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Dear Hannah,

RIIO-T1: transmission companies' business plans

Thank you for the opportunity to comment on the business plans submitted by the transmission companies. This response represents the views of companies within the Centrica group excluding Centrica Storage, it is non-confidential and may be placed on the Ofgem website and in the Ofgem library.

The appendices to this letter provide comments on the network development plans in electricity (appendix 1) and gas (appendix 2), and on the companies' financial proposals (appendix 3). Our main observations are the following.

- **Overall quality of the plans**—the companies have clearly made significant effort to relate their investment proposals to their strategic outlooks and the broader policy context. However, in certain cases we have found it difficult to understand exactly what the companies are proposing to deliver over RIIO-T1, and whether the corresponding investment plans represent value for money. We recognise that this exercise is made more difficult by the considerable uncertainty faced by the industry. However, we also believe that the business plans could have provided more detail on the costs and benefits of the different options considered. The documents sometimes felt incomplete and largely qualitative, leaving external parties unable to fully assess the proposals. Overall, while this new step in the RIIO process represents an improvement on the review process, there would be merit in making the plans more concise and more concrete to facilitate effective participation
- **Investment plans**—the investment plans seem to broadly reflect the views of stakeholders expressed in the engagement process. However, the transmission companies do not always demonstrate that they have considered alternative options for dealing with the issues identified. For electricity transmission, we also believe that the companies could identify more clearly the investments that will be made on an anticipatory basis.
- **Financial proposals**—we recognise that the network companies will have to raise new finance to fund their investment plans over RIIO-T1. However, we think that the companies have overestimated the costs associated with these requirements. In our

response to Ofgem's initial consultation we submitted substantial evidence on the cost of capital, the need for transitional arrangements, and the costs associated with the companies' pension liabilities. We think that these arguments still hold in the current context, and that they should be ultimately reflected in the price control decision. Furthermore, we note that the companies are proposing extensive uncertainty mechanisms which, if adopted, would shield them from a large share of the systematic risk they would otherwise be exposed to. We are concerned about the impact that such mechanisms would have on charging volatility, but we think that at the very least if they are adopted their impact of risk reduction should be reflected in the financial settlement.

We hope that these comments are useful. Do not hesitate to contact me if you have any questions.

Yours sincerely,

By e-mail

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Appendix 1: Electricity transmission

The shift to a low carbon economy will require both timely investment in the transmission network and more efficient system balancing. As such National Grid's RIIO-T1 business plans are vital to achieving this aim. We believe that significant progress has been made by National Grid in engaging with industry during the price control and in developing a process accessible by all types of user.

However, overall Centrica does not believe that sufficient detail has been provided in the published business plans. There appears to be a lack of detail of how the new measures relate to the outputs, the objectives against which they will be measured, and the associated estimated benefits. It is also apparent that the published business plan omitted some key annexes: the detailed plan, pensions, data tables and table narrative. As a result, the documents felt incomplete and largely qualitative, leaving parties unable to fully assess the proposals. The exclusion of the 'detailed plan' was notable as the available annexes referred readers to this document to gain a fuller understanding of proposals. Whilst we fully acknowledge that not all information can be published (e.g. unit costs, expected wage inflation) we do not understand why it is not possible to sanitise or summarise this data such that these issues are overcome. Given the short timescales it would have been useful to publish a summary of the plan outlining 1) which investments are being proposed 2) the expected cost and 3) the net financial benefit.

Below we provide comments on system operation issues and anticipatory investment.

System operation issues

Centrica agrees that the expected rise in constraint costs due to Connect and Manage will require NGET to be more innovative in the way it manages the network and hence we welcome efforts in this area. However, we would welcome more detail in terms of the proposed investment and the expected benefits. For example, NGET expects to spend £365.5m in direct OPEX and £262.3m in IT systems for asset health purposes and enhanced capability. NGET also plans to invest £35.3m in the RIIO-T1 period to improve their data centres. However, no detail has been provided as to the specific nature of these projects. For example, has a specific proportion been assigned to frequency response equipment or constraints management?

