Annex: Finance questions

Northern Powergrid's RIIO-T2 and GD2 methodology response

March 2019

Contents

1. Cost of debt questions

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

1. On the cost of debt, Ofgem should now continue its ED1 approach, as it proposes

2. Given Ofgem has ruled out pass through and debt cost sharing, we can see advantages from full indexation, essentially re-running the ED1 approach.

3. We previously advocated a cost of debt based on pass through of company costs, which would be straightforward for Northern Powergrid (with its transparent and conservative approach to debt financing) but which may be challenging for those companies with a less transparent cost of debt. Ofgem has decided against this approach.

4. With this decision taken, Ofgem should now maintain its full indexation approach:

    a. On a sector specific basis; and

    b. Recalibrated at successive review, where the evidence shows this is justified, to match the expected real debt cost of the sector.

5. This is essentially in line with the approach taken at RIIO-ED1, although technical refinements are warranted (as detailed below).

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

6. We agree that this proposal is logical given Ofgem's stated reasons for ruling out pass through (or similar) approaches to the cost of debt.

7. We think that debt sharing, or even pass through of debt costs, could be applied if all companies shared the transparent, simple, and conservative approach to debt financing that Northern Powergrid takes. However, in light of the implementation issues Ofgem highlights at paragraph 2.12 of the finance annex to the Consultation, Ofgem's decision to rule out pass through on a sector wide basis is logical.

8. Given the reasoning set out in paragraph 2.12, logic dictates that debt sharing should not be allowed in any circumstances. This necessitates that financing performance be removed from the proposed return adjustment mechanism , because including it would:

    a. amount to a sharing factor on the cost of debt through the back door; and

    b. require robust measurement of the cost of debt on an annual basis

9. Ofgem has ruled out the former because it would not be able to achieve the latter (or because this would be too costly). We assume Ofgem therefore does not intend to take the steps necessary to measure the cost of debt robustly on an annual basis.

10. Debt sharing would only happen in certain circumstances if it was included in a RAM. However, the potential cost to consumers if it did happen would be high as, if our understanding is correct, the necessary controls on observed debt costs would not be in place. Companies that take a less transparent approach to their debt costs than Northern Powergrid may, for example, be able to massage how their debt costs are spread over time in order to offset performance factors that would otherwise lead them to trigger the RAM. If Ofgem is not undertaking detailed monitoring of debt costs on an ongoing basis, it would never be any the wiser.

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?

11. We agree with the next steps.

12. In line with the approach signalled in the RIIO handbook, of a longer term commitment to debt financing costs, and Ofgem's principle of exposing companies to incentives over their debt costs, Ofgem should also explicitly retain discretion to retain the pre-existing RIIO-1 index in relation to a specific sector or company. This might be appropriate to where, for example:

    a. expected out- or under- performance in the RIIO-2 period is a direct consequence of company decisions in the RIIO-1 period that Ofgem considers should be exposed to incentives (for example this may apply to decisions to swap fixed rate debt to variable rate debt); or

    b. a single company's financing decisions could have a determining effect on a sector's debt allowance, if a mechanistic approach to index recalibration is followed, which may require Ofgem to pass through debt costs in circumstances where it would otherwise choose not to.

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?

13. Ofgem should use option (ii) from paragraph 2.14, specifically by deflating the nominal iBoxx using an expected value of CPIH.

14. Ofgem is right that there are issues with the current use of 10 year RPI inflation break-evens to deflate nominal debt costs, and as a consequence should use a five year forecast for CPIH (or CPI) to deflate nominal debt costs.

15. This is because the price control:

    a. Is moving to a CPIH basis, which is lower than RPI;

    b. Will only be five years long, with inflation beyond this accounted for at the next reset.

16. The value used annually, to deflate the nominal iBoxx index, should be calculated the same way, or possibly on a shortening time horizon (to align with the end of the price control period).

17. Ofgem will need to use reputable economic forecasts, such as the OBR's inflation forecasts, irrespective of whether it uses the "wedge" approach or the direct estimate approach. Because economic forecasts need to be used anyway, Ofgem should apply the CPI forecast directly, which will also have the benefit of avoiding any distortions in RPI linked inflation breakevens.

2. Cost of equity questions

Risk-free rate questions

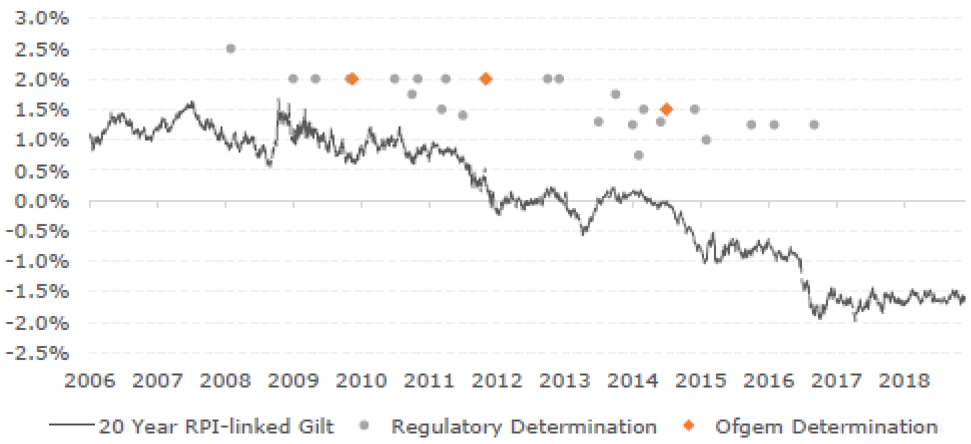
FQ5. Do you agree with our proposal to index the cost of equity to the risk-free rate only (the first option presented in the March consultation)?

