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RPI-X@20

RPI-X@20: Regulating energy networks for the future

Financeability

Peter Trafford, Head of Regulatory Finance

24th May 2010

Introduction

• RPI-X@20 is a comprehensive, two-year review of how we regulate energy networks asking whether the existing “RPI-X” framework remains fit for purpose.

• In January, we published a consultation paper – “Embedding financeability in a new regulatory framework.”

• It focused at a high level on what we mean by financeability, the issues raised by our current approach and a ‘straw man’ set of principles for the future – designed to stimulate debate.

• In the straw man, we discussed the various issues usually associated within the context of financeability. In particular,

  • The cost of capital,
  • Capitalisation & depreciation of the Regulatory Asset Value (RAV)
  • The calibration of the price control and the assessment of financeability.

• Our recent working paper provides more detail of our current thinking and draws on stakeholder responses to the January consultation.

Ofgem's financing duty

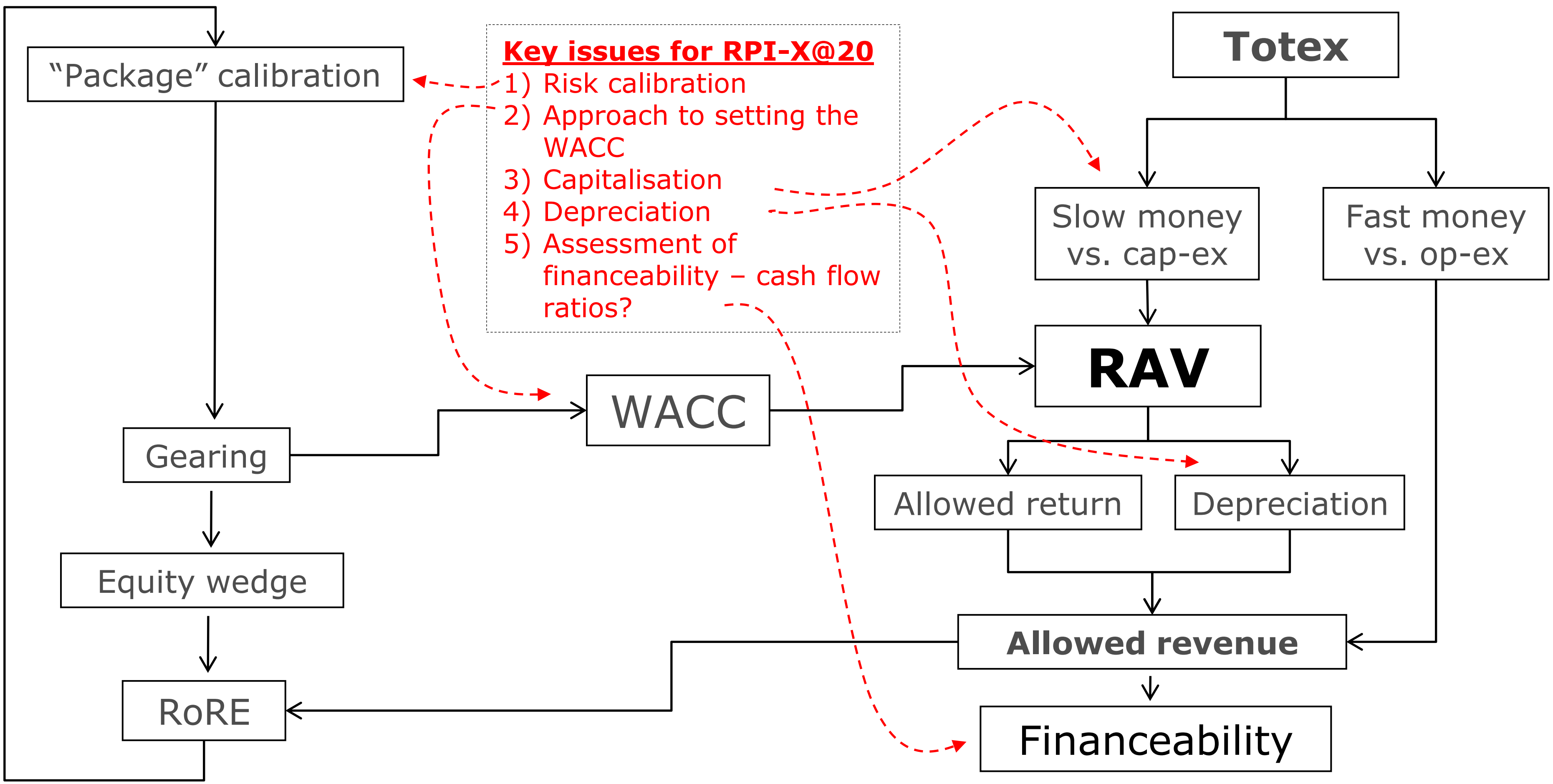
- Our principal objective is to protect the interests of current and future consumers.

