energywatch
your gas and electricity watchdog

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Dear Martin

Financing Networks: An Ofgem/Ofwat joint discussion document

energywatch welcomes the opportunity to consider the issues raised in the discussion document. This response is non-confidential and therefore we agree that it can be published on the Ofgem website.

General comments

We address our comments on these issues from the perspective of representing energy consumers. Consumers expect that network operators, as regulated monopoly providers which are subject to price controls that determine their allowed revenues and rates of return on investment, will ensure that secure, safe and reliable supplies of energy are delivered at an efficient and economic cost. The licensing regime, with its further emphasis on different types of incentive and adherence (on a qualitative basis) to certain standards and quality of service, is built upon achieving this objective.

On that basis, consumers would expect regulatory scrutiny of network operators' investment plans to be rigorous and designed to remove uncertainty. It is uncertainty that can lead to short-term decision-making by the regulated operator and potentially impairs efficient investment which, in turn, adversely affecting supplies to consumers over the longer term. It follows that price controls should be tailored towards providing a regime which allows effective decision-making on the part of operators over meaningful time horizons.

We are as concerned, along with regulators, about the excessive gearing to which network operators can subject themselves to finance capital and operational expenditure on assets, both for replacement and reinforcement purposes. If operators 'overstep the mark' financially, increasing their debt levels beyond those suitable for robust financial operation, there is a real risk of an operator going into administration.

The DTI recently consulted upon the effects of an 'energy administration' and the responsibility for cost recovery in that event. While the consultation was limited to assessing the most appropriate mechanism for effecting recovery, our view is that this situation could adversely impact consumers on two counts:

- The consumer will be expected to pay the costs of the operator's failure, regardless of the lack of control that consumers exercise over the financial decision-making of the operator company. At a time of rising energy prices, this creates a further unacceptable financial burden on hard-pressed energy consumers, particularly the most vulnerable; and

- Consumers in general may still be at risk of losing their energy supply through disconnection. Although there may be guarantees that certain categories of consumer ought never to lose supply, these guarantees, such as they are, cannot be applied to the entirety of consumers, effectively creating a situation of involuntary disconnection for a number of them. This clearly goes against the objective of providing secure and reliable supplies at economic cost.

It is reasonable for consumers to expect that network operators should run fiscally sound businesses and that regulators will use price controls to assist in this process without jeopardising energy supplies.

Gearing as a means of financing new investment

The document notes that the use of debt as a financing tool carries significant risks for network operators if there is disruption in the financial markets due to external shocks. While there clearly needs to be an appropriate balance to allow companies to have relatively open access to secure forms of finance, the higher the debt (gearing) carried, the more disruptive the effect to means of financing future investment.

Long-term investment is critical to safe and secure energy supplies. There would be significant adverse effects on consumers if network operators were unable to deliver investment on a timely and efficient basis due to lack of funding, or had to rely on excessively expensive forms of funding to execute their plans. Where statute places investment obligations on a network operator, particularly in gas distribution, this investment ought to be safeguarded on behalf of consumers, and prioritised through price controls, for instance, through the retention of appropriate ring fencing. However, price controls can only be adapted so far in order to provide leeway in this respect.

We note and agree with the licence obligations applicable to all energy network operators not to become involved in non-core activities, and that they should maintain a minimum high investment grade rating. The addition of cash lock-up arrangements to licence obligations provides more comfort to consumers given the essential nature of the service which network operators deliver to them, in particular the vulnerable. This creates a degree of certainty about the source of funds for future investment which should be low-cost and low-risk.

We agree with regulators who have indicated that re-opening price controls can create additional problems both in terms of the resources needed to assess the re-opened elements of the control and how the additional investment should then be treated in the regulatory asset base. Furthermore, consumers should not be expected to pay for the fiscal restructuring of debt by network operators if this creates additional long-term debt repayment, when there is little control by consumers over this aspect of the operator's business.

Helm and Mayer's suggested reforms to regulation of networks

We note the proposals of Helm and Mayer as outlined in the paper. At first glance, it may seem attractive to move to a more market-driven approach to financing of investment allowing increased debt levels, while splitting investment into low-risk, low-cost replacement expenditure, and higher risk, higher cost future investment. However, the consumer needs assurance that debt-driven funding will not create long-term problems as greater reliance on debt also leaves network operators open to market fluctuations in the cost of capital. Without the current reassurance provided by cash lock-up and maintenance of investment grade ratings, consumers may be subject to higher charges if debt is secured at uneconomic levels.

We also note the proposal to consider different, more flexible time horizons for operators' capital expenditure distinct from the five-year price control cycle. We would consider the priority for consumers to be efficient and timely expenditure. This may involve providing long-term certainties which are different from existing price control cycles and this may create innovative funding structures as a result. However, the approach needs further consideration to ensure that other potential beneficial aspects to consumers of operating a predictable price control cycle, such as efficient use of regulatory and company time in developing price controls which provide certainty and keeps costs low for all concerned, is not adversely impacted.

Going forward, we will continue to keep these issues under review as and when they are raised, always considering the possible impact on consumers.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

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Head of Regulatory Affairs