

BRIEFING NOTE: 14 AUGUST 2014

Ofgem's RII0-ED1 'Slow Track' Draft Determinations

On 30 July, Ofgem published Draft Determinations (DDs) for the remaining 10 electricity distribution network operators (DNOs), having already agreed a 'fast track' determination for the four Western Power Distribution (WPD) DNOs. Since these DDs set out Ofgem's proposed price controls for the 2015-23 period, they are a key determinant of investors' expected returns and the outputs and targets the DNOs need to deliver. Moreover, as the first set of price controls (albeit draft) handed down by Ofgem's new CEO, these DDs may provide clues as to the approach Ofgem will adopt under its new leadership.

The DDs represent a tough challenge for the DNOs, consistent with the recent trend in UK regulatory decisions targeting improved affordability for consumers and reduced returns for investors. DNO charges within customer bills will be, on average over the eight year price control period, £12 p.a. lower than presently. The DDs also incorporate a number of important – and unexpected – revisions to Ofgem's methodology, most significantly in relation to cost assessment and financial issues. Some of the key announcements within the DDs include:

- £1.9bn of totex requested by companies has been rejected.¹ While these reductions primarily relate to RPEs and smart grids which affect all 10 of the DNOs, the modifications Ofgem has made to its benchmarking methodology may have created some winners and losers;
- a lower cost of equity – albeit one that was flagged some months ago – of 6.0% has been imposed, meaning DNOs face one of the lowest WACCs ever set for regulated businesses in the UK;
- a revised methodology for indexing the cost of debt which better matches DNOs' embedded debt costs; and
- a package of rewards, penalties and incentives that Ofgem considers will enable each DNO to earn a return on equity in a range of roughly 2 – 10% (at 65% gearing).

Ofgem's forecasts of weak performance by the DNOs against key financial metrics add to the perception that these are challenging price controls.

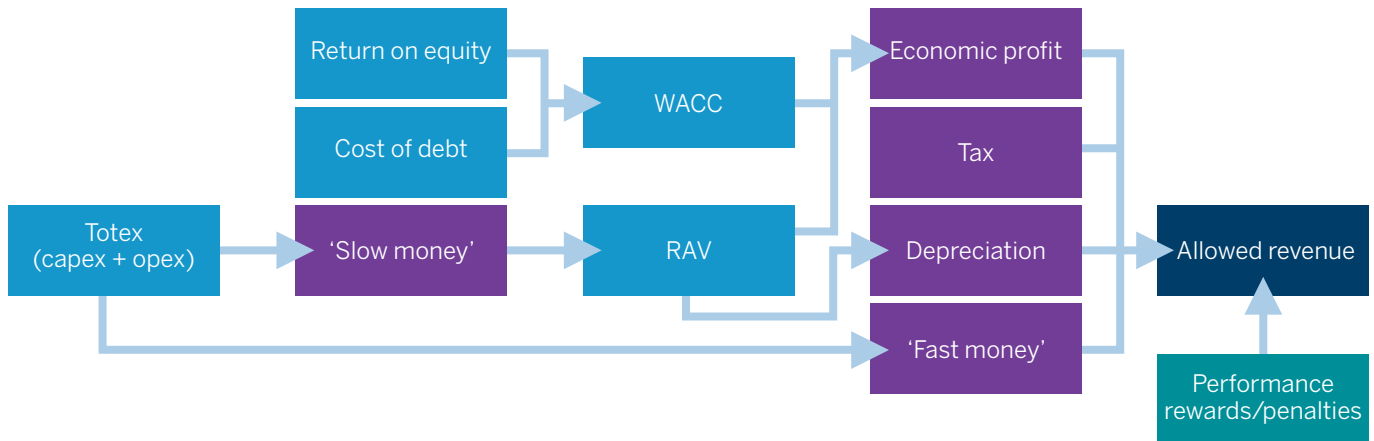
The DDs also suggest WPD, the only DNO to be 'fast tracked', has reaped a handsome reward from its 'fast track' status. By avoiding Ofgem's updated tougher cost challenges and lower cost of equity, WPD looks to have an opportunity to outperform its peers over the next eight years.