"to have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations on them"

- Efficient network companies should be able to secure financing in a timely way and at a reasonable cost.

- The regulatory framework should not:
  - Provide excessive returns,
  - Reward inefficiency, or
  - Bail out a company in financial distress as a result of its own behaviour.

Financeability interactions



Riskiness of cashflows

Timing of cashflows

Our updated straw man

- The platform for our ‘updated straw man’ is **regulatory commitment**

- We believe that by providing a strong set of principles on the various components of financeability, we will be making a firm regulatory commitment to companies and their investors – to facilitate longer-term thinking.

- The ‘updated straw man’:

    - Increases transparency,

    - Increases predictability,

    - Enhances our current approach

Risk allocation and gearing

Risk allocation

BOTTOM UP

Length of the price control

Uncertainty mechanisms

Totex incentive rate

Output incentives

TOP DOWN

Return on Regulatory Equity (RoRE) scenario modelling

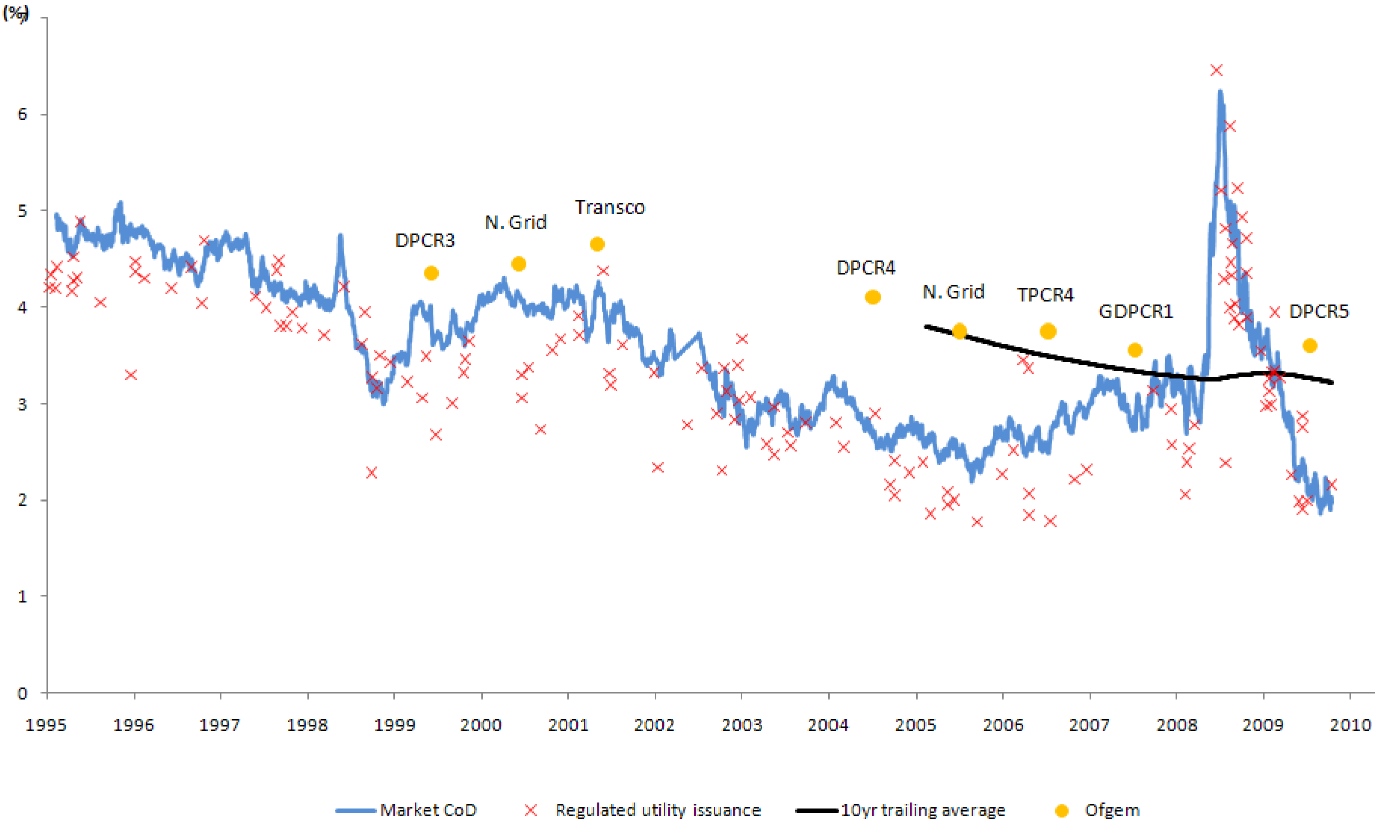
Range of returns

Equity buffer / gearing

The equity wedge will be large enough to manage the risks of the package but will not allow for excessive returns.

The cost of capital - debt

Forward cost of debt (real) vs. regulated utility issuance vs. Ofgem



Key points

- Allowed return on debt becomes essentially a backwards looking determination
- To be based on the long-term trailing average
- Annually adjusted,
- Will provide comfort that efficiently incurred debt costs will be fully funded over the longer term.

Capitalisation and depreciation – (1)

• The RAV is a regulatory construct that reflects historical investment,

• In DPCR5, we modified our approach to capitalisation, with all companies having a fixed percentage of their total network costs capitalised into the RAV – rest received as "fast money."

• **Rationale:** equalisation of incentives on op-ex and cap-ex to reduce boundary issues.

• **Issues:** Some companies received a greater proportion of costs as fast money than under the DPCR4 approach while some received less.

• The rate of regulatory depreciation has long been considered a financeability issue. In the past, Ofgem has adopted policies that boost near-term cash flows when financeability 'failures' have been identified (e.g. accelerated depreciation).

• **Problems:** Current consumers end up paying more for assets that are likely to have a much longer useful life.