18. Equity indexation is not necessary; the cost of equity is a long term parameter that can be reset every five years.

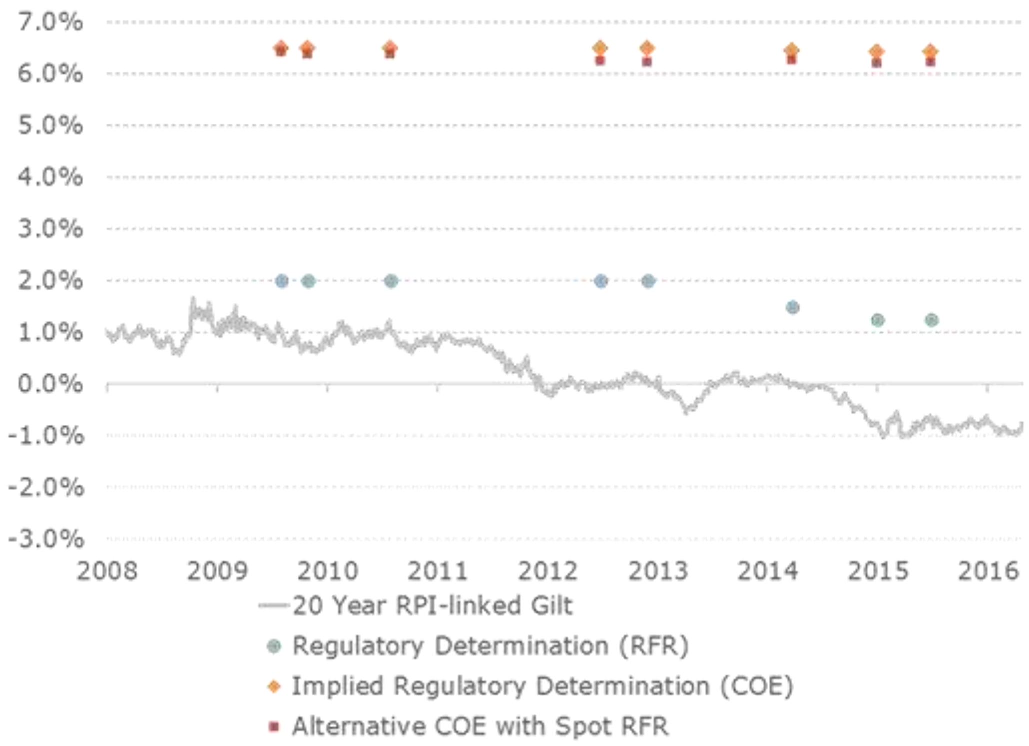
19. We are concerned that the Authority and other stakeholders have concluded that regulators have "aimed up" on the risk free rate ("RFR") and in doing so materially inflated the cost of equity. But this is not the case and should not be concluded from the chart presented in the consultation (and reproduced below).

20. The chart creates entirely the wrong impression for the consequence for the cost of equity. In the context of a set of settlements that (correctly) used a relatively fixed set of TMR estimates, and equity betas close to one, the impact on the cost of equity will have been far smaller than the chart seems intended to suggest.

Figure 5: The RPI risk-free rates: gilts versus regulatory precedents



21. The chart below shows how different the picture looks when the evidence is presented in full.[1]



22. The impression may have been created amongst some stakeholders that a very material error has been made by failing to use spot RFR[2]. This is clearly not the case. Although regulators have aimed up on the risk free rate, this has made very little difference to the cost of equity they have allowed.

23. But if Ofgem does index the cost of equity, the formula it has proposed, putting to one side the exact parameters, is the least damaging of the options.

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?

24. The cost of equity is a long term parameter and a long term gilt rate is therefore appropriate for the risk free rate used in estimating it.

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[1] For illustration purposes, we have adopted a fixed TMR of 7% and an equity beta 0.9 to estimate the effect of the adopting an estimate of RFR above spot levels.

[2] This is not the only issue with Ofgem's chart. The chart only shows spot rates with the benefit of hindsight, rather than a forward curve for expectations at the time of the settlement, which is the relevant market based comparator. We are also surprised by the figure for the risk free rate for ED1 as we had previously been informed that Ofgem and GEMA made no explicit assumption for this value in taking its ED1 equity returns decision, and that a 1.5% figure published by UKRN (and subsequently reproduced elsewhere) was erroneous. The ED1 equity returns decision itself stated that '*Focusing on the most up to date data … the implied forward rate rises to a peak of around 0.7–0.8 in nine years' time, before declining again. Hence, the latest market evidence suggests that* ***the risk-free rate over the RIIOED1 control period is unlikely to be as high as our previous range*** *(after adjusting for the RPI formula effect)* ***of 1.3 to 1.6 per cent****' (page 9, emphasis added)*. These statements make a point value of above 1.3 per cent unlikely and would instead place Ofgem's ED1 decision closer to the curve than many contemporaneous regulatory settlements.

25. We do not think that a real-RPI linked coupon should we used, and comment further on this in our response to FQ8 below.

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?

26. Equity indexation shouldn't be based on the risk free rate in the October before the relevant regulatory year. This would:

  a. expose investors to volatility in that month; and

  b. mean equity returns lag Ofgem's intended level for a sustained period, in a rising risk free rate environment.

27. Indexation should instead use data for the relevant year, which the financial model could accommodate, and which investors could see develop in real-time. This would necessitate the use of a forecast and a true-up, but the financial model already uses this approach for some other items.

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

28. No, Ofgem is moving away from RPI and should discontinue use of RPI linked data.

29. RPI linked gilt rates will reflect RPI-specific inflation expectations, and any other distortions that are specific to RPI linked assets. There is also ongoing uncertainty over the basis of RPI measurement.[3]

30. Since Ofgem is moving energy network RAV away from RPI indexation, it should not continue to use data that will reflect RPI in any approach to indexing the cost of equity on a year-to year basis. Instead a long term, nominal gilt, should be deflated using a credible long term expected value for CPIH (or CPI if eventually used in the settlement), such as the Bank of England's inflation target.

TMR questions

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)?

31. We generally support the views raised on behalf of the Energy Networks Association.

[3] For example the House of Lords Select Committee on Economic Affairs, in its January 2019 report on measuring inflation, recommended that consent be given by the Chancellor of the Exchequer to any changes recommended to RPI by the UK Statistics Authority.

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?

32. We generally support the views raised on behalf of the Energy Networks Association

33. Ofgem has re-interpreted the historical record on inflation as being consistent with CPI rather than RPI, and reduced its range downwards as a consequence. Ofgem has little or no evidence on historical inflation or returns that was not available when the Competition and Markets Authority ("CMA") took its decision to set a range equivalent to ca. 6% - 7.5% plus CPIH in the NIE price control reference. The evidence Ofgem has presented does not justify lopsidedly narrowing the CMA's range to truncate the top half of that range. A measured appraisal of the evidence on TMR, consistent with established precedent, would increase Ofgem's cost of equity range by at least 50 basis points.

34. The fact is that the UKRN figures were calculated using an inflation dataset which cannot be assumed to be consistent with CPI inflation since significant parts of the dataset use an inflation measure which is viewed as the best available proxy for RPI inflation. The only logical interpretation is that that the values are consistent with a higher total market return than Ofgem concludes.

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?

35. The reconciliation only covers a 50bps reduction in the estimated TMR. Of this, only 25bps is associated with the move from the Dimson Marsh and Staunton inflation dataset to the Bank of England's experimental Millennium dataset. Yet the inflation related reduction in the TMR is actually more like 100 basis points, three quarters of which has been omitted from the chart.