The DDs are likely to be the subject of much debate as the DNOs attempt to persuade Ofgem to adopt a less challenging set of Final Determinations (FDs) in November.

¹ Ofgem states the reduction in totex as £1.4bn. However, this figure is the allowed costs, which is based 75% on Ofgem's view of efficient costs and 25% on the DNO's own submission.

Introduction

The RIIO-ED1 price control sets allowed revenues for the 14 electricity DNOs over the eight year period 1 April 2015 to 31 March 2023. The chart below summarises the key elements of Ofgem's framework.



The 14 DNOs are owned by six different groups, one of which – WPD – owns four of the companies and secured a 'fast track' (or early) determination in February. The DDs published on 30 July set out proposals for the remaining 10 DNOs in relation to each of these 'building blocks', and most importantly in relation to:

- Totex: the opex and capex the 10 DNOs are expected to spend over the RIIO-ED1 period (which is split into 'fast' and 'slow' money based on Ofgem's assessment of the capitalisation rate);
- Financial Issues: cost of capital (WACC), financeability and movements in the Regulatory Asset Value (RAV); and
- Incentives: the penalties and rewards available to the DNOs for poor or strong performance.

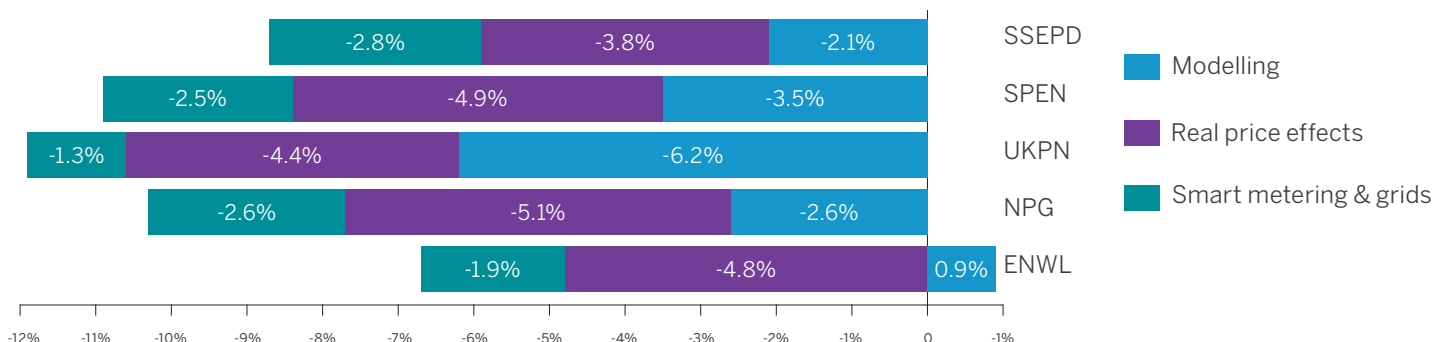
Each of these aspects of the DDs is considered in more detail below.

Totex

Key features of the DDs include:

- Ofgem used a combination of top-down totex econometric models and bottom-up activity-by-activity costs assessments to determine an overall estimate of required expenditures, but proposed some amendments to the detail of its methodology;
- According to Ofgem, DNOs (excluding WPD) should have included £695m of savings associated with becoming 'smart grids' over the ED1 period, compared to £296m included in their business plans – a 135% increase;
- DNOs' (excluding WPD) business plans argued that their cost allowances needed to be £772m higher because of real price effects (RPEs), but Ofgem concluded that cost allowances should actually be £78m lower (a reduction of £850m).²

The chart below summarises the impact of Ofgem's deductions from DNO business plans. Ofgem regards at least 6% of the proposed expenditure as inefficient for all of the DNOs, with UKPN faring the worst with an 11.9% cut. Moreover, the impact of Ofgem's views on RPEs and 'smart' is similar (in percentage terms) across all the DNOs, but the impact of the modelling exercise undertaken by Ofgem is more diverse.



