FINANCING NETWORKS – A DISCUSSION PAPER

Centrica's response to the Ofwat/Ofgem discussion paper of February 2006

Centrica is Britain's leading supplier of energy to households and other smaller retail customers. We are the largest single user of the gas transmission and distribution networks in Great Britain and one of the major users of the electricity networks. This gives us a significant interest in the issues raised in the discussion paper (DP), on our own behalf and that of the end customers whom we serve.

Introduction

We very much welcome this joint initiative on the part of Ofwat and Ofgem, to reconsider some of the fundamental issues behind the current approach to network regulation and examine the lessons of relevant experience across the two regulated industries. We agree that robust and well considered consultation can, of itself, help to reduce the regulatory risk premium. In our experience, the timetable pressure of an individual price control review process can lead to a presumption that the traditional approach should be maintained, or adapted only at the margins.

Especially at a time when significantly higher capex forecasts raise the prospect of further upward pressure on regulated network access costs (cf. the recent projections made for 2007-12 by energy transmission network operators as part of the Ofgem TPCR process), we welcome the opportunity to review whether alternative approaches could allow increased Regulatory Asset Value (RAV) to be financed at a lower regulatory cost of capital overall.

Although a number of the specific issues listed in section 8 of the DP lie outside our area of expertise, we do have a number of high-level comments on the wider question of financing energy networks. Most of these remarks relate to key issue for discussion (2) as set out in paragraph 191 of the DP.

First and foremost, we believe that the key criterion for testing any alternative approach should be demonstrable, quantifiable and deliverable customer benefits. In other words, is an alternative approach to networks regulation likely to deliver – over some suitable period of years – a sustainably lower cost of energy transportation from source to customer, taking into account relevant transporters licence obligations such as network security and standards of service?

In turn, the sustainable cost of energy transportation is a function of (inter alia) two key elements:

- the transporter's cost of capital, which is influenced by the extent of regulatory risk faced; and
- the efficiency with which the transporter conducts its licensed activities, both as regards opex and (more relevantly in the context of financing networks) its capital investment programme to deliver defined industry outputs.

The reason for setting the issues out in this way is that there can be a trade-off between the two elements. It is critically important that any new approaches designed to reduce the regulatory cost of capital should not, to any significant degree, undermine incentives to invest efficiently. This issue is brought into sharp focus by the observation that regulators have historically found it much easier to satisfy themselves of opex efficiency on the part of regulated entities than they have in relation to capex. At the same time, it is also necessary to avoid the creation of perverse incentives between opex and capex.

Conversely, we would very much welcome alternative approaches which can reduce the cost of capital while maintaining (at least) the current levels of reassurance and incentives as to investment efficiency.

The “split cost of capital” approach

Without wishing to pre-empt the outcome of the price control reviews in respect of additional capex allowances, we recognise the challenge inherent in the requirement to raise significant amounts of capital going forward to fund additional investment in long life assets, when such investment must be supported by revenues which are only certain over a 5 year time frame. We believe that the improvement in the quality and transparency of consultation over recent price control review periods can be expected to have helped reduce the regulatory risk premium, which in turn will assist the funding of the proposed investment programmes if they are approved.

With this in mind, Centrica believes that the joint Ofgem/Ofwat consultation is especially timely. In particular, we are attracted by the possibility of “locking into the RAV”, over a longer period, the committed capex portion of regulatory depreciation and returns – so as to allow these to be financed on a cost of capital which is highly geared and much closer to the long term government bond yields than a WACC resulting from conventional assumptions of 55-60% gearing.

We do not consider that this “locking in”, over a period much longer than the conventional 5 years between reviews, could realistically take place on the basis of a fixed cost of capital. In principle, we believe that it should be possible to index the assumed cost of capital, in some manner to be defined, with market indicators such as the cost of low-risk long term debt and (to a much lesser extent) the market return on equity.

In a liquid and efficient capital market, investors will select their preferred level of risk when choosing their investments. We do not see any “financeability” objection, in principle, to this approach.

However, we do concur with some commentators that index linking to a selected individual market indicator carries its own specific risks. If a classic “risk free rate plus corporate premium” approach were taken to the cost of debt, for example, there could conceivably be movements in interest rates on index-linked gilts of a particular dating for reasons which are not reflected in the market for corporate debt. If this approach is taken, then it would therefore be preferable to diversify this risk by linking to a basket of index linked gilts of different dates and durations.

Since the short term WACC would apply only for the normal 5 year period, it may be appropriate to retain the present "fixed cost of capital" approach in this case, alternatively, if appropriate indicators of average equity market returns could be identified, however, it is for consideration whether it would also be beneficial for some form of indexation to be applied in this case. When considering the application of index linking to all or part of the cost of capital, it is important to ensure that any potentially unusual outcomes in relative rates of return are anticipated.

This approach, which amounts to a "split cost of capital" as suggested by Helm (2003), would leave the normal periodic price control reviews to focus on (a) opex efficiency and (b) the efficiency of the new and replacement capex expenditure proposed for that period, we believe that this should be considered further.

Given that committed capex would subsequently be "locked in" to the RAV (and presumably not be subject to further regulatory review), it would be even more important than ever, in the initial review of proposed new capex, to ensure that this is at the minimum efficient level consistent with licence obligations and the delivery of defined industry outputs. On the evidence of the recent DPCR4 review, we are not convinced that this has always been the case.

