equity issuance costs in light of RIIO-2 business plans and notional gearing?

We support an approach by Ofgem that tailors notional equity issuance costs to individual companies following receipt of business plans.

This follows from our belief that the existing mechanisms do not compensate adequately for the raising of notional equity.

We believe further compensation would be needed in the event that companies would need to raise equity as a consequence of the transition to RIIO-2.

Without adequate compensation, any change in the notional gearing level will have a significant impact on company valuations, potentially impacting the investor appetite of pension fund investors.

7.5 Pension funding question

FQ35. Do you agree that for RIIO-2 we align transmission and gas distribution with electricity distribution and treat Admin and PPF costs as part of totex?

Yes, we agree that for RIIO-2, the treatment of these costs should be aligned with Electricity Distribution for Transmission and Gas Distribution, as the treatment of these costs should be consistent across all sectors.

7.6 Directly Remunerated Services question

FQ36. Do you have any views on the categories of Directly Remunerated Services and their proposed treatment for RIIO-2?

It is noted that the consultation document outlines proposals for the Electricity Transmission, Gas Transmission and Gas Distribution sectors and is silent on Electricity Distribution.

It is assumed that that Electricity Distribution will be considered separately in future consultations with proposals provided by Ofgem, at which point we will be able to provide our views on the Directly Remunerated Services proposed treatment for RIIO-2.

7.7 Disposal of assets question

FQ37. Do you have any views on the potential treatment of financial proceeds or fair value transfers of asset (including land) disposals for RIIO-2?

We believe the current RIIO-ED1 arrangement, whereby cash proceeds are netted off against totex from the year in which proceeds occur, is appropriate.