

# 3.2

# Annex

SP Energy Networks 2015–2023 Business Plan

Risk modelling for RIIO-ED1

NERA

May 2013



# **Risk Modelling for RII0-ED1**

Prepared for SP Energy Networks  
29 May 2013

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## 1. Overview

SP Energy Networks has commissioned NERA Economic Consulting to develop a financial risk modelling platform for use by its DNO businesses during the RIIO-ED1 price control review. The main aim of this model is to assess the financeability of the regulated business over the period from 2015-2023, given the company's business plan cost forecasts, and assumptions regarding key regulatory parameters.

### 1.1. Accounting for Risk and Uncertainty

Ofgem requires DNOs to submit well-justified business plans that set out their strategy to manage risks and uncertainties in an efficient way. For instance, Ofgem's Strategy Consultation paper stated that *"DNOs will... be required to demonstrate that their proposals take account of the various risks and uncertainties and provide a strategy to deal with these efficiently and maintain delivery"* and that *"The overarching principle for uncertainty mechanisms under the RIIO model is that we expect network companies to manage the uncertainty they face"*.<sup>1</sup>

Our work aims to assist SP Energy Networks in meeting this standard in compiling its business plan. To achieve this, the first step is to identify and quantify the various risk factors that its two DNO businesses face over the upcoming control period. We list the risk factors we identified and analysed in Section 2 of this report, which also describes the data we used in this study.

The next stage of our work was to develop a modelling framework within which to assess how these various risk factors affect the two licensed distribution businesses. To do this, as described in Section 3, we built on Ofgem's draft financial model<sup>2</sup> by adding the functionality to perform Monte Carlo simulations. Monte Carlo simulations allow SP Energy Networks to track how uncertainty around key input assumptions (e.g. opex or cost of debt risk) feed through into the "bottom line" for the business, i.e. its financial statements. Principally, the model we developed allows the derivation of probability distributions for a range of key financial ratios, including both credit and equity metrics, from assumed probability distributions on the risk factors identified in Section 2 of this report.

### 1.2. Identifying Appropriate Regulatory Parameters

Ofgem's Strategy Consultation document requires that that DNOs' business plans include *"proposals for notional gearing and where we should land within this cost of equity range (6.0-7.2 per cent), based on detailed evidence of their cash flow risk"*.<sup>3</sup>

The model allows SP Energy Networks to track how the probability distributions around financial ratios change following changes to regulatory parameters such as the allowed cost of equity and notional gearing. This functionality can help to identify levels for the notional

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<sup>1</sup> Strategy Consultation for the RIIO-ED1 price control – Overview", Ofgem, September 2012, pages 31 and 39.

<sup>2</sup> RIIO Price Control Financial Model (PCFM) - LiMo ED C1 84\_SP DNO 03-05-13, as received from Scottish Power on 10<sup>th</sup> May 2013.

<sup>3</sup> "Strategy Consultation for the RIIO-ED1 price control – Overview", Ofgem, September 2012, page 6.

gearing and cost of equity that are consistent with SP Energy Network's cash flow risk. In addition, the model can inform an assessment of appropriate levels for other regulatory parameters such as depreciation asset lives, IQI additional income, notional gearing, cost of debt indexation mechanisms and the capitalisation rate.

Because Ofgem is required to ensure that an efficient network company is financeable when setting price controls, the model allows SP Energy Networks to assess whether a given package of regulatory parameters is "appropriate" based on whether it passes a financeability test. As Ofgem states in its Strategy Consultation, "*We expect all business plans to contain... a holistic view of the package the DNO believes to be appropriate, i.e. the company's view on financeability metrics (with evidence), against their view on expenditure and outputs*".<sup>4</sup>

When setting price controls, Ofgem typically defines a financeable price control package as one that allows an efficient company to attain a "comfortable investment grade" credit rating (i.e. in the BBB to A range)<sup>5</sup> while securing finance to facilitate the delivery of its regulatory obligations.<sup>6</sup> We therefore built into the model the capability to perform a financeability test by comparing the modelled probability distributions around key credit metrics against the thresholds for each metric published by ratings agencies, as described in Section 3.2.

Although ratings agencies use a degree of judgment when setting credit ratings, comparing modelled ratios to published thresholds allows an approximate assessment of the likelihood that the companies will retain credit metrics consistent with issuing investment grade debt over the upcoming control period. Hence, a high probability of ratios below the level required for investment grade would suggest the DNOs are not financeable under the assumed package of regulatory parameters. In contrast, a low probability of ratios below this level suggests the company would be financeable.

The model also derives probability distributions around equity metrics. For example, Ofgem has said previously that "*in RIIO price controls our intention is that companies should be able to achieve an upside return on (notional) equity in the low double-digits, and be exposed to a downside return at or below the cost of debt*".<sup>7</sup> Therefore, for example, by examining the probability distribution around outturn Return on Regulated Equity (RORE), it is possible to assess whether the proposed price control package is consistent with this aim. The model also examines the equity ratios that form part of Ofgem's financeability test, i.e. Regulated Equity / EBITDA, and Regulated Equity / Regulated Earnings.<sup>8</sup>

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<sup>4</sup> Strategy Consultation for the RIIO-ED1 price control – Overview", Ofgem, September 2012, page 32.