Under such an approach, it would of course be essential for regulators to ensure that the lower cost of capital applicable to "sunk" capex, when taken together with the higher cost of capital appropriate to new investment, generates a material customer benefit commensurate with any risks attendant on changing a tried and tested regulatory paradigm.

As mentioned above, the lower WACC applicable to the "locked in" RAV could be indexed with underlying capital market indicators over a long period of time. The lower WACC applicable to the locked in RAV could include higher assumed levels of gearing than the conventional 55-60% assumption for the regulated business as a whole. It therefore follows that the higher WACC applicable to new capex could include lower levels of gearing than those conventionally assumed.

We are aware that the network companies may have concerns about a radical change such as moving to a split cost of capital at this stage of the regulatory cycle. For example, it has been suggested that this could result in a change to the risk premium, increasing uncertainty and reducing flexibility in available sources of capital.

At present, there is insufficient information available to assess whether a split cost of capital would bring overall costs to consumers down. However, in our view, such an approach does seem to offer the opportunity to achieve material customer benefits, and as such merits careful consideration and modelling prior to any decision being made.

To the extent that the risk faced by transporters in relation to new investment is reduced by some form of "user commitment" (e.g. at NTS entry, in the case of the gas transmission network), we consider that this should also be reflected in a lower regulated cost of capital.

Other issues

In passing, we do not consider that there are significant issues around the ability of regulated energy transporters to attract suitable equity finance at reasonable cost [key issue for discussion (3)]. Moreover, the fact that network businesses – such as Lattice, in the past, and the gas DNs, more recently – have changed hands at a significant premium to the RAV suggests considerable appetite among the investment community, on the basis of today's regulatory regime, and indicates (in hindsight) that past price control reviews could have been somewhat tighter than they were. In particular, we note that some analysts appear to support the premia which have been paid, on the basis of the currently applicable regulatory regime.

In reviewing a number of analysts' reports, we believe there is an expectation of a similar, relatively relaxed approach in the future, which appears to have been factored into many assessments. We would encourage the regulators to take a significantly tougher approach in future to cost of capital issues to prevent a recurrence.

Rather than being prescriptive on the appropriate use of opex/capex and repex, it is important to recognise that the regulator will need to balance three related elements:

- to allow companies revenue over the useful lifetime of assets
- to ensure a smooth path of transportation prices
- to ensure company financeability

As each of these areas will depend on the individual circumstances of the particular price control, it should be for the regulator to make the appropriate choices at the time of the control.

Finally, we question the implied assumption (paragraph 124 of the DP) that the cost of repex should be recoverable in the year that it is incurred. Subject to our earlier comments, we do not see why the cost of repex could not, at least in a large part, be spread over the life of the assets concerned – especially as the repex (and not just new capex) profile appears to be significantly uneven over time. Whilst there are complexities associated with matching recovery periods to the life of the asset, we see no reason in principle, why it should not be possible to achieve a number of bandings for repex which would take account of short, medium and long term asset lives.

We recognise the potential problems associated with increasing the numbers of cost categories available to the network companies. These problems include the possible perverse incentives to inappropriately re-categorise expenditure to maximise returns and the increased intrusiveness of regulation to prevent this outcome. However, there can be clear benefits associated with improved alignment of cost recovery with asset lifetimes. In any event, a consistency of approach across network companies can be expected to lead to greater transparency across network companies, permitting greater comparability in the future.

Summary

Much more work would need to be done, in relation to both mechanics and impact, before we could definitively advocate that Ofgem adopt the “split cost of capital” approach. If (as it appears) it holds out the genuine prospect of material customer benefit, then we consider that regulators should seriously review this alternative approach in more detail.

Given the timing of the forecast increase in capex (e.g. for electricity and gas transmission during 2007-12), it will be important to ensure that such consideration takes place at an early stage. In practice, we recognise that there may be difficulties associated with applying a full “split cost of capital” approach at this point, however, we do believe that it could be considered alongside the traditional approach during the energy TPCR and GDPCR reviews which are currently in progress. Even if, after full consideration, it is judged imappropriate at this juncture to apply the full split cost of capital approach, we do believe that there may be scope to apply some of the individual concepts raised in the “Financing Networks” consultation at an early opportunity within these reviews.

Historically, for example, there is evidence that regulators have tended to err on the side of caution in setting costs of capital for network companies, especially when faced with a significant capex programme to be financed. In the DPCR4, we believe that Ofgem “aimed off” the appropriate spot WACC on the grounds that historically low risk free interest rates might not be sustained over the subsequent 5 year review period. In hindsight, with continuing low gilt yields, it appears that this approach (motivated by caution as regards to financeability) has turned out to be over-generous – with adverse consequences for customers in terms of network costs.

In future, we believe that Ofgem could consider a different approach, which would:

- set a cost of capital in line with the appropriate spot WACC, reflecting (inter alia) current low interest rates, for price control year 1;
- index elements of the WACC over the 5 year review period with an appropriate basket of relevant market indicators, to ensure that a higher return is allowed in the event that real interest rates do in fact increase over that period; and thus
- allow regulated network services to be delivered at an efficient cost to the consumer, but without prejudice to the regulator’s other duties as regards the licensees’ ability to finance their activities.

Thus Centrica believes it should be possible to bring some of the learnings from this joint consultation process to bear during the current transmission and distribution price control reviews, even if the full scope of new ideas such as a “split cost of capital” cannot be fully evaluated and assimilated at this time.