



## **Ofgem's estimate of the "Halo Effect"**

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20 January 2011

Insight in Economics™

# Ofgem's "Halo Effect" is driven by two key flawed assumptions



In the RIIO – ED1 Price Control Strategy Decision\*, Ofgem found that:

“...bonds issued by network companies since the start of 2010 have outperformed the iBoxx index by 14 bps, compared to 53 bps over the history of the iBoxx index.”

**Ofgem's derives the result on the following key assumptions:**

1

## Inclusion of Index-Linked Bonds (ILBs)

- Ofgem includes coupon-paying ILBs (in particular in the period '05 – '08)
- New Pension Regulation introduced in [2005] created inelastic demand for these bonds
  - *The inclusion of ILBs is a key driver of Ofgem's apparent "halo" effect*

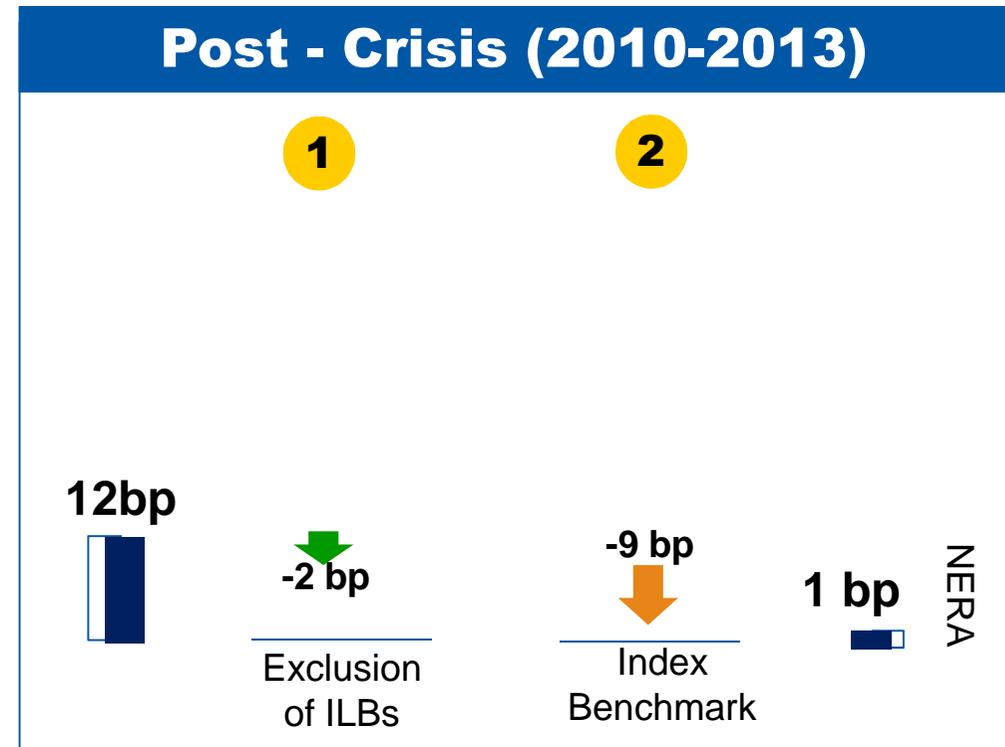
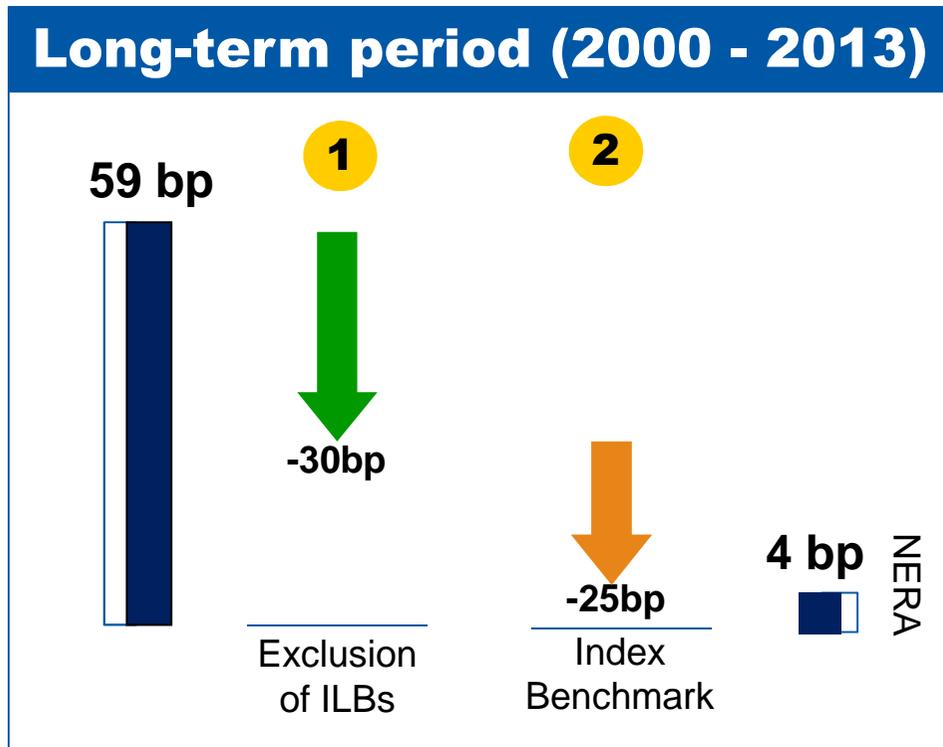
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## Inappropriate Index Benchmark