36. This omits a large part of the reduction in TMR actually being proposed. This omitted balance results from revisionist views on inflation. The 2003 and 2006 values were linked to RPI, whereas Ofgem has linked the 2018 values to CPI. Assuming a value for the long-run gap between RPI and CPI in 2003 and 2006 of, say, 70-80 basis points, the reconciliation would actually need to explain a gap of more like 120-130 basis points, not the 50 shown.

37. Ofgem has talked about value neutrality in making the switch from RPI to CPIH. This necessitates adding approximately 100 basis points to the cost of equity. Yet the "missing portion" of the reconciliation also proves that Ofgem has used that same switch from RPI to CPIH to justify reducing the TMR assumption by about 100 basis points. As a consequence, companies will get an annual RAV increase which is about 100 basis points lower, while they will get little or no increase in the cost of equity. This is not value neutral. It is nothing like it.

Equity beta questions

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, degearing and re-gearing, and the focus on UK companies?

38. Ofgem has failed to reference some of the issues that stakeholders, including Northern Powergrid, have raised at the Framework Consultation stage and since.

39. This includes the critical issue of accounting for political and regulatory risk. In determining where to locate its range for the cost of equity, Ofgem has not considered the role of political or regulatory risk and how this raises required returns in the sector above those which CAPM estimates will provide. These risks are on balance to the downside, and will not be fully correlated with the stock market and caught by beta. We highlight this, and the need for an evaluation of this missing risk, in our response to the Framework Consultation.[4] When Ofgem briefed its proposals to investors, we understand it was one of their first questions, and one that Ofgem could not adequately answer Ofgem must consider the balance of these risks when determining the cost of equity. So far it has failed to do so, instead choosing, across the board, to place most weight on the evidence that supports the lowest conceivable number. The end result is a range for the cost of equity that is inconsistent with a balanced appraisal of the evidence and is manifestly too low.

40. In terms of the technicality of the calculation, Ofgem has made mistakes. We provide details of these in our response to FQ15 below.

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

41. The report does not provide a basis for moving away from accepted practice in beta estimation. It is quite clear that there are circumstances in which OLS estimation is appropriate. The results also appear to confirm that the choice between OLS and GARCH makes relatively little difference, for a given time period and data frequency.[5]

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

42. The Indepen report proposes a non-textbook re-gearing adjustment, without setting out any theoretical basis for the adjustment. The adjustment suggested is also vague, caveated, and not suitable for direct use in a regulatory calculation. While Indepen has protected itself through its choice of words, by refraining from recommending a specific adjustment, Ofgem has directly applied the "suggestion" with no further consideration. Ofgem's summary of the Indepen report admits that

[4] Northern Powergrid's RIIO-2 Framework Consultation response paragraphs 357, 363-364 and 368

[5] To allow a proportionate response to matters being consulted upon, we have limited our review and response to the summary of the report presented in the Consultation.

this is a departure from the traditional approach. This novel and unjustified approach should be avoided, for the same reason that Ofgem has stated in the Consultation that it will re-gear.

43. Ofgem's summary of the Indepen report also states that Indepen suggests that different GARCH models would be suitable for different network companies on theoretical grounds. No theoretical basis is provided for this, or for model selection for specific companies, and the proposals sounds like data mining through model selection.[6] There is no sound basis for a move to GARCH models.

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

44. Ofgem has made two errors in its re-gearing of beta:

   a. An arbitrary 10% adjustment is applied to market gearing based on Indepen's "view" that an adjustment should be made "until further research has been undertaken", where 10% is just a suggestion ("say 1.1x") as a "starting point".[7]

   b. Spot gearing rates have been used in Ofgem's re-gearing calculation, rather than gearing rates over the whole estimation window, with no justification.

45. Both of these are departures from standard and long accepted practice by respected regulators and finance practitioners around the globe. Ofgem's calculations are flawed and these adjustments should be reversed. We estimate that correcting these errors in beta calculation alone would increase Ofgem's point estimate of the cost of capital by more than 100 basis points.

46. We would highlight in particular that Ofgem is wrong to state at paragraph 3.106 (seventh bullet point) that '*Raw beta estimations are more reflective of actual investor costs and avoid the potential for the effects of gearing to be misunderstood*'. This ignores textbook finance theory, and the fact that risks are more tightly concentrated on equity when equity represents a smaller proportion of a company's value. It is Ofgem and Indepen's statements that encourage the effects of gearing to be misunderstood.

Cross-checking the CAPM-implied cost of equity questions

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

47. It is standard practice to apply various forms of cross checks to CAPM estimation, when applied in the context of regulatory determinations.

48. However, Ofgem needs to apply the cross checks as a genuine check, not through a lens designed to confirm a prior view that allowed equity returns should be low. The Consultation still belies Ofgem's

[6] To allow a proportionate response to matters being consulted upon, we have limited our review and response to the summary of the report presented in the Consultation.

[7] Indepen, *Ofgem Beta Study - RIIO-2*, pages 34-35

pre-disposition to evidence that confirms a low-view. In particular, in its comment on risk versus return it lists a set of risks protections[8] but fails to mention:

a. the political and regulatory risk that energy networks are exposed to;

b. how the profile of political risk has changed recently; or

c. the fact that many of Ofgem's proposals for ex post clawback mechanisms and assessments would raise regulatory risk.

49. Having undertaken an entirely partial analysis of risk, the Consultation goes on to state that "as a result of our assessment of risks above, in the round, we expect networks to be low beta assets (consistent with an exposure to risk that is considerable lower than that facing the average stock market firm)".[9]

50. As well as being based on a flawed assessment of risk, this statement omits to highlight that the 60% gearing assumption Ofgem has made in setting its CAPM allowed cost of equity is significantly higher than the gearing of the average stock market firm. This difference in gearing will "soak up" a material difference in equity risk between the underlying investments.

51. Ofgem goes on to say "this [analysis] gives us confidence that the cost of equity derived from the CAPM is consistent with the risks likely to be borne by network companies in RIIO-2". These statements demonstrate that Ofgem's choice of cross checks, and their interpretation, suffers from confirmation bias.

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?

52. Ofgem's cross-checks on the cost of equity range are flawed

53. Turning to Ofgem's cross checks, the Consultation fails to see obvious warning signs. In particular, Ofgem has not highlighted that market to asset premia on listed water companies have disappeared, as Ofwat has re-based expected allowed returns in the water sector to 5% plus CPIH from 2020. We reproduce the chart in the Consultation below:[10]

[8] The Consultation, page 128, paragraph 11.25

[9] The Consultation, page 129, paragraph 11.27a, first bullet point

[10] The Consultation, Finance annex, page 43

Figure 11: Market-to-asset ratios of three publically listed companies

Source: CEPA analysis

54. Instead of recognising the latest position, Ofgem's commentary bizarrely highlights that "We can see that these listed companies have been trading at a premium for the majority of the previous nine years. This implies that investors may expect the return on the RAV to be greater than their costs of capital".[11] Yet the majority of the previous nine years don't reflect recent valuations in current market conditions, in light of the risks facing networks in general and Ofwat's proposals on the cost of equity.