<sup>5</sup> Moody's equivalent for a triple B rating is denominated as "Baa".

<sup>6</sup> Strategy decision for the RIIO-ED1 electricity distribution price control: Financial issues Supplementary annex to RIIO-ED1 overview paper, Ofgem (26d/13), 4 March 2013, para 3.1.

<sup>7</sup> RIIO-GD1: Final Proposals - Finance and uncertainty supporting document, Ofgem, 17 December 2012, para 3.37.

<sup>8</sup> Strategy decision for the RIIO-ED1 electricity distribution price control: Financial issues Supplementary annex to RIIO-ED1 overview paper, Ofgem (26d/13), 4 March 2013, para 3.4.

## **2. Identifying and Quantifying Risk Factors**

### **2.1. Process**

We began this model development task by identifying and quantifying key drivers of costs and revenue. As a starting point, we reviewed Ofgem's Strategy Consultation document and the subsequent decision document, in particular the supplementary annexes on "Outputs, incentives and innovation", "Uncertainty mechanisms" and "Financial Issues".

We compiled a list of key sources of risk which included all main components of the price control, such as capex, opex, cost of debt, real price effects, as well as the incentive schemes that Ofgem has proposed as part of the RIIO-ED1 package. At the same time, we reviewed the different uncertainty mechanisms Ofgem has proposed that mitigate some exposure to these risks. Through discussion with SP, we established which cost and revenue risk factors were most material, and so merit detailed treatment within the Financial Risk Model.

For each of the key risk factors, we formed assumptions regarding the statistical distributions of the cost and/or revenue impact, where appropriate, taking into account the likely limits on revenue exposure set under the price control. For example, Ofgem defines upper and lower bounds on the revenue impact for certain incentive schemes, and in these cases we defined the distribution on the revenue to be within the range set by Ofgem.

In discussion with Scottish Power, we defined assumptions on the appropriate "shape" of the statistical distributions we assumed and parameterized the distributions according to input data from Scottish Power or from our own independent analysis. Generally, we model the distributions in such way that Scottish Power's central view of its costs of performance is considered as the most likely outcome, i.e. the mode of the distribution.

### **2.2. Data and Assumptions**

#### **2.2.1. Cost uncertainties and uncertainty mechanisms**

The basis for the modelling of cost uncertainties is the cost forecasts contained in the SPD and SPMW Business Plans. These cost forecasts provide the mode of the statistical distributions for actual costs we assume in the Financial Risk Model. We also assume that they form the basis of any revenue entitlements made by Ofgem in the upcoming review. That is, we effectively assume that the SPD and SPMW cost forecasts are accepted by Ofgem and the business is fast tracked.

We also explicitly model the effects of Ofgem's proposed uncertainty mechanisms, taking into account the mechanics of the regulatory framework that aim to mitigate some of the business risks DNOs face; hence we avoid the potential for overstating the DNOs risk exposure. The following paragraphs describe the distributional assumptions we assume and set out the major incentive and uncertainty schemes we model.

##### **2.2.1.1. Totex / IQI incentive mechanism**

In the RIIO-ED1 framework, most major cost categories are subject to the totex incentive mechanisms, also known as the IQI efficiency incentive. The IQI incentive mechanism determines the share of totex overspend that the DNO will bear, or conversely, the share the

DNO retains if it underspends. The model assumes for fast-tracked DNOs an incentive rate of 70%, based on the assumption that the business will be fast-tracked.

For the simulation of outturn costs, we specify statistical distributions for the following categories of totex:

- Load related capex;
- Non-load related capex – asset replacement;
- Non-load related capex – other;
- Faults:
- Tree cutting; and
- Controllable opex.

The model assumes triangular distributions for each of these categories of totex over the RIIO-ED1 period, with the most likely case defined by the Business Plan cost forecast. The user can then specify upper and lower bounds on cost risk for each of the above categories. Having specified distributional assumptions regarding the costs, in each simulation run, the model picks a random value from the assumed distribution. The DNO then bears the share of any totex over- or underspend, as defined by the IQI mechanism.

#### 2.2.1.2. Load related expenditure

Ofgem has decided that DNOs can trigger a reopener for load-related capex if they can demonstrate a net efficient expenditure 20% greater or smaller than Ofgem's base allowance over the whole ED1 period (i.e. actuals plus forecasts for the remainder of the period), and the level of overspend is equal to or exceeds the materiality threshold of 1% of average annual base revenue.