- Pre-financial crisis, utility bonds were mainly A-rated
  - *The A/BBB index used by Ofgem is an inappropriate benchmark for utility CoD over that period in particular*
- Post-financial crisis, a higher proportion of utility bonds are BBB rated
  - *This explains why issues post-crisis are more in line with Ofgem's index*

\* Strategy decision for the RIIO – ED1 electricity distribution price control, Financial issues. Supplementary annex to RIIO – ED1 overview paper. Reference 26d/13, 4 March 2013.

# Correcting for Ofgem's flaws reduces the "halo" effect significantly



Source: NERA Analysis

NOTE: NERA uses "current yields" rather than "coupon yields" as the appropriate return measure against the iBoxx total return index. The impact on the final spread estimates due to the methodological difference is negligible.

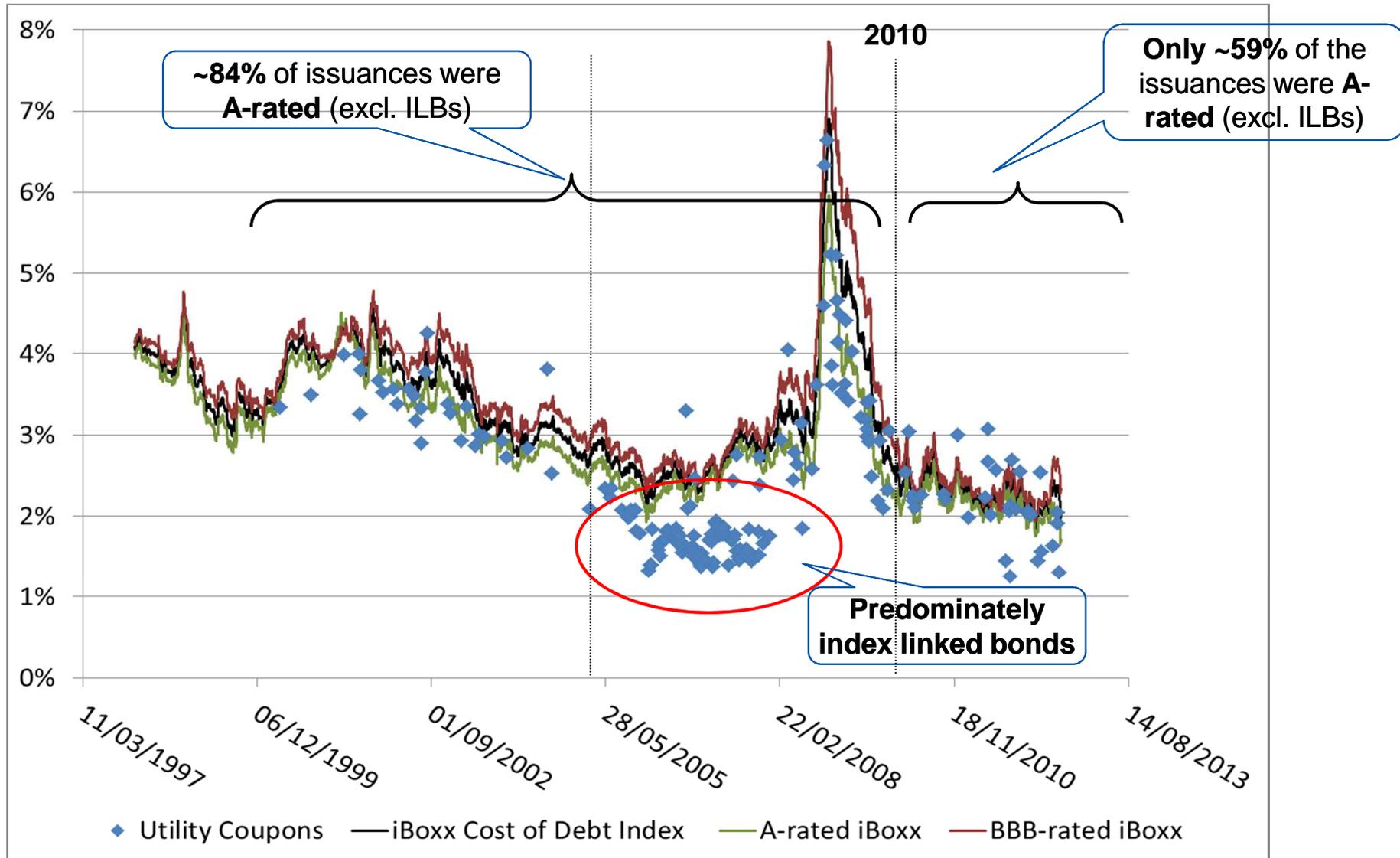
➔ Correcting for 1) and 2) results in a spread between the Relevant iBoxx Benchmark and Utility CoD of between **1 - 4 bps.**