NGET states that it is seeking to mitigate the additional costs that increased renewables will impose by improving their forecasting capability, developing new commercial contracts and improving IT systems. We recognise that more intermittent generation on the network will make system balancing more challenging for the SO and that Connect and Manage is likely to result in higher congestion costs. However, in order to properly assess their plans parties require much more detail. For example, what types of contracts does National Grid want to engage in? What are the planned IT improvements?

Finally, the estimated savings from the above investments are £600 million over the price control period. However, the additional investment required to achieve this saving is not explained. It should also be noted that the case of proposed business plan will depend on the accuracy of the constraints forecast which we know from past experience can be very difficult to achieve.

Anticipatory investment

In electricity transmission it is vital that the networks carry out sufficient anticipatory investment to support the changing usage of the network. The major risk here is that underinvestment in electricity transmission will lead to rising constraint costs (and potentially

rising wholesale energy prices), which will ultimately flow through to consumers. We believe that the risks of underinvestment in the network are greater than the risks of overinvestment and hence anticipatory investment should be a central pillar of NGET's business plan.

We welcome the work done by National Grid to develop the Electricity Scenarios Illustrative (ESI) model and its thinking on network investment projects versus congestion costs. We believe that this forms strong foundations for a cost benefit analysis. However, despite the relatively large amount of detail provided on investment proposals a full assessment is difficult. Of the 33 projects listed in the ESI model, it is not clear which would be constructed on an anticipatory basis and which are underwritten by generators. This is important to the assessment of business plans as it is our understanding that under RIIO, projects that are constructed on an anticipatory basis might be treated differently from other investments.

Annexe 2: Gas transmission

Investment uncertainty

The consultation document sets out high level statements concerning the investment needs, challenges and uncertainties which NGG will face over the course of the gas transmission RIIO-T1 price control. However, it is extremely light on specific and measurable outputs. For example, there are numerous references to the broad subjects which NGG intends to focus upon over the 8 year period, but very few of these are supported by concrete statements about what NGG intends to spend or achieve, by when, and how it will measure and report its success.

We see that key investment drivers over the coming decade will arise primarily from:

- import projects;
- new storage;
- CCGTs; and
- where proven, constraint alleviation, in particular the “South East” issue.

We have arranged a bilateral meeting with National Grid in order to explore the latter issue in more detail.

However, at the moment little concrete information is provided on NGG’s assumptions for such projects. We recognise that a significant proportion of the planned expenditure is driven by potential new connections, particularly gas fired generation and storage. Many of these projects will be shrouded in significant regulatory and/or economic uncertainty. Given this high level of uncertainty, there is a clear need for robust uncertainty mechanisms to protect both NGG and network users.

NGG’s preferred option to manage the uncertainty surrounding any investment requirement in respect of network flexibility is through a specific price control re-opener. While we believe that this may be appropriate, we note that NGG has in recent years demonstrated a reluctance to request a re-opener (an Income Adjusting Event) in the case of the failed Canatxx Fleetwood storage project, even though it was clear at an early stage that the revenue signal and associated expenditure should be considered spurious. NGG clearly acts as a commercial organisation and as such will tend to demonstrate a natural tendency to accept the full extent of any commercial upside while seeking the full protection of any price control flexibility to protect against potential downside, and this should be borne in mind when structuring price control uncertainty mechanisms.

There therefore exists the potential for significant revenue windfalls for NGG. In order to protect against this, where uncertainty mechanisms are allowed through the RIIO process, we look to Ofgem to continue its rigorous policing of allowable expenditure, in order to protect network users and consumers.

Further to this point, as a network user we agree with statements made that network reliability, safety and environmental performance remain paramount. However we are not in possession of the necessary technical knowledge to be able to assess the extent to which NGG intends to deliver value for money when maintaining or enhancing the current benchmark performance. Again, we believe this is a key role for Ofgem.

TO Commodity charge

Whilst this issue of an extremely high and volatile TO Commodity charge¹ in itself does not constitute an investment plan, we believe that the current regime significantly undermines GB's attractiveness as a destination for new gas supplies. There could, therefore, be a significant difference between the network investment that is needed under current arrangements – which we believe act as a disincentive to bring gas supplies to GB – versus the significantly greater network investment which would be needed if the current flawed arrangements were rectified to create equitable, stable and predictable network charges. Therefore solving this problem at an early stage – preferably ahead of the commencement of the RIIO T1 price control, could materially alter NGG expenditure requirements over the next 8 years.