As noted above, the risk model generates stochastic expenditures for the years up to the reopener window. At the reopener, companies have to forecast their overspend for the remainder of the price control period. We made the simplifying assumption that the forecast overspend for the period as a whole is extrapolated from the overspend seen to date. Simulated actual expenditure is assessed against the reopener conditions, and the reopener is triggered only if both conditions are satisfied. If triggered, the reopener adjusts for any variation in efficient expenditure beyond the 20% deadband. We modelled the uncertainty mechanism in line with Ofgem's decision to have two reopener windows in 2017 and in 2020.

#### 2.2.1.3. Non-load related capex - asset replacement

As noted above, asset replacement expenditure is simulated based on a triangular distribution around the SP cost forecasts. However, this category of expenditure is subject to a separate assessment that we developed the functionality to model.

At RIIO-ED1, Ofgem decided to modify the existing health index (HI) by stripping out the criticality element and creating a separate criticality index, measured on a scale of C1 to C4. Furthermore, the health and criticality scores for relevant assets will be combined and consolidated into a newly developed composite risk index. Using DNOs' forecasts for their



network's position according to the new H&CI index, Ofgem proposes to calculate an expected improvement in each DNO's asset risk score based on their business plans, which will represent the DNOs' agreed deliverable for RIIO-ED1. At the end of RIIO-ED1, if the DNO fails to demonstrate that its actual level of asset replacement meets the level agreed at the beginning of the price review, the DNO will be penalised through a penalty of 2.5% of the value of this underspend through a downward adjustment to its RIIO-ED2 allowed revenue. If the DNO meets the requirement, an upward adjustment to its RIIO-ED2 allowed revenue will be applied, such that it receives a reward of 2.5% of the value of this overspend.

In developing the model, we built in a place holder that allows the user to enter the year in which this review of DNOs' performance against the H&CI index occurs, and to model the effect of this review on cash flows. Ofgem proposes to specify the agreed deliverable for this mechanism based on a target risk score. As it remains unclear at the current stage, how Ofgem would calculate such a score, we based the modelling on financial expenditures for H&CI relevant assets. However, if as currently envisaged, the review will only take place at the end of ED1, there will be no financial impact for the ongoing RIIO-ED1 years so the scheme has no effect on the modelling.

#### 2.2.1.4. Smart metering volume driver

Ofgem has proposed a smart metering volume driver for the upcoming price control, which will link allowed revenues to the number of call-outs associated with the smart meter roll out. We have incorporated a placeholder for the proposed smart metering volume driver, although at the current stage, we haven't been able to form reliable assumptions on the volume targets or the incentive rate, so the driver is currently deactivated.

#### 2.2.1.5. Non-controllable opex (non-totex)

Non-controllable opex does not form part of totex (i.e. for the IQI) and is treated as a pass-through item in the financial model. The Financial Model simulates uncertainty in non-controllable opex using a triangular distribution, but because it is a pass-through item, allowed revenue adjusts (with a lag – see Section 3.3 below) to reflect simulated costs.

### 2.2.2. Incentive schemes

Ofgem considers a number of incentive schemes for RIIO-ED1 to encourage the DNOs to deliver the primary outputs and secondary deliverables efficiently. Most incentives include financial rewards or penalties, while some are reputational or informational or have a potential financial impact only on the subsequent price control in ED2 through a later true-up. For our risk modelling and financeability assessment, we focused on those incentives that create revenue risks in the RIIO-ED1 period.

In general, for the revenue outcome from incentive schemes, we defined triangular distributions around Scottish Power's view on the most likely outcome (i.e. mode). Where Ofgem has defined a maximum reward or a maximum penalty a DNO can receive through an incentive scheme, these incentive revenue caps and floors determine the upper and lower bound of the triangular distribution.

Incentive scheme performance in one year is most likely correlated with performance in another year during the price control. Outputs and deliverables such as customer satisfaction

evolve gradually over time. A year of poor performance with maximum penalty in one area is unlikely to be followed by a year with strong over-performance and high revenue rewards. The model therefore simulates the incentive scheme outcomes by taking random draws from the described distributions for the first and the last RIIO-ED1 price control years (i.e. 2015/16 and 2022/23) and interpolates the outcomes for the period in between.

#### 2.2.2.1. Broad Measure of Customer Satisfaction (BMCS)

The revenue exposure related to the Broad Measure of Customer Satisfaction is stated as a percentage of the annual allowed base revenue, which we assume is represented by the baseline Final Proposals allowance, excluding the effects of all incentive and uncertainty mechanisms.

The BMCS incentive scheme incorporates five different elements, each with a respective maximum reward or penalty the DNO can receive (see Table 2.1). The total revenue exposure sums up to +/- 1.5% of annual base revenue. We defined for the outcome in each category a triangular distribution around SP's view on the likeliest outcome. The upper and lower bound of the triangular distribution are determined by Ofgem's proposed caps and floors.

