

Our Ref
Your Ref

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Date 19 May 2006

Dear Martin

Response to Ofwat/Ofgem Paper on Financing Networks

Thank you for giving us the opportunity to comment on the above consultation paper. I can confirm that this response can be placed on Ofgem's website.

We support the response from the Electricity Networks Association (ENA) and do not repeat here the detailed points made in it. We also support the points made by NERA in their 'issue papers' provided initially to EDF Energy and submitted to Ofgem by the ENA. Similarly, the detailed points made by NERA are not repeated here. This response should therefore be read alongside those submissions.

We are strongly opposed to the suggestion of splitting the cost of capital between past and future investments. In particular, its introduction would wholly undermine the basis upon which investors have provided capital to price-controlled businesses and would thereby discredit the UK regulatory system. Such an outcome would clearly not be in customers' interests. We note with some alarm that the proponents of this approach have not outlined a proposed migration route from the current arrangements to the ones envisaged by them.

In any case, the idea of associating the cost of debt with 'historic' regulatory asset bases seems to us to be an unnecessary complication. If regulators wished to minimise the cost of capital by reducing the level of risk faced by price-controlled companies, they could easily do so by protecting them against all cost/revenue shocks (even, in extremis, those resulting from the negligence of the companies concerned). Having a split cost of capital is simply not necessary to achieve such an aim. However, regulators have not gone down this path because they understand that a degree of risk, and the associated prospect of increased returns through incentive regulation, is

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what attracts equity to the sector – and equity provides an essential and healthy buffer for customers against cost/revenue shocks.

With regard to financeability, we believe that the first objective of regulators should be to get the cost of capital right – in particular by basing it on long-term, mutually consistent time-series market data and by using a number of repeatable estimating methods to inform their judgements. If, despite this, there remain cashflow shortfalls across a particular sector (i.e. which apply to the average company) regulators should, in recognition of their respective financing duties, use present value (PV) neutral approaches to allowing additional income, such as ‘accelerated’ regulatory depreciation. However, before embarking on such a route, it is important for regulators to understand the longer-term funding consequences and, in particular, whether material cashflow issues will emerge in future periods (which in turn would require a longer-term understanding of capital expenditure requirements).

Where a company (or limited number of companies) is still unable comfortably to maintain an investment grade credit rating because of relatively high levels of operational gearing (e.g. because of a relatively large capex programme compared to its RAV), additional revenue should be allowed. In principle, this would also be PV neutral and recovered during a future period of correspondingly low capex, however, this may be difficult to achieve in practice (i.e. it may be a long time before such circumstances arise).

We would not support regulators taking a more flexible approach to modelling dividends since it is unclear how such judgements could be fairly applied across companies at a review, or to a company across time. Regulators should not assume in notional balance sheets that the shareholders in one company will accept capital growth instead of dividends and the reverse for another – this would be discriminatory. Nor would it be appropriate to make differing assumptions across price control periods.

If you have any questions regarding this response please contact me on 01293 657846.

I am copying this letter, together with NERA’s ‘issue papers’ and the ENA’s response, to Emma Cochrane at Ofwat.

Yours sincerely

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