55. The up-to-date results instead signal that markets expect water sector returns to be aligned with the expected cost of capital, at a return on equity for the next regulatory period of 5% plus CPIH (including any uplift that might happen on appeal). Ofgem must recognise the balance of the evidence.

56. Better sense checks clearly show that the equity beta and total market return are being calibrated too low.

57. Ofgem should be able to see that the range is set too low with some simple sense checks: if the ten year yield on RPI linked gilts returns to 2.0% real, and debt spreads are at typical levels of circa 150 basis points, its equity return would be only 80 basis points above debt returns.[12] This will not encourage equity investment because equity carries the vast majority of the operational, political and regulatory risk involved in operating the regulated assets. Ofgem's base calibration is manifestly too low, and a higher equity beta is necessary, which would give a higher spread over debt returns at a higher risk free rate.

58. Ofgem should be setting a range that is higher, and choosing a value in the top half.

59. By way of comparison, Ofwat is proposing a value 100 basis points higher than Ofgem; a value which could still be revised upwards in the price review or on re-determination by the CMA. And in the NIE

[11] The Consultation, Finance annex, paragraph 3.123

[12] The CPI linked cost of equity would be circa 5.3%, compared to a CPI linked cost of issuing new debt of 4.5%.

determination, the CMA adopted a cost of equity equivalent to ca. 5.1% plus CPIH at 45% gearing. Re-geared to 60%, the value would as high as 7.0% plus CPIH. In this context, Ofgem's 4.0% plus CPIH is implausible.

60. Ofgem should remove its erroneous adjustments on equity beta, and properly recognise the evidence from the water sector on listed asset premia.

61. Ofgem should revisit its approach to setting the TMR in the light of the switch from RPI to CPIH – it has chosen the most value destroying approach to dealing with the change, violating its commitment to NPV neutrality. Other approaches could be equally justified that would allow Ofgem to make good on its commitment and have a less damaging impact.

62. Ofgem should then choose a value at or towards the top of this range on the basis that setting too low and allowed cost of equity is more damaging to energy consumers than one that is the too high by the same absolute amount.

63. Ofgem should abandon its unjustified and arbitrary 50 basis points downward adjustment.

64. If Ofgem did this, it would arrive at a range for the cost of equity much closer to but, nonetheless, lower than the current ED1 settlement, while still being significantly below the T1 and GD1 settlements. This would be better aligned with the balance of the evidence and which would continue to encourage investment.

65. Taking all of these issues into account, the evidence shows that the appropriate cost of equity is in the region of 200 to 250 basis points higher than Ofgem's current assumption.

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

66. As well as a flawed assessment of the range, and inappropriate narrowing, Ofgem has failed to consult on its proposal, stated in the Consultation, to use the mid-point of its cost of equity range as its 'starting point', and in doing so Ofgem has ignored a well-established regulatory safeguard.

67. Having chosen a range for the cost of equity which is itself too low, Ofgem then chooses the midpoint of the range as its point estimate (prior to the 50 basis points adjustment that we discuss below). In other words, Ofgem has abandoned regulatory practice to date by assuming that the risks of setting the cost equity too high and of setting it too low are symmetrical.

68. The asymmetry of risk and the reasons for ensuring that the cost of equity is not too low have been repeatedly articulated by regulators, including the CMA and are summarised well as follows.

> *Given the uncertainties in cost of capital estimates, we considered the cost of setting an allowed WACC that was too high or too low. If the WACC is set too high then the airports' shareholders will be over-rewarded and customers will pay more than they should. However, we consider it a necessary cost to airport users of ensuring that there are sufficient incentives to invest, because if the WACC is set too low, there may be underinvestment from BAA or potentially costly financial distress…Given the significance to customers of timely investment at Heathrow and Gatwick, we have given particular weight to the cost of setting the allowed WACC too low. Most importantly,*

we note that it is difficult for a regulator to reduce the risks of underinvestment within a regulatory period.[13]

69. Academic evidence shows the consumer detriment from a cost of capital that is set too low is worse than the detriment from one set too high.[14] This is a considered reason that regulators, including the predecessor of the CMA, have given for decisions to set the cost of equity towards the top of their estimated ranges, in line with their respective duties to consumers.[15] Ofgem should do the same.

70. Looking more narrowly at the type of cross-checks Ofgem considers, the list should also be expanded to include direct estimates of the cost of equity from dividend growth estimation from individual stocks, e.g. listed water or energy networks.

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?

71. The cost of equity is Ofgem's incentive for investment. It is not an arbitrary number to add or subtract value from an overall settlement. Moreover, the process for setting the cost of equity should be recognisably similar to that used in previous reviews and rooted in objective evidence. This provides the reassurance of continuity to investors, enabling investments to be brought forth, and efficiency improvements to be made. Not only has Ofgem set the cost of equity too low, but the process by which it has arrived at that number does not provide the continuity of approach that reassures investors.

72. It is by now well understood in theory and practice that the costs to consumers of a regulator setting too low a cost of capital outweigh the costs of an error of the same magnitude being made in the opposite direction. This is why good regulatory practice is to establish a credible range for the cost of equity, and then position the outcome away from the bottom of the range. But Ofgem has proposed a cost of equity range that is already too low and has then chosen a value at the bottom of it. As far as we call tell, no regulator has ever aimed down to the bottom of its range in this manner.[16] It is not something a credible regulator should contemplate. Its approach will cause significant consumer detriment because investors will be unwilling to provide the equity finance necessary to make key long-term investments.

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[13] Competition Commission, *A report on the economic regulation of the London airports companies (Heathrow Airport Ltd and Gatwick Airport Ltd)*, September 2007, page 49. https://webarchive.nationalarchives.gov.uk/20111202214947/http://www.competition-commission.org.uk/rep_pub/reports/2007/fulltext/532.pdf.

[14] For example, Ian M. Dobbs, 2012, Journal of Regulatory Economics, 39(1) 1-29, *Modelling welfare loss asymmetries that arise from uncertainty in the regulatory cost of finance*

[15] For example, Competition Commission, 2007, *BAA Ltd A report on the economic regulation of the London airports companies (Heathrow Airport Ltd and Gatwick Airport Ltd)*, pages 49-50

[16] Frontier Economics working on behalf of the energy networks association identified no examples

73. One of the components of Ofgem's aiming down is its proposal for a downward adjustment of half a percentage point on the assumption that companies will outperform in other parts of the settlement.