² RPEs refer to input cost inflation exceeding (or falling short of) general price inflation (which is measured using the Retail Price Index (RPI) for the DNOs).

Given the common impact (including on WPD for 'smart') the DNOs may collectively resist Ofgem's interventions relating to 'smart' and RPEs. The focus of debate surrounding RPEs is likely to be on the interpretation of the more up-to-date evidence Ofgem has relied on and on the appropriate way to manage the uncertainty around outturn RPEs (an area Ofgem has flagged it will consult on further ahead of FDs).³ The robustness of Ofgem's expected savings from 'smart' may be challenged on the basis that even though Ofgem considers its estimates to be conservative, there is significant uncertainty around the benefits from 'smart' and it is important to ensure the balance of risks (of over and underspends) is evenly distributed.

Although 'smart' and RPEs may be more obvious targets for the DNOs, Ofgem's econometric modelling (and other benchmarking techniques) may also be subject to challenge. In particular, while Ofgem has continued to use a mixture of bottom-up and top-down assessments to determine cost allowances, there have been some important revisions in the details of the approach:

- the top-down models have been updated to rely on 13 years of data (five years of historic data and eight years of forecasts, rather than just three years of historic data), as Ofgem now has more confidence in the forecast data provided by DNOs;
- in forming an overall view, the two top-down models are now afforded 25% weight each and the single bottom-up model 50% weight (rather than 12.5% and 75% respectively previously);
- the upper-quartile efficiency target is now calculated after the three models are combined, rather than for each model individually and then weighted together; and
- RPEs and smart grids have been incorporated after the upper quartile calculation, rather than before.

Since some DNOs will have benefited from these changes, while others will be worse off, expect the debate about the modelling methodology to rumble on until FDs.

Another debate which might emerge is the size of the reward for being fast tracked. Despite the revisions Ofgem has made to its modelling approach causing WPD to now look slightly less efficient than some of its peers, Ofgem has ruled out revisiting its fast track determination published in February. Ofgem places significant weight on the benefits that the 'fast track' procedure can secure (by inducing companies to put forward their best

proposals) but given that WPD will already be benefiting from a higher allowed cost of equity some may question whether the rewards for fast-tracking are overly generous.

Financial Issues

Ofgem has determined:

- a cost of equity of 6.0% in real, post-tax terms;
- a cost of debt based on a trailing average of A and BBB benchmark bond indices, equal to 2.6% real, pre-tax in 2015-16;
- a notional gearing assumption of 65%, which when combined with the costs of debt and equity above implies a real vanilla WACC of 3.8% for 2015-16;⁴
- capitalisation rates (i.e. the proportion of totex added to RAV) of 68 – 80% across the DNOs;
- existing assets will continue to be depreciated over a 20 year period, but additions to the RAV will be depreciated over a 45 year period on a straight line basis;⁵
- the expenditure profiles, combined with the capitalisation rates and asset life assumptions, imply RAV growth of around 1% p.a. (in real terms) for each of the DNOs;⁶ and
- based on comparisons to the financial metrics commonly employed by rating agencies, the DDs will enable the 10 DNOs to maintain an investment grade credit rating (in Ofgem's view).

Ofgem's proposals in relation to the cost of equity are in line with its earlier guidance in February,⁷ notwithstanding that the DNOs all asked for much higher allowances. Similarly, the proposals in relation to asset lives are consistent with the methodology Ofgem set out in 2013.⁸ Important revisions have, however, been made to the approach to cost of debt and financeability.

³ Ofgem's ED1 proposals incorporate a fixed ex-ante allowance for RPEs – as has been Ofgem's approach to past price controls – but Ofgem may consider implementing mechanisms to reduce risks on shareholders and consumers e.g. price control re-openers or automatic adjustments to allowances triggered by certain events.

⁴ Because the cost of debt is indexed it will change from year to year. Consequently, so will the allowed WACC.

⁵ Asset lives for new assets will not switch from 20 to 45 years immediately, but rather there will be a gradual transition over an eight year period.