**Table 2.1**  
**Broad Measure of Customer Satisfaction: Revenue Exposure**

[as % of base revenue]	Maximum Penalty / Lower bound	Maximum Reward / Upper bound
Customer Satisfaction Survey		
Minor connections	-0.5%	+0.5%
Interruptions	-0.3%	+0.3%
General inquiry	-0.2%	+0.2%
Complaints metrics	-0.5%	+0.0%
Stakeholder engagement	-0.0%	+0.5%
<b>Total</b>	<b>-1.5%</b>	<b>+1.5%</b>

Source: Ofgem Strategy Decision "Outputs, Incentives and Innovation", Scottish Power data.

#### 2.2.2.2. Interruption Incentive Scheme (IIS)

Ofgem sets the overall revenue exposure for the Interruption Incentive Scheme at +/-250 basis points RORE basis points per annum with a symmetric revenue and penalty cap. To model this scheme, we calculate the value 250 basis point on RORE in £ million, and assume a triangular distribution around this revenue effect around SP's best view on the most likely revenue outcome from the IIS.

#### 2.2.2.3. Connections Guaranteed Standards of Performance

The Connections Guaranteed Standards of Performance scheme is a penalty-only mechanism. Operators have to pay prescribed levels of compensation to the customer where GSOP standards are not being met. Therefore, the modelling uses a triangular distribution with a

mode and upside limit of £0, with the lower bound determined by SP's view on its maximum exposure.

We considered the expected cost per annum for GS2. The mode of the triangular distribution we assume is at the most likely level forecast by SP, with an upper bound at zero and a lower bound in line with SP's view on its maximum downside exposure. Additionally, we modelled GS6 payments in case of non-completed connection works as a low probability high impact risk factor. We modelled the exposure to these exceptional one-off payments through a Bernoulli, such that the user enters an appropriate probability of the event resulting in penalty payments, as well as the average payment per event.<sup>9</sup>

#### 2.2.2.4. Time to connect (minor connection customers)

The time to connect incentive scheme applied to minor connection customers is a reward-only incentive. As such, the triangular distribution for the revenue outcome resulting from the scheme has a downside cap at £0. Ofgem sets the maximum revenue reward to +0.4% of annual base revenue which we take to be the upside cap of a triangular distribution.

#### 2.2.2.5. Incentive on Connection Engagement (major connection customers)

By contrast, the Incentive on Connection Engagement (ICE), which relates to major connection customers solely, is a penalty-only incentive. The maximum revenue exposure for a licensee is -0.9% of annual base revenue.

The Strategy Decision documents state that the maximum penalty that can be applied to a DNO will be proportionate to the market segments that have passed the Competition Test, but Ofgem has yet to decide on the approach used to scale the size of penalty. Our risk model adopts a working assumption of maximum risk exposure, and defines a triangular distribution with lower bound at 0.9% of base revenue and upper bound at zero.

### 2.2.3. Cost of debt

The Financial Risk Model accounts for uncertainty around both the cost and volume of debt issued over the ED1 period.

In line with the Ofgem model, we assume the cost of SP's *embedded debt* is based on the 10-year trailing average cost of debt index.

The amount of new debt issuance that takes place is determined by modelled costs and allowed revenues, which are random variables in the model. More expenditure will result in higher amounts of new debt being issued, and vice versa. We assume that new debt is issued at the prevailing spot rate for A/BBB-rated corporate bonds.

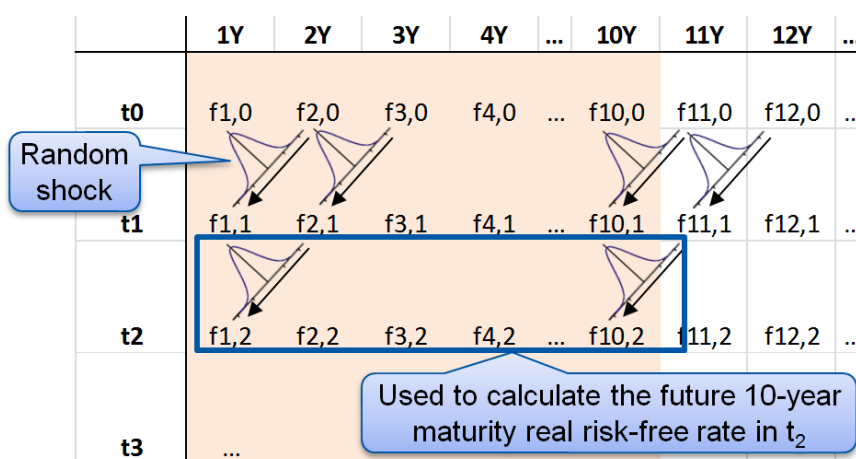
To simulate the market price of debt, we simulate future real risk-free rates as future interest rates on a 10-year maturity UK government bond by randomly shocking the current Bank of

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<sup>9</sup> Please note that GS6 in fact distinguishes between four different types of connections work for which four different daily penalty rates apply in the event of uncompleted work. We consider a high level aggregate approach here and consider an overall GS6 outcome. If detailed data is available, the model may accomplish for the different types of connections and payments.