# Ofgem's "halo effect" is driven by Index Linked issues in '05 - '08



NERA  
Economic Consulting

## Utility Coupons vs. iBoxx A and BBB

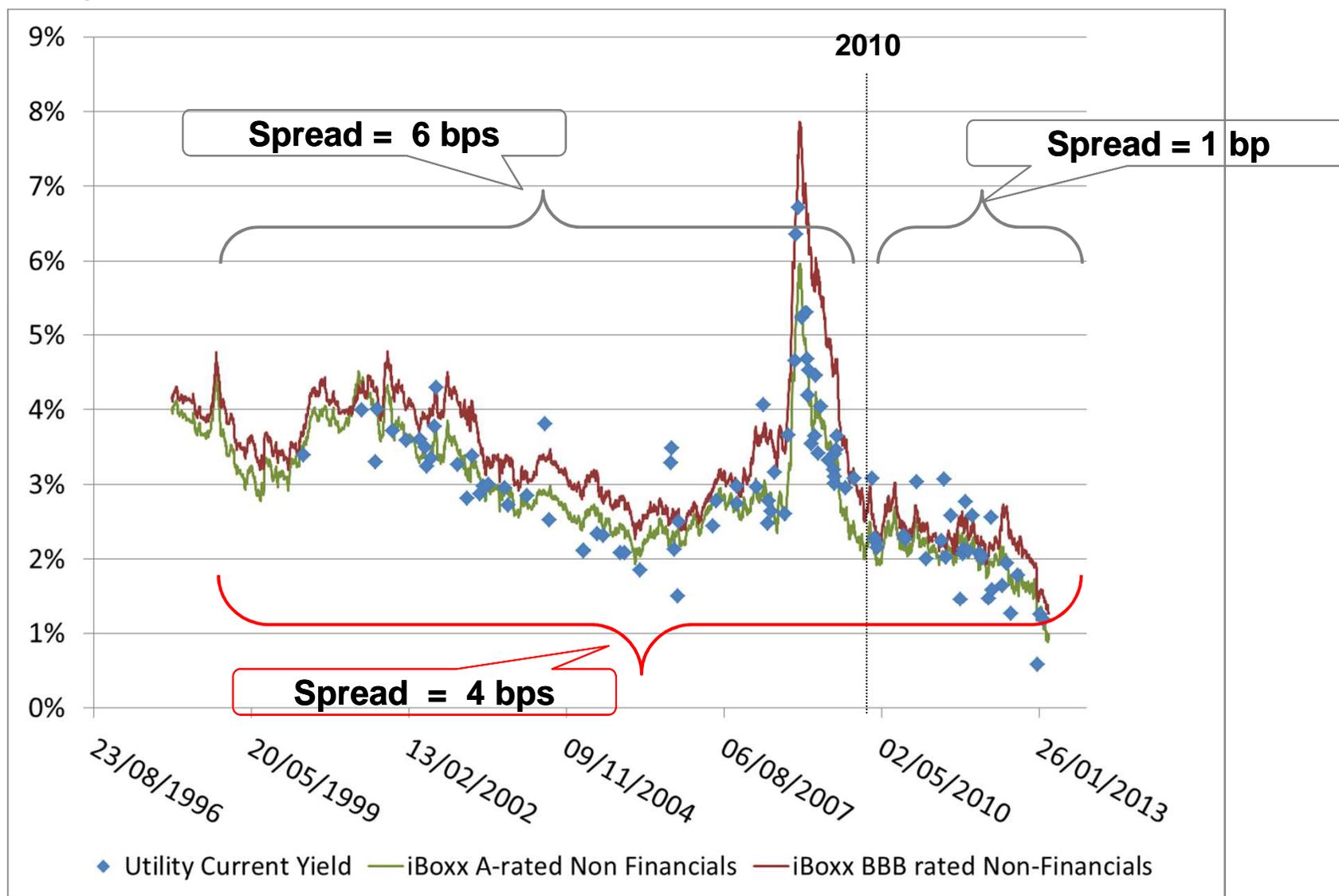


Source: NERA Analysis based on Iboxx, Bloomberg and Ofgem data;

# Controlling for Credit Rating Reduces the “Halo Effect” to 1 – 6 bps



## Utility Current Yields at issuance vs. Relevant iBoxx benchmark (excl. ILBs)



Source: NERA Analysis based on Iboxx, Bloomberg and Ofgem data; Note: Data excludes ILBs



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