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Dear Interested Parties

Financing networks

Introduction

In October 2004, HM Treasury and the DTI published a report on "The Drivers and Public Policy Consequences of Increased Gearing".

This led to the Ofgem and Ofwat discussion document "Financing Networks" published in February 2006. A seminar was held to discuss the issues arising on 27 April and a summary of responses published on 2 August.

In parallel, Ofgem has reached the final stages of the current transmission price control review and is part way through the gas distribution price control review.

The purpose of this letter is to set out Ofgem's conclusions from the Financing Networks consultation and explain how this will be taken forward. This letter focuses on the issues in the context of regulating the main privatised energy networks – regulation of new licensees (whether IGTs and IDNOs[1] or, in future, offshore transmission licensees) will need to reflect their differing circumstances.

Increased Gearing

Ofgem concurs with the view put forward strongly through the consultation that decisions on financing structures should be a matter for company management, provided the regulatory framework is sufficient to protect consumers.

[1] Independent Gas Transporters and Independent Distribution Network Operators

In our view, increases in gearing have arisen primarily as a result of market factors combined with the search for more efficient financing. We note that it has been argued that increased gearing will dilute incentives, but also that it would strengthen incentives – we do not consider there is a strong case for regulatory intervention as a result.

We do see a need to ensure higher gearing does not transfer risks to consumers and that the regulatory framework can deal with financial distress. We consider that, in the electricity and gas network sectors, the mechanisms that exist to address pressures of increased gearing appear adequate. We view the financial ringfence conditions we have included in all energy network licences as important in this regard, including the cash "lock-up" provisions for companies reaching the floor of investment grade status. We continue to use credit rating assessments in the financial ringfence, because we have not identified any better alternative. We have also moved to a post-tax cost of capital, with clawback of tax benefits from high gearing at the licensee, in part to reduce incentives to increase gearing. However, we recognise that we cannot foresee all future market developments and we will need to remain vigilant to new risks arising and, where appropriate, consider how to respond.

Facilitating investment

Many respondents noted that the regulatory framework in the water and energy network sectors has been successful and is perceived as relatively low risk. There is widespread support for the view that the key to ensuring adequate capital supply for investment lies in continuing to strengthen the predictability of (or regulatory commitment to) both the Regulatory Asset Value (RAV) and the returns which can be earned on it throughout its life. This may, in time, be expected also to yield benefits in terms of lowering required returns, by reducing actual or perceived levels of regulatory risk.

We have already taken a number of steps to improve the predictability of price control reviews and to reduce perceptions of risk. These have included:

- more extensive consultation, through publications, workshops and meetings;[2]
- where practicable, establishing principles for our approach across sectors (for example in relation to pensions);[3]
- moving to rolling capex incentives to address periodicity and setting out in proposals documents more clearly how such incentives (rewards and penalties) will apply and how the RAV will be calculated;[4] and
- instituting annual cost reporting based on detailed rules and templates, with annual review and annual publication of an indicative RAV figure (which we would not expect to alter unless new information becomes available).[5]

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[2] See *Assessment of the Electricity Distribution Price Control Review Process*, ref 91/05, Appendix 2 for an outline of the DPCR4 process, at www.ofgem.gov.uk
[3] See *Developing Monopoly Network Price Controls, Initial Conclusions*, ref 54/03, paragraph 4.35 at www.ofgem.gov.uk
[4] See *Electricity Distribution Price Control Review, Final Proposals*, ref 265/04, Appendix 1 at www.ofgem.gov.uk
[5] See *Electricity Distribution Cost Review 2004/05*, ref 263/05 at www.ofgem.gov.uk

Subject to consultation, we would expect to adopt similar approaches in future. However, we accept that the lack of clear incentives from previous price reviews has led to more uncertainty in rolling forward the RAV for historical investments than we would have liked. This has been a necessary transition – in the light of previous price control settlements, we had to protect consumers' interests by applying a reasonable interpretation of what was intended. Going forward, we agree with respondents to the discussion paper that we can best protect consumers' interests by providing clarity about the basis of RAV calculations and the mechanics of incentives at the outset of each price review (while retaining such discretion as is necessary, e.g. to avoid gaming of detailed rules).

Against this background, there does not appear to be a strong case for any radical reform, in particular in moving to full application of the "split cost of capital" model. However we do consider that some of the observations that prompted Dr Helm's proposals do need to be addressed. These are discussed further below.