England’s real forward curve.<sup>10</sup> Figure 1 illustrates the simulation of a future path of the real risk free rate. In the picture  $t_0$  is the current year and  $t_1, t_2$ , etc. are future (simulated) years. Current 1-year maturity forward rates are randomly shocked with normally distributed variables.<sup>11</sup> Shocked 1-year forward rates are then re-combined appropriately using the Fisher equation to obtain simulated 10-year forward rates. Using this method, we have simulated 4000 future paths, from which one is randomly picked at each iteration. Each path has an equal chance to be picked within the Financial Risk Model.

**Figure 1**  
**Simulation of Future Risk-Free Rates**



Source: NERA analysis

The real cost of the future new debt issued by SP is then calculated by adding to the simulated real risk free rate a debt premium spread.

The *spread* corresponds to the expected debt premium paid by a A/BBB-rated non-financial company on top of the risk-free rate for a bond with a maturity of 10+ years. The estimated spread is calibrated on historic debt cost indices published by iBoxx for the relevant rating and maturity. The level of the future spread in each year is inversely correlated to the level of the simulated real risk free rate, so that the actual (real) cost of new debt is less volatile than the simulated risk free rate. This is consistent with market evidence on the volatility of a utility company cost of debt.

The actual *nominal* cost of debt is then obtained by applying the Fisher formula to the future real cost of debt using expected inflation.

<sup>10</sup> The Bank of England forward curve is the UK “instantaneous implied” real forward curve based on yields on UK government bonds and on yields in the collateral repo market.

<sup>11</sup> Using “white noise” random variables, i.e. normally distributed with an expected value of zero and a strictly positive standard deviation, calibrated on historical data over the past 5 years

Ofgem's future allowed cost of debt in each year of the RIIO-ED1 period is updated with the simulated costs of new debt for an A/BBB-rated non-financials corporate bond with 10+ years maturity.<sup>12</sup>

#### **2.2.4. RPI**

Allowed revenues in the model are indexed each year based on a forecast of RPI. The current version of the risk model<sup>13</sup> uses the central RPI forecast reported in the latest Ofgem RIIO-ED1 model that was made available to us (LiMo ED C1 84\_SP DNO 03-05-13).

However, we also developed an alternative approach for the assessment of simulated RPI risk, where in each simulation run the model selects an inflation forecast from a range of different independent forecasts for RPI during the RIIO-period.<sup>14</sup> These inflation forecasts are all reported in the HM Treasury Publication "Forecasts for the UK economy: a comparison of independent forecasts" from May 2013 and drawn from reputable sources; hence they are assumed to occur with equal probability.

#### **2.2.5. RPE**

At present, we do not model uncertainty about future RPEs separately from the other risk factors affecting the various categories of expenditure (see above). However, we have incorporated an alternative approach for simulating RPE uncertainty into the model, which is described in a separate report prepared by SP.

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<sup>12</sup> Note that the cost of debt allowance in the model is an allowance in real terms and inflation is remunerated through indexation of the revenues, in line with Ofgem's methodology.

<sup>13</sup> Model version "130524\_LiMo ED C1 84\_NERA Risk Model.xlsm" sent to Scottish Power on the 24<sup>th</sup> May.

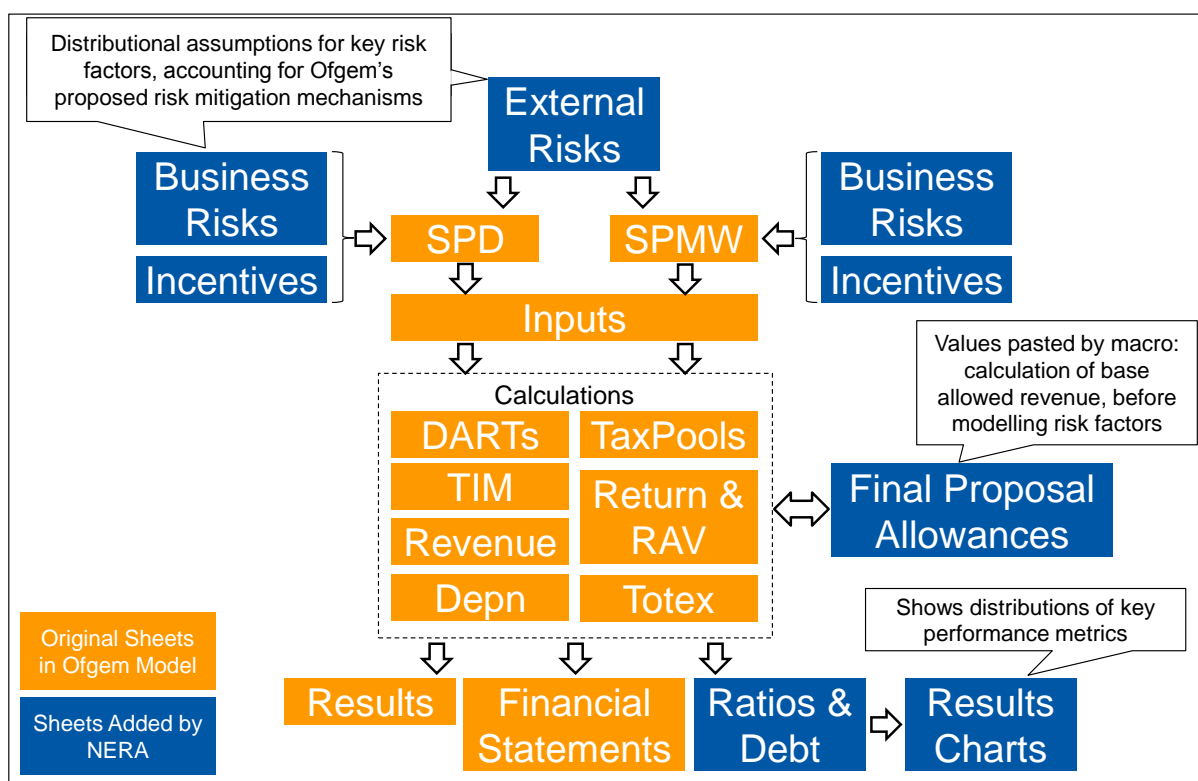
<sup>14</sup> We assemble the medium term forecasts available. If the forecast is not complete for the entire ED1 period we substitute the average value of forecasted RPI growth for years where it is not available.