74. This adjustment is not only without any merit in its own right, it also carries with it serious unintended consequences. It is without merit for several reasons:

   a. The evidence that Ofgem relies upon to support its assumption of continued outperformance (and to calibrate the 50 basis points) is based on a selective historical sample and also ignores the impact Ofgem's proposals in other parts of the price control settlement that will significantly reduce the future prospects for outperformance.

   b. The theoretical model that Ofgem relies upon is deeply flawed.

   c. A reduction to the cost of equity on account of an unrelated mis-calibration in another part of price control settlement would not be by definition well targeted. It would be manifestly badly targeted, and would violate the principles of better regulation, to which Ofgem must have regard.

75. The unintended consequences will be very damaging to investors and consumers alike. It will lead to:

   a. Erosion of investor confidence and increased investor risk, as it is:

      i) An arbitrary adjustment to previous practice, for which there is no known UK precedent or satisfactory conceptual or evidential basis; and

      ii) A retrospective claw-back of the value of past investments.

   b. Weakened incentives for efficiency and innovation, due to Ofgem clearly signalling that future outperformance will affect its future calibrations of settlement returns.

   c. Distortion of the incentive to invest because the cost of equity is too low.

76. Ofgem must abandon the downward adjustment.

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

77. No, it omits a number of price control settlements, such as DPCR2, DPCR3 and DPCR4, or TPCR1, TPCR2 and TPCR3, and it fails to consider arrangements in place in the gas sectors prior to 2007. These earlier price control settlements may show different patterns of performance.

78. The analysis should also show results price control by price control, and on a RAV weighted average basis, to illustrate differences between controls, rather than showing the distribution of returns across all licensees and in all price controls at the same time. When dealing with any time series data it is necessary to present it as a time series in order to identify any break points.

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.

79. In order to assess RIIO-2, information on prospective outperformance is necessary, in light of the targets and productivity assumptions being set, not information on historical performance under previous price controls, which depended on a set of price control assumptions and external factors that will not be repeated for RIIO-2.

80. As we state in our responses to other questions, Ofgem should use this assessment of future outperformance to inform the calibration of specific areas of the price control where Ofgem expects outperformance might arise, not to inform a badly targeted adjustment to the allowed return on equity.

3. Other finance questions

Financeability questions

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?

81. Ofgem's proposed approach to assessing financeability, at paragraphs 4.12 to 4.14 of the finance annex to the Consultation, is generally sensible.

82. It is important that the stress tests include a range of financial conditions and other potential shocks, not just operating performance narrowly defined, although we assume Ofgem's statements incorporate this. It is also important for Ofgem to consider whether actual companies will or can be financeable under its proposals.

83. As noted elsewhere, Ofgem's financeability assessment must be undertaken on a standalone basis, without recourse to any cashflow mechanism. The need to have recourse to a cashflow mechanism would indicate that Ofgem is failing to ensure the companies are financeable.

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

84. Ofgem must ensure that the costs that companies necessarily incur in delivering their obligations are financed, including the cost of capital and depreciation on long term investments.

85. Where it requires companies to finance investments over the long term, it needs to: (1) set an adequate cost of equity (and cost of debt); (2) consider notional gearing very carefully (making full allowance for the cost of the notional company issuing equity); and (3) consider unwinding changes

to asset lives, to the extent these are giving discounts to current consumers, relative to fully-loaded cost reflective charges and at the expense of future consumers having to pay fully-loaded charges.

86. If Ofgem were to get these three areas right, its reason for the introduction of the cashflow floor would fall away.

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

87. No, we don't. Several appear to have been written to justify the cashflow floor. Others are much more sensible but have been ignored by Ofgem in its assessment.

88. Design principle e) goes as far as to state that the cashflow floor should '*remove constraints on the cost of equity that might otherwise apply*'. Objective (i) says more or less the same thing. If Ofgem achieved this, it would remove the constraint of ensuring that companies could finance their activities. This helps demonstrate one of the many problems with a cashflow floor. It appears to be designed to relieve Ofgem of the need to have regard to its duties when it sets the cost of equity. Of course, it cannot actually do this because Ofgem's duties will remain unchanged, although the mechanism does create regulatory risk for companies.

89. We also agree that Ofgem should consider the objectives stated in the Consultation of leaving shareholders fully exposed to incentives, preserving incentives on licensees to manage their debt costs. But Ofgem has ignored these points. If it considered them, it would realise that:

   a. management and shareholders would be protected from many of the consequences of poor performance for very protracted periods, and consumers would suffer from this poor performance for longer periods as a consequence;

   b. management (or shareholders, when offered the option of responding to a cash call) would be able to adjust their financing structures in order to turn the mechanism to their advantage;

   c. any steps Ofgem took to preserve incentives, and prevent payouts by the mechanism in certain circumstances, would immediately strip the mechanism of any value to bond holders.

90. Introducing one will be worse for energy consumers than having none at all. Ofgem should instead meet its duties under the relevant legislation, including its duty to ensure that companies can finance the cost of their obligations, by setting adequate allowances for all costs, including the cost of equity.

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

91. Two of Ofgem's objectives for a cashflow floor relate to maintaining strong incentives on licensees. Yet the proposals would severely undermine incentives, because a cashflow floor would protect poor management and be detrimental to consumers

92. Ofgem has a duty to ensure that companies can finance their regulated activities. If Ofgem sets a price control that won't allow for this, but protects licensee debt investors from the consequences of that decision, it simply will not have met its duty.

93. On the other hand – if Ofgem sets a price control that will allow a company to finance its regulated activities - the cashflow floor as currently proposed could only reduce pressure on underperforming management, leading to worse outcomes for energy consumers.

94. This is an actively damaging regulatory innovation that should not be implemented.

95. The reality is that companies can take many actions to avoid cash shortages, to the point that entering the mechanism would be largely decided at management and shareholder discretion. This creates an adverse selection problem for Ofgem, with bad outcomes for consumers.

96. Shareholders could take an easy choice not to inject equity when there is a cash call, before seeing how risks play out and injecting equity later if they do not materialise.

97. If spot rates on debt rise above the allowed cost of capital (with its lagged value for historical debt rates), shareholders might prefer the mechanism to debt issuance.

98. And if Ofgem takes any comfort that current holdco finance structures make this unlikely, it shouldn't: financing arrangements can change rapidly when the incentives are strong enough.[17]

99. As the Financial Times puts it: "Britain's energy regulator is drawing up plans for a "bailout" scheme for the large monopolies that run Britain's gas and electricity networks, which would see consumers provide 'potentially unlimited' money to companies that run into unexpected financial difficulty and could not make debt payments".

