WALES&WEST UTILITIES

Ferry Road
Grangetown
Cardiff/Caerdydd
CF11 0XR
T:029 2076 7600
enquiries@wwutilities.co.uk
www.wwutilities.co.uk

24 hour gas escape number
Rhif 24 awr os bydd nwy yn gollwng

0800 111 999*

*calls will be recorded and may be monitored
caiff galwadau eu recordio a gellir eu monitro

Martin Crouch
Director – Electricity Distribution Regulation
The Office of Gas and Electricity Markets
9 Millbank
London SW1P 9GE

19th May 2006

Dear Mr Crouch,

Financing Networks – A Discussion Paper

This letter is in response to the joint Discussion Paper published by Ofgem and Ofwat into the financing of distribution networks. Please find below comments in response to the issues raised in the discussion paper. For ease of reference these follow the order of Section 8: Issues for discussion, although some general observations are provided first.

If you would like any further information please contact me on 029 2058 8070 (julian.bagwell@wwutilities.co.uk) or Charles Hazelwood, Chief Financial Officer, 02920 588 087 (charles.hazelwood@wwutilities.co.uk).

Yours sincerely

Julian Bagwell
Commercial Director

cc Emma Cochrane
Head of Corporate Finance
Office of Water Services

WALES&WEST UTILITIES

<u>Response to Financing Networks – A Discussion Paper</u>

General Comments

Regulation of monopoly networks has evolved in a number of ways since privatisation. A key concern of the industry has been to understand and manage regulatory risk. That concern remains today, and it is important that any proposals for change should be considered both on their merits but also in terms of what risks they introduce, and what risks they mitigate. In the analysis that follows, reference is made to this issue of regulatory risk in a number of instances.

An associated issue is that, in most respects, arrangements are already in place that could be undermined by particular proposals. For example, if a company already had index-linked debt and its regulator assumed a different proportion, then one way to manage the risk of a mismatch between assumed and actual return arising from the capital structure would be to move to that new proportion, which could require it to engage in re-financing and transaction costs that it would not otherwise occur. It is important to consider such transition issues when seeking to implement any of the ideas in the paper.

Finally, we note that the document is described as a discussion paper. In terms of our own gas distribution price control review, already underway, it would be helpful in any regulatory commentary on the response to the discussion paper that implications for our review are spelled out clearly.

Key issue for discussion (1).

<u>Should financial ring fencing arrangements be extended to cover all monopoly businesses and modified so that they all include cash lock-up provisions? How might the introduction of cash lock-up provisions affect existing financial structures including holding company debt? Are the current ring fencing provisions sufficient to allow the activities of the licensed undertaker to be fully separated from other group entities? If not, what additional ring fencing provisions might be appropriate and what might be the costs and benefits of these?</u>

Gas Distribution Networks (GDNs) have extensive ring fencing arrangements and are only allowed to carry out tightly defined permitted purposes with the exception of the 2.5% *de minimus* threshold permitted under Licence Condition SSCA36. Additionally Licence Condition SSCA37 requires the GDN to submit a certificate to the Authority every year regarding the availability of financial resources for the forthcoming 12 months. There are also requirements for the GDN to advise the Authority of its intention to pay a dividend. Further constraints are imposed by Licence Condition SSCA38, which requires the GDN to maintain an investment grade rating and Licence Condition SSCA39, which defines financial transactions that are not permitted, or are only permitted with the prior consent of the Authority.

Therefore, at least as far as the gas industry is concerned, GDNs are subjected to a considerable amount of ring-fencing and we do not see any evidence to suggest that further changes are required.

Key issue for discussion (2).

Would the separation of past and future capital investment improve the incentives for investment, lower the overall risk of regulated businesses and reduce the cost of finance? Are there any practical implications if such an approach was adopted?

There is some theoretical underpinning for the concept of dual rates of return, depending upon the perceived risk of different classes of investment. There are considerable practical problems that in our view make such an approach impractical.