### 3. Modelling Approach

#### 3.1. Overview of Model Structure

The Monte Carlo simulation tool we developed for Scottish Power builds on Ofgem’s draft regulatory Price Control Financial Model for RIIO-ED1.<sup>15</sup> We have restructured and added to Ofgem’s model in order to transform the deterministic regulatory model into a risk model that explicitly distinguishes between actual and allowed costs and is capable to simulate random variation of the key risk factors using Oracle’s software “Crystal Ball”.

**Figure 3.1**  
**Revisions to Ofgem Model to Incorporate Monte Carlo Model Framework**



Source: NERA

Figure 3.1 illustrates the structural changes we have undertaken to get from the Ofgem model to a Monte Carlo model framework. Key changes include:

- Differentiating between actual costs and allowed costs, and turning input factors into stochastic variables. Actual costs are modelled as stochastic variables, mainly on the “Business Risk” sheets. This sheet then calculates how allowed revenue changes over time in response to shocks to actual expenditure. From the “Business Risk” sheets, simulated costs and updated allowed revenue both feed through the model into the existing financial statements worksheets. By accounting for risk mitigation mechanisms

<sup>15</sup> Model version LiMO C1 84, received from Scottish Power on 10<sup>th</sup> May 2013.

and the modelling of re-openers, IQI cost sharing or indexation mechanisms, we avoid the potential for overstating the risk exposure of the business;

- Modelling of the annual iteration process that updates allowed revenue (see Section 3.3), including the use of a macro to calculate, and then fix across all iterations of the Monte Carlo simulation, the FP allowances;
- Modelling of Ofgem’s risk mitigation mechanisms. As noted above, the “Business Risk” sheets calculate how allowed revenue changes following shocks to costs;
- Modelling of incentive schemes and resulting revenue impact. These calculations are mainly performed on the “Incentives” worksheets;
- Modelling of external risk factors, such as the cost of debt or inflation. The prevailing cost of debt is a random variable, as described in Section 2.2.3 above, which is simulated on the “External Risks” sheet. We also model explicitly how this feeds into the 10-year trailing average cost of debt index, and hence the allowed cost of debt;
- Including model flexibility to switch between notional and actual financing structure. To do this, we included a series of switches on the User Interface worksheet;
- Modelling automated issuance of debt. Debt is issued within the price control period to ensure the business has sufficient cash to cover (stochastic) expenditure, as described further in Section 3.2 below;
- Generating distributional charts for key financial ratios and financeability metrics. As we discuss below in Section 3.4, the model recalculates all relevant ratios and records how these ratios vary from one iteration to the next. The analysis of the realized values resulting from hundreds or thousands of iterations allows the derivation of probability distributions for each financial metric.

### 3.2. Modelling of Finance & Tax

Consistent with Ofgem’s modelling approach, we assume that at the start of the price control period the amount of embedded debt in the business is set equal to the assumed notional gearing level, multiplied by the RAV.<sup>16</sup> Likewise, we assume that in the first year of the control period that the company has equity in the business equal to RAV multiplied by (1-assumed notional gearing). We assume interest costs related to embedded debt are equal to Ofgem’s 10-year trailing average cost of debt.

