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Dear Martin

Financing Networks – Discussion Paper

Thank you for the opportunity to respond to the Joint Ofgem/Ofwat Discussion paper on Financing Networks.

I attach a response prepared on behalf of Western Power Distribution (South West) plc and Western Power Distribution (South Wales) plc.

Yours sincerely



ALISON SLEIGHTHOLM
Regulatory & Government Affairs Manager



Financeability: Western Power Distribution Response

There is a general consensus that network operators are facing large increases in capital investment programmes. However, the capex growth requirement for water network operators, driven by significant replacement and quality of supply needs, is greater than for electricity distribution network operators whose requirements are primarily driven by network replacement. Our response to the “financeability problem” is therefore mainly aimed at electricity distribution:

1) Capital investment reviews should be thorough

- The financeability problem may be alleviated if the regulator makes a thorough review of an operator’s proposed capital investment programme to ascertain that it is realistic and that there is a high probability that the programme will be fully spent

2) Revenue uplift solution is arbitrary and unfair

- In the previous water and electricity distribution price reviews some operators benefited from a revenue uplift in selected years on the basis that minimum financial ratios failed under central case assumptions
- In the electricity distribution sector such an adjustment would reward an operator that has performed badly in the past (the financial downside being carried forward) whilst an operator that has performed well would not receive a corresponding uplift and so would lose out; an unintended consequence of introducing a revenue uplift mechanism could be to remove the incentive for operators to perform well
- It is unclear whether the revenue uplifts awarded will have to be paid back in future years and so are net present value positive to the operators concerned; this compounds the arbitrary and inequitable nature of this adjustment

3) Nominal cost of capital is not a solution

- Under this proposal a nominal cost of capital would be applied to an historic cost asset base, rather than a real cost of capital applied to an asset base that is index-linked for inflation
- This has a short term attraction in that more cash is generated up-front for operators but the flip side is that

customers bear a significant price hike. In the long term cash generation is reduced because the asset base is not index-linked to inflation; this compounds the problem that the asset base does not represent the true economic value of the business. In addition the asset base would no longer be a hedge against inflation for investors and the company's pension obligations.

4) Cost of capital increase is the most appropriate tool

- Where an efficient distribution network operator's financial projections do not produce minimum financial ratios there is a prima facie case for increasing the cost of capital allowance
- Increasing the cost of capital allowance to the same level for all distribution network operators has the advantages that it is equitable, is not arbitrary in nature and does not effect a change in the current regulatory methodology

5) Cost of capital uplift mechanism

- The cost of capital in previous price reviews has been determined using the CAPM approach
- As the CAPM approach is to an extent theoretical it may not produce an answer that satisfies the minimum financial ratios criteria; in such circumstances it would be appropriate to show separately a cost of capital uplift (i.e. an addition to the CAPM derived cost of capital) that the regulator deems necessary in order that all operators meet the minimum financial ratios
- Showing a cost of capital uplift separately would make the cost of capital calculation more transparent thereby increasing certainty for future reviews
- It is generally acknowledged that published electricity distribution RAVs under-state the true values of operators' assets (replacement cost is around four times RAV values). A cost of capital uplift mechanism could be used as a proxy to deal with this issue

6) Retain the current regulatory regime

- The RPI-X regulatory regime has achieved significant benefits for the customer since privatisation with reduction in prices and improvements in quality of supply
- Whilst there is always room for refining the regime, such as adding the IIP incentive mechanism, a wholesale change

would reduce predictability and thereby financeability deteriorates

7) Spilt cost of capital has a conceptual attraction

- The Helm proposal to change the regulatory regime whereby operators receive a lower cost of capital on the existing lower risk asset base and a higher cost of capital on future higher risk investments is conceptually attractive and may be applicable in the water sector
- However, it rewards those network operators who have failed to invest and may signal others that investment should be deferred as long as possible
- The question of how to determine when the capital expenditure becomes part of the historic asset base (and therefore is subject to the lower cost of capital) would require strict rules to ensure equality

8) The regulator should not be involved in the financing arrangements of operators

- There is much discussion in the paper on influencing operator debt and equity financial structures
- It is the role of an operator's owners to determine their capital structure as driven by the financial markets, investors and the rating agencies; it is NOT the role of the regulator to be involved in an operator's financing arrangements
- The paper discusses index linked debt in some depth; again, whilst there may be advantages for all stakeholders if index-linked debt is used, it is not the role of the regulator to be involved in an operator's financing arrangements

9) Transparency aids lower prices and the cost of capital in the longer term

- Ofgem considerably improved transparency in the last review
- Publication of annual RAVs will increase transparency to the markets and interested parties
- In addition annual publication of Ofgem's Regulatory Reporting Pack (RRP) will further increase disclosure and aid regulatory certainty
- The RRP should be within the scope of the audit opinion