The primary structural problem is that the logical conclusion from the arguments put forward in the Discussion Paper is that companies would need to separate into a RABCo and an Opco. The Opco would undertake the "riskier" capital projects, earning a premium rate of return, and once the project is completed (or at some suitable point in time after project completion) the assets would transfer into the RABCo and be securitised against debt. In practice unless the RABCo CoC is set for the entire operational life of the asset, that is until fully depreciated, then the review of the CoC will still need to set every five years. Either approach introduces new forms of risk:

- if the CoC is set on a life of asset basis, this would lead over time to a multiplicity of CoCs, for example the original CoC for RABCo, the premium CoC for Opco and successive revised RABCO CoCs applying to new assets transferred into the RAV, both from the Opco and those replacement investments that the RABCo undertook itself. This leads to two risks, the first that over time the number of different CoCs presents severe problems in terms of modelling and ensuring that various assets are assigned the proper CoC, and the second that such problems lead to pressure to revert to a simpler approach, which may or may not provide proper recompense for the risk exposures then extant;

- if the CoC is set every five years, then the usual concern that the resetting does not provide the appropriate level of return would be exacerbated by pressure on the differential between the Opco CoC and the RABCo CoC.

In either case, the adoption of a supposedly close to risk free rate for the RAV in fact contains risks in relation to that RAV.

A separate risk exists in terms of defining the appropriate CoC for RABCo. There will be strong pressure to assume a very close to risk free rate, the assumption being that all risk is in the Opco. In practice, the calculations of the risk premium for the Opco will be focused only on its project risks, whereas there will always be the possibility of risks for the RABCo as well. There are at least two sorts of risk, the first project risks of the same type as experienced by the Opco and the second other risks associated with the RABCo revenue control. For example, we have recently been exposed to considerable risk on shrinkage gas costs. Whilst these problems may be resolved going forward, we have had to absorb the past costs involved, and we do not believe that such an exposure was recognised when our cost of capital was set. Whilst we would still have had to absorb such costs had the RABCo/Opco model been in place, we believe it unlikely that the RABCo CoC would have recognised them *ex ante*.

An addition risk is involved in the process of setting the two CoCs for RABCo and Opco. Whilst the intent might be to produce the same outcome as the present process for setting a single CoC, focussed attention on the risk aspects of the different CoCs will almost certainly produce pressure for a result that is less, not more, than the present

combined rate. Whether or not such pressure is resisted, it represents an additional regulatory risk. The obvious counter argument is that it is more appropriate to disaggregate assets into risk classes, and apply a relevant CoC to each, and in principle we agree. Our concern, as discussed above, is the presumption of a virtually risk free rate for the RABCo when in practice that is unlikely to be the case.

The RABCo/Opco model also has practical problems. It introduces additional layers of management and bureaucracy, reduces management focus on the outputs that need to be delivered to the customer and there are examples where a similar approach has been tried and abandoned (for example 24 Seven).

There is an additional concern relating to GDNs. Gas distribution, unlike transmission, has few major projects that are long lived. We have a wide range of capital projects, most of which are completed within a short period of time. This is a day or so for most connections projects, and perhaps 6 to 8 weeks for most other projects except those which involve additions or extensions to the Local Transmission System. This contrasts sharply with other capital projects such as Heathrow T5, water and sewerage infrastructure assets and major enhancements to the gas and electricity transmission systems, where construction is over several or even many years, and where some of the risk issues discussed in the paper may be more relevant.

In summary we understand the theoretical arguments in favour of a split cost of capital, but we consider that there are severe practical difficulties associated with its implementation, and we also consider that regulatory risk is likely to increase, not decrease, as a result. We do not therefore favour such an approach.

Key issue for discussion (3).