As we roll forward the Monte Carlo simulation over time, the model assumes that cash flow short falls during a year are financed (in the first instance) through short-term floating rate loans. However, we assume a limit on the size of the short-term floating rate facility such that whenever the closing value of short-term floating rate debt exceeds this threshold, the model automatically issues a new long-term bond. Both the threshold for bond issuance and nominal value of new bonds are model inputs. The costs of variable debt and long-term bonds are stochastically simulated within the model.

In line with Ofgem’s modelling approach, we assume that:

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<sup>16</sup> From a financing perspective, we modelled each of SP’s DNOs as a separate ring-fenced entity.

- The model injects new equity (or repurchases its shares) to ensure that modelled gearing does not deviate by more than a specified threshold from assumed notional gearing;
- Each DNO's annual cash outgoings include dividends equal to 5% of the notional equity portion of RAV; and
- Of each DNO's long-term debt, 25% is index-linked.

Finally, the model also allows the user to consider a scenario in which the costs of embedded debt are based on the company's actual rather than its notional financing structure. The actual financing structure calculates the outturn cost of debt based on the DNOs' actual embedded debt.

### 3.3. The Annual Iteration Process

One of the major differences between Ofgem's model and our Financial Risk Model is the distinction between allowed and actual costs and revenue in the stochastic framework. The RIIO-ED1 regulatory framework will include an Annual Iteration Process that updates the allowed revenue for DNOs, as actual data becomes available on their actual performance, costs and output levels.

As a starting point to modelling the Annual Iteration Process, we developed a macro that calculates baseline Final Proposals Allowances, assuming no uncertainty and that actual costs and outturn costs are equal at the level forecast in the Business Plan. It then saves the values in the "FP Allowances" sheet, which it can then compare against recalculated allowed revenue at each subsequent simulation.

The model then sets actual revenue equal to the Final Proposals Allowances for the first years of the price control period, and adjusts actual revenue with a lag once actual outturn allowed revenue is generated from the simulation, i.e. after accounting for simulated costs and the various uncertainty and risk mitigation mechanisms. Specifically, the model calculates an incremental change to Final Proposal base revenue, known as the "MOD" term for each period, which is determined as the delta between actual and allowed revenue, inflated (or deflated) at the WACC. The adjustment lag (in years) is an input assumption that the user can specify.<sup>17</sup>

### 3.4. Model Outputs to Assess Financeability

By running many iterations of the model, the model derives probability distributions around key metrics of the DNOs' financial performance. In particular, the model allows the derivation of distributions around the key financial ratios that Ofgem uses to assess financeability, and the ratings agencies use to set credit ratings. As a starting point, the model therefore derives distributions of the ratios shown in Table 3.1.

Table 3.1 sets out the definitions of the ratios and the reference value for a Baa rating for each sub-factor according to Moody's rating methodology for regulated electric and gas

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<sup>17</sup> While Ofgem's deterministic model calculated the MOD term only for one year at each time and saved historical values, our Financial Risk Model incorporates the functionality to recalculate base revenue each year for the whole RIIO-ED1 period.



networks. However, in interpreting these ratios, we recognise that a projection that one or more financial ratios will fall below the thresholds normally required to achieve an investment grade rating does not necessarily mean it would be downgraded and/or is not financeable. Specifically, ratings agencies examine trends and exercise judgment when evaluating a company's creditworthiness. They also consider a broader range of factors than just credit scores, including, for example, the regulatory environment.

**Table 3.1**  
**Financial Ratios and Reference Value for Baa (Moody's)**

Ratio	Definition	Reference for Baa
<b>Credit Ratios</b>		
FFO interest cover ratio (cash interest only)	$(\text{FFO} + \text{Net cash interest paid}) / \text{Net cash interest paid}$	$\geq 2.5$
Post-Maintenance Interest Cover Ratio	$(\text{FFO} - \text{RAV Depreciation} + \text{Net cash interest paid}) / \text{Net cash interest paid}$	$\geq 1.4$
Gearing	Closing Net Debt / Closing RAV	$\leq 75\%$
FFO / Net debt	$(\text{FFO} + \text{Net inflation interest paid}) / \text{Closing Net Debt}$	$\geq 8\%$
RCF / Capex	$(\text{Retained Cash Flow} + \text{Net inflation interest paid}) / \text{Capex (slow pot expenditure)}$	$\geq 1.0$
RCF / Net Debt	$(\text{Retained Cash Flow} + \text{Net inflation interest paid}) / \text{Closing Net Debt}$	$\geq 10\%$
<b>Equity Ratios</b>		
RORE (Notional gearing, Allowed CoD)	Regulated equity return (Actual return net of regulated debt return at allowed CoD) / Regulated equity (notional equity share of RAV)	n/a
RORE (Notional gearing, Actual CoD)	Regulated equity return (Actual return net of regulated debt return at actual CoD) / Regulated equity (notional equity share of RAV)	n/a
Regulated Equity / EBITDA	$(\text{Closing Net Debt} + \text{Closing RAV}) / \text{EBITDA}$	n/a
Regulated Equity / PAT	$(\text{Closing Net Debt} + \text{Closing RAV}) / \text{Profits after tax}$	n/a
Dividend Cover Ratio	Profits after tax / Dividends paid	n/a
<b>Scale and Complexity of Capital Programme</b>		
Capex / RAV	$\text{Capex (slow pot expenditure)} / \text{Closing RAV}$	$\leq 12\%$

Source: Ofgem RIIO PCFM version LiMO CM 84, Moody's Rating Methodology: Regulated Electric and Gas Networks, NERA.