Capitalisation and depreciation – (2)

• Under the updated straw man, issues around capitalisation and depreciation are considered in the context of inter-generational fairness and only affect financeability in so far as they affect our ability to give regulatory commitment.

Capitalisation

• We believe the DPCR5 fixed % of totex approach is appropriate. However, the %, which could vary by company, would be based on the amount of cap-ex like costs submitted in a company's business plan.

Depreciation

• We believe that the depreciation rate should reflect the average expected economic life of the asset base

• This could mean a slowing down in the return of capital (electricity) and a speeding up for gas

• There may be benefit in profiling depreciation to reflect likely future consumption

Assessing financeability

- Under our updated straw man, we would continue to assess financeability in the round, considering evidence from a number of sources. More focused on the LT.

- The use of cash flow ratios, as used by credit ratings agencies will play an important part. We consider PMICR and net debt/RAV to be the most relevant.

- We will set a cost of capital that appropriately remunerates investors for the risks they face. Combined with regulatory commitment, this should provide a financeable package over the longer term.

- As a result of our longer-term focus, we will not advance cash flows nor give revenue uplifts when short-term financeability failures have been identified.

- We would seek to understand the reasons behind such failures (e.g. high capex relative to RAV) but the onus would be on the company to resolve the situation.

- The greater onus on companies to take action to maintain their investment grade ratings reduces the requirement for Ofgem to make adjustments to other areas of a price control.

Next steps

- We believe that this updated straw man could provide an appropriate way of providing regulatory commitment, transparency and a longer-term focus that balances the interest of current and future consumers.

- We are keen to hear comments on whether this model is an appropriate way of embedding financeability in a future regulatory framework.

- Comments received, along with our updated thinking and analysis will form the basis of a minded-to-paper to be published alongside the rest of the RPI-X@20 project consultation in the summer.

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