100. Rating agencies have already published their initial assessment of Ofgem's present proposals for the cashflow floor. They are clearly unimpressed.

101. Moody's initial view is that the "mechanism is likely to have significant practical limitations" and that it provides "no support for leveraged holding companies". It does not offset the low cost of equity, with Moody's describing Ofgem's proposals as "a credit negative divergence from established regulatory practice".

102. Fitch notes that:

[17] Examples can be seen in the UK water sector. Facing increasing pressure from the regulator and policy makers, some of the highly geared water companies have started to decrease their opco gearing level by borrowing at the holdco level and passing the funding onto the opco. For example, Thames Water has been reported to have borrowed £250 million in excess of its group refinancing requirement, in order to reduce the gearing level of its opco from 81.1% to 76% by April 2025.

103. [T]he benefit of this mechanism in its proposed form is limited for companies with investment-grade ratings. Firstly, liquidity is rarely a core concern at investment grade, as we would generally expect liquidity concerns to arise towards the low 'B' rating territory. Good liquidity is a necessary but not sufficient feature for a company to have investment grade rating. In the most likely scenario, the liquidity support and dividend lock-up would come into force after a network migrates to speculative grade and its license is either revoked or questioned.

104. Secondly, the cashflow floor appears to merely buy time rather than address the underlying issue causing the liquidity emergency in the first place. It would work well if the issue was caused by a major one-off event or something that could be controlled by management within a short period of time. However, its benefit would be limited if there was persistent operating or financial underperformance due to factors outside of management's control (eg extremely ambitious performance targets in combination with low totex allowances or onerous inherited swap portfolio).

105. Finally, the cost of liquidity support is high and could on its own put more pressure on a network's financial profile.

106. We are even less convinced. The cashflow floor will be equivalent to allowing companies to "temporarily" accelerate the depreciation on their RAV, under the proviso that the company must "buy back" that RAV under a repayment plan. Rating agencies have tended to strip out of their credit metrics the impact of accelerated depreciation, since it is offset by slower RAV growth, and we see no reason to expect a different approach to this mechanism. Moreover, measured on a net basis, RAV will be reduced while the cashflow floor is in in operation. It remains to be seen whether this might lead rating agencies to adjust their measure of RAV for various other credit metrics.

107. Ofgem has also recognised at paragraph 4.22, and in its objectives, that if actual debt holders are not protected, and certain debt could go unsupported, the mechanism will not provide the confidence necessary for it to provide credit support or to reduce debt costs. Yet Ofgem also says that it wants to prevent manipulation of the mechanism.[18] Ofgem has listed only a fraction of the ways in which company manipulation of the mechanism could occur, and far more discretion would be required to prevent manipulation. This would in turn undermine the confidence on the part of debt investors that the mechanism is intended to bring about.

108. This is not a circle that Ofgem can square. It is impossible to reconcile the objectives Ofgem has set for the mechanism; and a mechanism that falls somewhere in-between the objectives, and achieves none of them, will damage incentives to no benefit.

[18] Finance annex to the Consultation, paragraph 4.30 (third bullet) and paragraph 4.33

Corporation tax questions

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

109. No, we do not support this proposal.

110. Meanwhile, "badges" like the fair tax mark carry their own risks and issues that mean Ofgem should not invest its reputation in them. Those companies eligible to join should be allowed to take their own decisions.

111. We have two primary reasons for saying that companies should make their own judgements:

   a. We understand that any company that has a non-UK owner is currently ineligible to join (i.e. most energy networks, including Northern Powergrid, cannot join) and, whether or not this requirement is changed, there may be other barriers to wider participation.[19]

   b. SSE's prominent role in the development and governance of the scheme, with an SSE director represented on its board, may lead to stakeholders, politicians or the media to question its impartiality. While we can see why SSE might promote its merits, it is no silver bullet.

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?

112. Instead of relying solely on a Fair Tax Mark, Ofgem should also recognise:

   a. compliance with the requirements of Schedule 46 of the Finance Act 2009 (with regard to a Senior Accounting Officer) as a means of ensuring good governance and personal accountability; and

   b. compliance with Part 2 of Schedule 19 Finance Act 2016 (with regard to publication of a tax strategy) as a means of ensuring tax transparency.

113. The requirements in the Finance Acts have additional legitimacy when compared to a Fair Tax Mark, because:

   a. They were determined by Parliament, rather than a not-for-profit society with "investor members".

   b. Failure to comply carries the threat of enforcement action and penalties.

[19] At present no energy networks or energy suppliers, other than SSE, is listed as having the fair tax mark accreditation, even though some would no doubt have attitudes to tax consistent with having a tax mark.

114. Recognising compliance with the legislative requirements will also allow companies to be more cost efficient, because companies would not have to incur the administrative costs necessary to meet multiple requirements which may be duplicative but nevertheless slightly different.

115. Northern Powergrid's tax strategy can be found on its website.[20]

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?

116. Ofgem's options for taxation have not moved on materially since the Framework Consultation, and our views on the appropriate framework for tax allowances remain the same:

a. Ofgem must remunerate efficiently incurred tax bills that companies incur in meeting their obligations by making allowance for the taxes that a notional, standalone, entity would incur.

b. Ofgem should give companies at least some small incentive to avoid paying too much tax, within the law and on behalf of energy consumers.

117. This is essentially the model Ofgem has followed to date. The current approach to tax allowances is the best available. Ofgem has also confirmed in the consultation that it has reviewed the tax trigger mechanism and found that "this mechanism is working relatively well".

118. Yet all of the options that Ofgem has elaborated for RIIO-2 to date suffer a major flaw against this framework and would not be in the interests of consumers:

a. A move to "pass through" would remove incentives, encourage inefficiency and, since taxes are calculated for corporate entities, Ofgem would pass through tax for activities beyond the notional business.

b. The option in the Consultation to allow for the "lower of actual or notional" taxes would systematically under?allow for tax (e.g. where timing differences arise), even for an efficient company, which Ofgem has a duty to fund.

c. The option to add to the current approach a discretionary and one-sided clawback mechanism at the price control close out, based on whether taxes actually paid are lower than the notional allowances, would raise regulatory risk (and the cost of capital) and suffer the same critical flaw as the "lower of actual or notional" option.

119. Meanwhile, "badges" like the fair tax mark carry their own risks and issues that mean Ofgem should not invest its reputation in them. Those companies eligible to join should be allowed to take their own decisions.