⁶ Compound annual growth rate of RAV for the five DNO ownership groups varies between 0.7% (SSE) and 1.3% (ENW) in real terms.

⁷ Ofgem (2014) "Decision on our methodology for assessing the equity market return for the purpose of setting RIIO-ED1 price controls", February.

⁸ Ofgem (2013) "Strategy decision for the RIIO-ED1 electricity distribution price control – Overview", p43, March.

Cost of debt

Recognising that the DNOs typically have higher embedded debt costs (i.e. interest rates on debt they have already raised and which will not be repaid during ED1) than other network businesses, Ofgem has decided to modify its approach to determining the cost of debt for the 10 'slow track' DNOs. While the cost of debt will continue to be indexed to benchmark bond indices, the period over which these indices are averaged has been revised. Specifically, whereas WPD's cost of debt is based on a rolling 10 year average of the index, the other DNOs will have their cost of debt set based on an extending (or "trombone" as Ofgem describes it) trailing average. For 2015/16 this means the cost of debt will be based on a 10 year trailing average, but in 2016/17 an 11 year trailing average will be used, 12 years in 2017/18 and so on. There are two important consequences of this change:

1. the allowed cost of debt will be less sensitive to future movements in the benchmark bond indices; and
2. assuming the index remains lower than its historic average, as seems likely in the short term at least, the allowed cost of debt will now be higher.

That Ofgem has now adopted several different methods to set the allowed cost of debt for the various networks it regulates arguably makes the approach Ofgem will take in future less predictable.⁹ On the other hand, some comfort might be taken from a regulator which is willing to be pragmatic in its decision making. There are, however, two potential issues with Ofgem's approach to the cost of debt:

1. since the revised index will not be applied to WPD, it is possible that WPD could be worse off than the other DNOs e.g. if interest rates remain low in future WPD's index will decrease as historical years with higher interest rates drop out of the index window, but the other DNOs' index will be less affected. Ofgem has, however, committed to ensuring that WPD is no worse off as a result of fast tracking.¹⁰ While the gains to WPD in other parts of the determination (e.g. on cost of equity) look likely to be sufficient for WPD to expect to be better off overall, what happens if interest rates remain very low?
2. Ofgem argues that its cost of debt allowance does not need any additional uplift to cover the costs of issuing debt because the benchmark index it uses does not take into account a 'halo effect' (whereby DNOs are able to issue debt more cheaply than other companies with similar credit ratings). However, if the DNOs were each to be downgraded one notch (which Ofgem concedes the financeability tests suggest may be possible), would the increase in the cost of debt be more than enough to offset the 'halo effect' such that the allowed cost of debt would not be sufficient to cover expected debt costs?

Financeability

While Ofgem argues that the DDs enable the 10 DNOs to maintain an investment grade credit rating, Ofgem also acknowledges that the proposed price controls mean that the PMICR for all of the DNOs will be below a level consistent with an investment grade credit rating and that consequently there is a risk that each of the DNOs will be downgraded one notch (from the A- / BBB+ ratings they currently have).¹¹ Ofgem's view is, however, that the issue lies not with its DDs, but rather with the mechanics of the PMICR. In particular, Ofgem contends that there is a mismatch between the PMICR's numerator comprising elements measured in real terms and the denominator measured in nominal terms. Ofgem goes on to develop its own version of the PMICR (the "PMICR_G") which it argues is a better measure and which suggests DNOs achieve stronger performance. The question is, will the rating agencies agree?

Adding to the unease around Ofgem's approach to financeability is Ofgem's decision not to publish the financial ratios for the 10 DNOs even though they published the ratios for WPD.¹² It is unclear how related the two are, but it is difficult to resist the inference that the projected ratios have not been published because they suggest the DNOs' performance will be very weak.