In addition to the above ratios, we therefore aggregate a series of credit metrics into a single index that reflects the company's overall credit score using the weightings published by

Moody's.<sup>18</sup> The single index we derive from our Financial Risk Model combines the company's performance against financial ratio thresholds with scores relating to other determinants of its overall creditworthiness. The resulting index can then be compared to published thresholds consistent with a range of credit ratings. Moody's assessment of credit risk in the regulated electric and gas networks sector focuses on four broad factors which encompass 13 specific sub-factors. Our Financial Risk Model simulates key credit metrics and the Capex-to-RAV ratio which reflects the scale and complexity of Scottish Power's capital programme.

In calculating the Moody's index, we keep the scores achieved by the companies for sub-factors besides financial ratio performance and capex programme constant across scenarios, and set them based on data from SP. This means, for example, that we assume no change in the ratings agencies' perception of the regulatory regime in the UK, or the business models operated by the DNOs. Table 3.2 shows the weighting for each factor and the assumed rating score for SP.

Although we have tried to implement Moody's ratings methodology as closely as possible to the approach described in its Rating Methodology for Regulated Electric and Gas Networks, there is some ambiguity in Moody's descriptions, in particular about the application of the second stage weighting (Moody's step 6).<sup>19</sup>

Furthermore, the methodology states that the rating utilises historical and projected financial results, depending on whether Moody's believes that a company's credit metrics will improve or deteriorate.<sup>20</sup> For our simulations, we use a historical 3-year average of the key credit metrics.

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<sup>18</sup> Moody's Rating Methodology: Regulated Electric and Gas Networks, Moody's Global Infrastructure Finance, August 2009.

<sup>19</sup> We apply a simple multiplication of the sub-factor weighting with both the Step 3 penalty factor (1,1,1,1.15,2.3) and the Step 6 numerical factor (1,3,6,9,12,15), consistent with Moody's example set out in footnote 3 on page 7 of the Rating Methodology.

<sup>20</sup> Moody's Rating Methodology, page 6 and page 19.

**Table 3.2**  
**Rating Factor Weighting and Rating Value Assumptions**

Rating Factors	Factor Weighting	Rating for SP
<b>1 Regulatory Environment and Asset Ownership Model</b>		
Stability & predictability of regulatory regime	15%	Aaa
Asset ownership model	10%	Aa
Cost and investment recovery	10%	A
Revenue risk	5%	Aa
<b>2 Efficiency and Execution Risk</b>		
Cost efficiency	6%	Baa
Scale and complexity of capital programme (Capex/RAV)	4%	simulated
<b>3 Stability Of Business Model and Financial Structure</b>		
Ability and willingness to pursue opportunistic corporate activity	3.33%	A
Ability and willingness to increase leverage	3.33%	Baa
Targeted proportion of operating profit outside core regulated activities	3.33%	Aaa
<b>4 Key Credit metrics</b>		
3yr PMICR	15%	simulated
3-yr Net Debt/RAV	15%	simulated
3-yr FFO/Net Debt	5%	simulated
3-yr RCF/Capex	5%	simulated
<b>Total</b>	<b>100%</b>	

*Source: Moody's Rating Methodology: Regulated Electric and Gas Networks, NERA.*

In addition to these ratios used by ratings agencies, at recent price controls Ofgem has also used the Return on Regulated Equity (RORE) as another means of assessing DNOs' financeability. The model allows us to estimate probability distributions around RORE, for comparison against Ofgem's aspiration that DNOs can achieve an upside return on (notional) equity in the low double-digits, and be exposed to a downside return at or below the cost of debt (see Section 1.2 above).

We calculate the equity return as the DNO's total actual revenue after annual iteration process, less allowed regulated debt return<sup>21</sup> and less allowances for fast-pot expenditure, non-controllable opex, RAV depreciation, additional income, pass-through items and tax allowance. Deviations of the resulting equity return from the Ofgem notional cost of equity indicate operational over- or underperformance at notional gearing and notional cost of debt.

While this RORE definition, consistent with Ofgem, does not account for any over- or underperformance resulting from the mismatch between actual and allowed cost of debt, we also calculate an alternative RORE at notional gearing but at actual cost of debt. The calculation of the regulated equity return for this equity metric differs from the above in that it deducts the regulated debt return at actual instead of allowed cost of debt, with everything else being the same.

<sup>21</sup> Regulated debt refers to the debt level at notional gearing.

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