[20] The 2018 strategy is available at: https://www.northernpowergrid.com/asset/0/document/3830.pdf

120. Ofgem states that, through the ENA, it has raised the concern that tax allowances could materially deviate from tax costs and challenged the companies to prove whether this was or was not the case.

121. The companies have prepared and submitted their Regulatory Finance Performance Reports in November 2018 which show the tax under or over performance compared to allowances. For Northern Powergrid the variance is immaterial; if the returns from other companies have provided evidence of material differences Ofgem should present the information and further examine how such differences have arisen so that stakeholders can consider whether or how this should be addressed.

122. The Framework Consultation stated that the ring-fence review could be used to identify any potential added protection mechanisms to marry with the existing notional mechanism, under what it termed option A.[21] We presume that that 'added protection' Ofgem proposes under option A in the Consultation (at paragraph 5.14 in the finance annex) has been identified as a consequence of this review. To allow informed comment, Ofgem should publish the findings of its ringfence review, clearly articulate any issue it has found, and set out why it has proposed this highly discretionary form of ex post tax reopener.

123. Absent any justification of the proposal in the Consultation from Ofgem, we would highlight that a discretionary ex post claw back mechanism of the type Ofgem proposes would be damaging to:

a. investor confidence in the allowances it receives under the price control settlement, particularly where it could, ex post, be penalised for factors that have nothing to do with the price controlled business; and

b. the small incentive necessary for companies to find appropriate ways to manage and reduce their tax bills on behalf of energy consumers, which will reduce the bills they pay over the longer term.

124. As well as ruling out option C, as we state earlier in this question response, it should also rule out option B (pass through of tax payments), as this would include tax that does not relate to the price control, and potentially relates to unregulated activity, and would also remove the incentive on companies to manage tax liabilities on behalf of energy consumers.

RAV indexation (CPIH) questions

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?

125. We support Ofgem's proposal to move immediately to CPIH indexation, with no transition

126. Given Ofgem has decided to make the move to CPIH indexation, there would need to be strong reasons not to make the move immediately in respect of the entire RAV. A transition would add complexity and delay the benefits from moving to the new approach.

[21] Ofgem, March 2018, RIIO-2 Framework Consultation, page 98, paragraph 7.94

127. While Ofwat has decided to transition existing RAV gradually, it justified this on the basis of a high proportion of RPI linked debt in the water sector. There is less RPI linked debt in the energy network sector than the water sector and therefore this justification is weaker.

128. Although there is no justification for sector wide transitional arrangements, Ofgem could still consider any company specific issues at the business plan stage. Companies with RPI linked debt have a number of options, such as swapping it to CPI linked debt, or gradually buying back RPI linked debt so its balance grows less quickly than RPI.[22] Companies have always made financing choices that do not necessarily match the indexation approach in the price control and remain free to do so.

129. We note in saying this that Ofgem has always chosen to leave companies within a sector exposed to the consequences of their own financing decisions. We comment on Ofgem's options in respect of portfolios of RPI linked debt in our response to the next question, on value neutrality.

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

130. To secure an overall investor perception of NPV neutrality, Ofgem needs to set a cost of equity allowance that is credible, and does not appear to opportunistically exploit the additional headroom that the move to CPIH will create in credit metrics. The current cost of equity proposals secure the opposite perception, especially when:

a. Ofgem has taken the harshest possible interpretation of the evidence on the historical TMR, choosing to deflate the historical evidence on returns using an inflation index which is labelled in an experimental dataset as CPI rather than using a historical RPI index, a decision which reduces the TMR by a material amount, as demonstrated by NERA's report on this topic on behalf of the ENA.

b. Ofgem's cost of equity proposals are placed against comparators such as Ofwat's proposals for the water sector (which are a full percentage point higher, in a sector where the risks are lower and that is not facing the energy transition).

131. Beyond this, NPV neutrality does not require a true-up to RPI, or for the gap between RPI and CPIH. Any such true up would mean continued use of RPI in the arrangements, and would not secure a clean break. There is continued uncertainty over the future approach to measurement of RPI brings added complexity and cost to any proposal to partially continue its use.

132. But there are genuine costs associated with existing RPI linked debt in the context of a move to CPIH, and we can see Ofgem has two options in respect of this cost:

[22] If companies use the circa 1 percentage point in additional cost of debt allowance they will receive under a CPIH linked price control, compared to an RPI linked price control, their RPI linked debt balances would accrete a slower rate than would otherwise occur.

a. it could set company specific measures that would protect those companies with RPI linked debt, such as a true-up for the gap between RPI and CPI for the individual companies based on its specific financing arrangements; or

b. it could set notional allowances for the cost of debt to accommodate the cost of the notionally financed company swapping its notional RPI linked debt to notional CPI or CPIH linked debt, resulting in a small uplift in debt allowances for the sector.

133. Of these options, only the latter is consistent with Ofgem's long-established approach to setting a sector level allowance with the cost of debt, so that companies remain exposed to their own decisions on whether to finance nominal or real and, if real, using which inflation index. The issue of outliers presented by some companies taking a heavily RPI linked approach (under what will become a CPIH linked control) are no different to the pre-existing issues cause by some companies retaining a nominal debt portfolio under a price control that assumes a proportion of debt finance is index linked. Ofgem has never proposed measures to protect such companies from the consequences of their financing decisions.

Regulatory depreciation and capitalisation rate questions

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?

134. In our response to question FQ23, we state that Ofgem should consider unwinding changes to asset lives, to the extent these are giving discounts to current consumers, relative to fully-loaded cost reflective charges, at the expense of future consumers having to pay fully-loaded charges.

135. We do not have the same detailed knowledge of transmission and gas distribution but our experience from electricity distribution is that:

a. Energy consumers were given a 'privatisation dividend', that meant annual charges for network use were below those that would have been levied if assets always been subject to the basis Ofgem determined was appropriate for ED1.

b. Successive policies of accelerated depreciation, at DPCR2 to DPCR5, helped maintain this privatisation dividend, although it had narrowed as investment expenditure increased in DPCR5.

c. The change to extend asset lives at ED1 is now pushing network charges further below economic cost reflective levels, because current consumers are enjoying the benefits of past accelerated depreciation on old assets, but are gradually reducing the contribution they make to future consumers by paying less depreciation on new assets.

d. Eventually, in the mid-2030s, network charges will bottom out and then start to rise faster in real terms than they otherwise would, until around 2060, to a level well above the one that would be seen if Ofgem had not changed its asset life policy.

136. Ofgem faces no duty to unwind the value of the 'dividend' from past accelerated depreciation policies, to the benefit of current consumers and to the detriment of future consumers.