Incentives

Key features of the DDs include:

- rewards and penalties are available for companies in relation to their performance in a range of areas including safety, customer service, environmental targets and reliability;
- Ofgem has made some revisions to its Information Quality Incentive (IQI) incentive scheme – which determines the rewards and penalties for totex out- or under-performance – to avoid all companies being penalised for submitting costs higher than Ofgem's own assessment;
- 53 - 57% of any over or under-spend will be borne by each DNO. The remainder will be passed on to customers;
- Ofgem's package of rewards, penalties and incentives will enable strong performing DNOs to enhance returns above the 6.0% base return Ofgem has allowed (though the opposite is also true). In Ofgem's view, DNOs should expect to earn a return on equity in a range of roughly 2 – 10% (at 65% gearing), depending on how well they perform.

⁹ Ofgem has adopted the rolling 10-year trailing average for the Gas Distribution Networks (GDNs), National Grid Electricity Transmission (NGET), National Grid Gas Transmission (NGGT), Scottish Power Transmission (SPT) and WPD, but modified indices for Scottish-Hydro Electricity Transmission Limited (SHETL) and now for the remaining 10 DNOs.

¹⁰ See Ofgem (2013) "Strategy decision for the RIIO electricity distribution price control – Overview", p33, March.

¹¹ PMICR is the Post-Maintenance Interest Cover Ratio.

¹² The DD financial model does not include the "FinancialStatements" or "FinancialRatios" tabs (which set out Ofgem's projections of key credit rating metrics) that the WPD Fast Track Final Determination financial model includes.

Although Ofgem has retained the IQI mechanism, some revisions have been made to the design of the menu. In particular, the 'breakeven point' at which a DNO will be neither rewarded nor penalised has been increased to a score of 102.9 from 100.¹³ Ofgem attributes this change to wanting to ensure that companies that have provided good information are rewarded, though this change also has the effect of avoiding a situation where all of the DNOs would need to outperform the price control in order to achieve their cost of capital.

While the outputs and associated incentives Ofgem has imposed are largely similar to those proposed by the DNOs themselves, the approach to network losses remains some way short of ideal. Ofgem has acknowledged that the losses data available historically has been unreliable, making it impossible to robustly measure and incentivise losses. There have been significant issues trying to conclude on rewards and penalties for losses performance over the DPCR4 period (which ended in 2010), while the losses incentive that was included at DPCR5 has ultimately had to be removed. Pragmatically Ofgem has now decided that there will be no losses incentive mechanism over ED1, with DNOs incentivised to keep their losses as low as reasonably possible through a licence condition. The roll out of smart meters holds out hope that losses will eventually be robustly measurable, but for the time being it appears that Ofgem (and DNOs) are stuck with a second-best solution.

Overall, Ofgem's package of rewards, penalties and incentives will enable each DNO to earn a return on equity in a range of roughly 2 – 10% (at 65% gearing). This range represents a step-change lower compared to previous RIIO price controls, which have typically been consistent with a range of 4 – 10% (or marginally higher). While the lower base cost of equity assumption Ofgem has adopted for ED1 might suggest a downward shift in the range, the widening of the range may be the result (in contrast to the approach to the cost of debt) of Ofgem dogmatically sticking to principles that the range should be roughly symmetrical (i.e. potential upside equals potential downside) and that "upside ... provides the potential for double digit returns on (notional) equity, and RoRE downside ... is at or below the cost of debt".¹⁴ The question is, is that wise? With the DDs already putting pressure on financial ratios, would it have been more prudent to avoid further potential pressure by truncating the downside of the range to a figure closer to (or slightly above) the current cost of debt?

Next Steps

The 10 DNOs have until 26 September 2014 to respond to Ofgem's DDs. Ofgem will then – taking into account the responses from companies and other stakeholders – finalise their proposals. Final Determinations will be published in November. Each of the DNOs will then have the option to appeal to the Competition and Markets Authority (CMA) if they are dissatisfied with Ofgem's Final Determination.

¹³ The score equals the DNO's totex submission divided by Ofgem's assessment, multiplied by 100. A score of 100, therefore, implies that the DNO's submission is the same as Ofgem's assessment.

¹⁴ See Ofgem (2012) "RIIO-T1: Final Proposals for National Grid Electricity Transmission and National Grid Gas – Finance Supporting Document", p36, December.



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