Network flexibility

We do not believe that the case has been made for network investment in order better to manage network flexibility constraints. We would therefore welcome any activity which might help to provide greater transparency on genuine network constraints and therefore justification for remedial action.

However, even at this early stage, and assuming that constraints were proven, we would caution that solutions may be found in actions other than investment by NGG in its network. One example may be, for example, an onshore gas storage solution close to the source of localised constraints. Such a solution could be provided by the competitive storage market.

We note that one of Ofgem's key requirements for the RIIO process was that a range of options should be considered, and we would like to see this requirement carried on throughout the process such that there is not a presumption in favour of NTS investment over other potential solutions.

Force majeure

We also believe that the RIIO process presents an ideal opportunity to rebalance the extent of the risks which NGG is expected to bear, and those which it is able to insulate itself from through calling force majeure (FM). Over the last few years the industry has experienced two significant events which have resulted in NGG calling force majeure in respect of entry capacity constraints. One of these events stemmed from adverse tidal conditions affecting a pipeline estuary crossing, with the other relating to difficulties in obtaining planning consents in order to fully satisfy an incremental entry capacity signal. While we recognise that there will inevitably be events where contract FM should be invoked, these two events have highlighted the ease with which NGG is able to insulate itself from the financial impacts of these events, and also the extent to which shippers are disadvantaged when faced with challenging NGG-initiated FM. We therefore look to the RIIO process to introduce greater rigour around the use of FM in relation to network constraints.

¹ Any shortfall between NGG's target TO entry revenue and revenue from TO entry capacity charges is currently recovered via the TO Commodity charge, which is levied on all entry allocations other than storage and short haul allocations. Revenues from entry capacity charges have declined over recent years and now account for approximately 32% of allowed TO entry revenue. Therefore the commodity charge is used to collect 68% of the allowed revenue. This is expected to continue to increase further going forward. This charging regime falls well short of achieving the relevant objectives for network charging. The RIIO price control provides the opportunity to establish a fit for purpose capacity regime which better adheres to the relevant objectives for network charging.

Appendix 3: comments on the companies' proposed financial packages and uncertainty mechanisms

In our response to Ofgem's initial consultation, we provided substantial evidence concerning the cost of capital, financeability requirements, and pension costs. In particular, we argued that:

- Ofgem's assumption for the upper bound of the cost of equity was high by comparison with relevant benchmarks;
- the reduced risk exposure permitted by the indexation of the cost of debt should be reflected in the determination of the other building blocks of the WACC and the assessment of financeability;
- energy customers seemed to be exposed to greater risks in relation to pension deficit repair costs than in other regulated industries; and
- there was no obvious need for transitional arrangements to mitigate the financeability implications of changes in asset lives.

We believe that these arguments still hold and that they should be reflected in the financial package for RIIO-T1. We recognise that some of the companies have discussed these points in their plans, but we do not support the conclusions that they have reached. The companies' interpretation of recent market developments (for example the premiums paid at recent transactions) remains unconvincing, and they do not seem to recognise the implications of more recent regulatory decisions (for example the Competition Commission's decision on Bristol Water).

We do not propose to repeat these arguments in detail here, but we will look to Ofgem to scrutinise the companies' financing proposals very carefully.

We recognise that some of the companies have made some effort to relate their financial proposals to the broader regulatory package, but we think that their methodology has important flaws. We comment more specifically on this aspect of the plans below.

The use of RORE and the relationship between incentives and allowed returns

We note that some of the companies have used the return on regulated equity (RORE) to analyse the relationship between the proposed regulatory package, financial risk, and the cost of equity. NGET's analysis is the most developed in this area, albeit the other business plans seem to be underpinned by similar approaches. Our comments focus on NGET's analysis but are of wider relevance for the setting of allowed returns in RIIO-T1.