137. Instead it would seem more appropriate to fine tune asset lives to maintain a steadier level of charges (relative to the economic level) across time, which would have the added benefit of helping to address company financeability issues. The fact a move to 45 year asset lives was likely to create future financeability issues for electricity distribution companies was highlighted by Ofgem in its defence, at a CMA hearing into the appeal by British Gas of the ED1 price control modification, of its decision to allow electricity distribution companies a transition period to 45 year asset lives. This decision granted more time to consider the issue and adjust asset lives as appropriate.

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

138. Yes, considering capitalisation rates after business plan submission is a sensible process.

139. Rather than allowing companies to set their own capitalisation rate, Ofgem should set a notional totex capitalisation rate for the sector. This will reinforce Ofgem's approach of equalised incentives between different categories, because the capitalisation rate of companies would not depend directly on their own decisions to favour one type of cost over another. The ED1 approach, in contrast, allowed companies to influence their own capitalisation rates, for example if they adopted a capex heavy approached to managing their network, rather than capex light (or innovative) approaches.

140. In distribution, this notional rate could be established quite easily as a weighted average across the sector.

Notional gearing and equity issuance questions

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

141. We can see the rationale for a notional gearing that is lower than the RIIO-1 assumption for distribution sectors. Lower gearing helps provide financial resilience and gives capacity to meet future challenges, as long as the cost of equity is appropriately set (which, as we note in response to other questions, would require Ofgem to increase its proposed allowance).

142. As we stated in our RIIO-ED1 business plan, the use of equity finance is a core part of Northern Powergrid's strategy for coping with unexpected events. Equity finance is much more flexible than debt finance and, given the uncertainties facing energy networks, maintaining a sustainable level of equity finance, and the lower levels of debt (financial gearing) that this entails, is an important aspect of maintaining the service we offer to customers.

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

143. For any sectors where Ofgem assumes a step down in notional gearing, it must ensure it provides a credible allowance for a notional company, operating with the type of debt portfolio that energy networks actually have, to make the step, including the costs associated with debt buy backs and equity issuance.

144. Equity issuance is expensive. CEPA has failed to recognise this reality in its view that the 5% cost benchmark established at previous price control reviews should be reduced to 3%. Page 61 of CEPA's RIIO-2 report deals with the issue in a sentence or two, and cites a 3% 'starting point' for RIIO-2 to its report on new transmission assets. But there are significant differences between a new operator raising equity finance and an existing operator making a cash-call on its investors. For example, the costs of the latter includes:

   a. any detrimental effect the cash-call has on a market valuation of the stake already held by those investor; and

   b. the costs associated with an existing operator buying back its existing debt investments, at rates that will exceed prevailing market conditions (since the process of buying back debt will move the market for that debt).

145. CEPA's 3% 'starting point' based on new investments is therefore below the value that Ofgem must assume for RIIO-2. 5% remains appropriate.

146. This allowance should not depend on whether actual companies issue equity as, if it did, this would undermine incentives for companies to take a sustainable approach to their financing and reduce their reliance in debt in future. Ofgem should not undermine the incentive for companies to take action to support their credit quality before Ofgem has to in order to meet its duties.

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?

147. We agree that Ofgem should retain its pre-existing approach to pensions (updated in April 2017). There is one minor difference between sectors on the treatment of pension admin and PPF costs. It is sensible to align the approaches.

Directly Remunerated Services and asset disposal questions

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

148. We do not think there would be any benefits in fitting the directly remunerated service (DRS) categories for all of the sectors against a set of generic DRS categories. Because the sectors are

different, the services being provided differ. If Ofgem harmonises the categories to a generic list, it will have the consequence that different services in different sectors are referred to as the same thing. At the very least, this risks causing confusion to external stakeholders.

149. We also think that further development of the existing DRS for electricity distribution would be appropriate in a future where electricity distributors provide an increasing number of services to, or undertake investments on behalf of, National Grid and the ESO. This will help ensure that those services are charged for an appropriate basis, which might not be precisely aligned with the treatment of the miscellaneous category they would be likely to be allocated to at present.

150. However, we do see that, if similar services are being treated differently in different sectors, the rationale should be inspected closely, and the treatment should be aligned if this is appropriate. We would agree with Ofgem that connection charging approaches should be aligned to distribution connection charging; otherwise this causes distortions in incentives to connect to different networks and at different voltages. This may go beyond the DRS wording. Similarly, we see little rational for cross-subsidisation of part of the connection costs (the 10m rule) in gas distribution. To the extent that these connection charging differences arise because of Ofgem's approach to regulation, rather than differences established by Parliament in the relevant primary legislation, this would warrant a specific consultation.

151. There are also fundamental differences between the sectors beyond the specific categories of directly remunerated service (DRS). For example (with emphasis added):

a. The GDN licence (as at modification in 2013) states in special condition 4C 6 that "Part C of this condition sets out, **without limitation**, certain **categories of services** provided by the Licensee **that are to be treated** as Excluded Services." This means that, if the service is on the list in Part C, it can be treated as a DRS, irrespective of the general principle.

b. The DNO licence, following modification in 2015, states in the equivalent paragraph that "The services listed in Appendix 1, in particular, are Directly Remunerated Services **to the extent that they comply with the General Principle set out below**." This means that, even if the service is on the list in Appendix 1, it cannot be treated as a DRS unless it also meets the general principle.

152. In other words, the test for classifying revenue as a DRS is more onerous in electricity distribution than it is in gas distribution, and presumably also transmission. And, Ofgem's measure of the returns in these respective settlements, RORE, will presumably omit any returns being earned in GD1 or T1 as a consequence of this different approach to the DRS general principle.

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?

153. Alignment of all sectors to the ED1 approach would be appropriate.

154. Ofgem's inclusion of transfers and disposals as part of totex in ED1 avoids distortions between different approaches that would otherwise encourage companies towards maintaining their status

quo portfolio of assets even if this would be in-efficient. For example, if a company could sell one site, and buy a cheaper site, it should have an incentive to do this, sharing the benefits directly with customers through the sharing factor.

155. Ofgem has two safeguards against companies taking short term decisions :

a. Totex cost benchmarking, especially in distribution where Ofgem can directly compare between companies on a true totex basis, means that, if a company disposes of assets that lead to higher long term costs, that company will perform worse in Ofgem's cost benchmarking and will not receive an allowance to cover those higher long term costs.

b. Ofgem's ring-fence conditions, in particular SLC26 of the electricity distribution licence, mean that DNOs must give Ofgem two months' notice of any disposal of a relevant asset where a general consent does not apply, along with any information Ofgem requests, allowing Ofgem to apply direct scrutiny and either consent to the disposal or to object if it may represent bad stewardship.

156. Ofgem should maintain these strong incentives, and appropriate safeguards, at RIIO-2.