<u>Is there any evidence of a lack of regulatory commitment to regulatory asset values or equity funding and if so how might this be best rectified?</u>

In the early days of Price Control reviews there was considerable uncertainty over RAVs. Examples include the focussed and unfocussed discussion relating to the Gas RAV and the reduction of the RAV uplift from 25% to 15% in the first and reopened electricity distribution price control reviews. Since the early days of uncertainty the RAV value has been established through a series of review decisions and the maintenance of past decisions on RAV, particularly those taken by the Monopolies and Mergers Commission and its successor the Competition Commission. Today this acceptance of precedence, albeit with the usual caveats about not fettering discretion, means that there is evidence or regulatory commitment to the RAV, although the caveats mean that there is not 100% certainty.

Additional uncertainty arises because of the changing view of capital expenditure. In previous electricity and gas reviews it is probably fair to say that more attention was paid to opex. As the potential for outperformance diminishes, however, at the same time as there is greater political interest in networks and their performance, capital has assumed a greater importance. In our own case, the capital overspends incurred by the GDNs over the last five years, in part due to higher customer demand for connections and increased repex volumes, will now require Ofgem to take a view on whether the expenditure was both necessary and efficiently incurred. Whilst it is wholly correct this exercise is undertaken it does add uncertainty and potentially acts as a dampener to those companies wishing to invest in the infrastructure, if such investment will be

subjected to the benefit of up to five years hindsight and if resolution in terms of its inclusion in or exclusion from the RAV takes place several years after it is incurred.

Key issue for consideration (4).

Should regulators assume that a proportion of debt is index-linked when setting price controls? Is access to the index-linked debt markets (or related instruments) available to all companies regardless of their specific financial/corporate structure? Are there longer term implications for the companies' financial stability of adopting a significant proportion of index-linked debt? What is the demand for corporate index-linked debt and are there constraints on investors' portfolios? Would it be more expensive?

Whilst an assumption of a proportion of debt being index-linked might provide comfort in respect of short term financeability, the proportion of index linked funding that a company holds should be a judgement for shareholders and not regulators. A company's actual debt profile is normally established over time and will tend to have a long duration consistent with the nature of business. Requiring companies to change their index linked debt profile in order to meet regulatory assumptions would create re-financing costs and does not engender a regime of regulatory certainty. These costs will be greater if regulatory assumptions drive companies to seek out limited index linked debt due to increased liquidity premiums and the potential for reaching sector exposure limits set by investors. Financeability concerns should be addressed using methods considered in discussion point (8) below.

Key Issue for discussion (5).

Are there any changes that would be required to the regulatory regime in order to facilitate equity injections? What would be the implications for the highly geared companies?

An appropriate amount of equity was made available to facilitate acquisition of the independent Gas Distribution Networks in 2005. All potential investors seek reduced regulatory risk, evidenced by a consistent approach to funding and a Cost of Capital appropriate to the controllable and wider risk profile of the business.

Key Issue for discussion (6).

Would it be reasonable for regulators to be more flexible in their approach to modelling dividends as a method for stabilising gearing and easing any financing constraints? Would such an approach require changes to the regulatory regime in order to increase certainty and if so what sort of changes would be most appropriate?

We have no specific concerns with current practice.

Key Issue for discussion (7).

Should regulators adopt pragmatic definitions of ratios used by the credit rating agencies? Is the specific level of any particular ratios critical to credit worthiness? Is it the overall level and trend of ratios that is important? Would there be significant difficulties for companies if the majority of ratings were BBB?

Neither regulators nor Credit Rating Agencies should view ratios in isolation. Given Credit Rating Agencies place different emphasis on key ratios a pragmatic approach is sensible. The overall trend of ratios is more important than one specific ratio, but there is a relationship between perceived credit worthiness and cost of funds, so any assessment of cost of capital used in settling allowed income must take into account future credit-worthiness of the Licensee.

Key Issue for discussion (8).

If there are remaining issues of financeability what are the advantages and disadvantages of (a) revenue uplift (and should this be PV neutral (b) accelerated depreciation (c) profiling returns on a nominal basis?

Our preference is for a revenue uplift, which we agree should be PV neutral. Accelerated depreciation results in "generational" issues, whilst profiling returns on a nominal basis introduces change, increasing perceived regulatory uncertainty, without providing clarity on any longer term solution.