NGET has modelled confidence intervals around its RORE during RIIO-T1 and concludes that:

- the spread of possible RORE will be greater in RIIO-T1 than in TPCR4 (ie, the company will be exposed to more risk);²
- a range of uncertainty mechanisms are required in RIIO-T1 to reduce the company's risk exposure to a level consistent with that prevailing in TPCR4;³

² NGET (2011a), 'RIIO-T1 Overview', July, paragraph 155.

³ NGET (2011a), paragraph 158.

- unless this is achieved, Ofgem would have to concede a substantial increase in the allowed return on equity (potentially up to 9% or 13%).⁴

While we agree that the RORE can be a useful tool to analyse the relationship between price control mechanisms and financial risk, we have some issues with the way NGET has used this tool.

- **Firstly, we think that NGET has overestimated the extent to which the variance in RORE might drive the cost of equity.** NGET assumes a very straightforward, linear relationship between the standard deviation in RORE and the equity risk premium.⁵ In reality, the standard deviation in RORE encompasses all risk factors affecting the company (both systematic and idiosyncratic), while in principle the equity risk premium should only reflect systematic risk factors.⁶

We think that this distinction is important because intuitively we would not expect much of the variance in RORE to be systematic in nature, especially if the uncertainty mechanisms proposed by NGET are adopted. In effect, the package of mechanisms proposed by NGET would largely shield the company from any risk associated with variations in the *volume* of investment to deliver, while potentially leaving the company exposed to variations in *unit costs*. While volume effects might have a pro-cyclical component (in that NGET might have to deliver more projects at times of high economic growth), cost effects are likely to be mostly anti-cyclical (in that NGET might face lower materials and contractors costs at times of lower economic growth, allowing the company to outperform regulatory assumptions more easily).

We do not think that this distinction between different types of risks is of mere theoretical relevance: equity investors are very clearly attracted to the sector for its defensive characteristics and the benefits it brings to their portfolio in terms of diversification. The value of such defensive characteristics is bound to increase in a market environment where there is a paucity of low-risk assets.

For these reasons, we think that NGET has overestimated the impact of these risks on its WACC. We are unsure whether there is a robust method for linking RORE variance with the cost of equity, but we certainly think that NGET's proposed approach overestimates the strength of this relationship and, therefore, the required return on equity in RIIO-T1.

- **Secondly, we are not convinced that the variance in RORE modelled by NGET justifies the proposed cost of equity,** even if we accept the methodology proposed by the company for linking these two parameters together. NGET estimates that it will face a standard deviation of 0.43% around its allowed return (with the proposed uncertainty mechanisms), and argues that this level of risk exposure would justify an allowed return on equity of 7.5%. By comparison, the standard deviation around historical equity returns in world markets has been 20%, while the arithmetic average has been 7.2%.⁷

We recognise that this comparison is not straightforward: the variance in RORE reflects the impact of unexpected shocks *for a particular year*, whereas the variance in stock returns reflects the discounted impact of unexpected shocks *for all subsequent years*, so one would expect variance to be lower for RORE than for stock returns. Nevertheless, there would be merit in comparing the modelled standard deviation in RORE in RIIO-T1

⁴ NGET (2011a), paragraph 326; and NGET (2011b) 'Finance', paragraph 233.

⁵ NGET (2011b), paragraph 225.

⁶ Idiosyncratic risk may still be relevant for the analysis of the WACC but is better accounted for in the gearing assumption.

⁷ Dimson, Marsh and Staunton (2010), Global Investment Returns Yearbook 2010.

with comparable indicators of dispersion in market generous. Intuitively, a return 7.5% seems rather generous for a company that faces a 95% confidence interval of 0.85% around its allowed return.

- **Thirdly, we would welcome more transparency in NGET's analysis of differences between TPCR4 and RIIO-T1.** NGET's analysis seems to bundle two factors together: the change in incentive rate to 50%; and the extension of the price control length to 8 years. While the first factor can clearly be expected to increase the standard deviation, the second factor might have more complex implications. For example, if input prices are not serially correlated, or if they tend to follow a mean-reverting path, then it is conceivable that extending the length of the price control period could actually *reduce* the level of uncertainty surrounding the enterprise value over the price control period.