Financial modelling and ratios

Financeability issues are best left to licensees to resolve, provided (a) there is adequate regulatory commitment (in the sense referred to above), and (b) the marginal costs of raising additional capital (where this is needed) are properly taken into account in setting allowed rates of return.

Nevertheless, we recognise that financial markets place considerable weight on financial ratios, particularly debt/RAV but also shorter-term measures such as interest cover. We therefore see a need for a dual approach. We will, as described above, work to improve the predictability of price controls and communicate these improvements, which should reduce market concern about short-term ratios. In the meantime, we will continue to assess the financeability of the price control proposals using current techniques. We will base any adjustments required on careful consideration and consultation, rather than adopting a mechanistic approach.

Where any enhancement or acceleration of revenues appears to be necessary to ensure price controls are financeable, we consider that adjustments should generally be NPV neutral and always transparent. In some cases, it may be appropriate to model on the basis of equity injections to cover part of the costs of new investment, taking account of the associated transaction costs.

Cost of capital

We are mindful of the impact of cost of capital decisions on the investment climate. Our decisions on the allowed rate of return are taken in this context, based on longer-term trends. We have used the CAPM framework for our decisions but have emphasised that CAPM itself permits a wide range of interpretations.

In presenting the final proposals to DPCR4, we emphasised that should market data continue to point to lower figures than we had used, we would increasingly take that into account. Given market data since late 2004, it should therefore not be a surprise that we have used a lower cost

of capital figure in the initial stages of thecurrent TPCR. Decisions on the exact figure will necessarily be a matter for each price review.

As noted above, we are not persuaded that the split cost of capital approach is appropriate. However, we note that this is only one aspect of the package of measures proposed by Dr Helm and we do consider that three of the underlying observations merit further work:

- the importance of regulatory commitment;
- that, in relation to the cost of debt, regulatory assumptions have tended to exceed market out-turns and that risk could be reduced by using actual market values rather than an ex ante assumption; and
- that the size of the RAV is not necessarily the main driver of risk facing companies, and that the size of new investment programmes and nature of operations may be relevant drivers.

On regulatory commitment, we agree that this is important in reducing the cost of capital and have set out above (under facilitating investment) the practical steps we are taking to address this.

On the cost of debt, we can see both advantages and disadvantages in linking revenues to average out-turn bond (gilt or corporate) yields. This would transfer interest rate risk, at least in respect of new debt, from companies to customers. In terms of existing debt, the residual risks will depend on whether this is fixed/bond or floating rate – but companies can in any event hedge such risks. The proposal may also increase variability in customer charges. Some of these issues could be addressed by using a moving average. We propose to develop some options and modelling, to share ideas with Ofwat and, where appropriate, other economic regulators, and to consult further on this in due course, for potential application after the current round of price controls.

On the drivers of risk, we do not consider that a more detailed analysis of the variability of returns (or covariance with systemic factors) would be likely to change our view on average returns or to lead us to a split cost of capital approach. However, such analysis could be useful in informing our views on differences in risk across sectors (and possibly even between companies). We have begun to analyse these differences in the energy network sectors and would expect to develop this during the current GDPCR. We will also share ideas with Ofwat in this area.

We also note Dr Helm's points on the difference between the average and marginal cost of capital. We do not agree that the marginal return applied directly to (i.e. multiplied by) the value of new investment must be increased. Our regulatory framework places substantial emphasis on other drivers to invest, based on obligations, output measures and incentives – this encourages companies to target investment on delivering outcomes rather than just targeting increased expenditure. Clearly, for this system to work, aggregate returns must adequately remunerate investment – but the evidence from the large increases in investment we are seeing in practice suggests that the system is working.

Next steps

Ofwat and Ofgem have agreed that it is now for each regulator to take account of the findings of the joint study in developing their approaches to future price control reviews, taking account of the particular circumstances of the sectors they respectively regulate. We will continue to discuss and share thinking on these issues with Ofwat and other economic regulators.

As noted above, we have begun work on analysis of comparative risks across sectors and have outlined work on linking the cost of debt to market out-turns in some way. We recognise the importance of careful consultation before implementing changes to the financial framework and would intend to consult on any policy developments coming from this work well before implementing them. We will also give further consideration to other ways of improving regulatory commitment.

We also note that the seminar we conducted with Ofwat was very well received. While we have extensive contacts with the financial community, we accept that broader events could help communicate our approach to investors and advisers. We will therefore include in our draft corporate plan a commitment to hold a City seminar during 2007/08.

If you have any questions about or comments on the contents of this letter, please contact Martin Crouch on 020 7901 7255 or martin.crouch@ofgem.gov.uk.

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