



Promoting choice and value
for all gas and electricity customers

DPCR5 workshop Financial Issues

19 May 2008

Key financial issues for DPCR5

Cost of capital

Financeability and financial modelling

Pensions

Regulatory asset value (RAV)

Taxation

Cost of capital – recent decisions

	DPCR4 (Dec-04)	TPCR4 (Dec-06)	GDPCR (Dec-07)
Cost of debt	4.10%	3.75%	3.55%
Cost of equity	7.50%	7.00%	7.25%
Gearing	57.50%	60.0%	62.5%
Vanilla WACC	5.55%	5.05%	4.94%
Post-tax WACC	4.84%	4.38%	4.27%

Cost of capital - context

Cost of equity – Lack of beta data and issues with reliability

- Total equity market returns suggests 6.5-7.5%
- Relative risk work in GDPCR

Cost of debt – Effects of credit crunch – how long-lasting?

- Less liquidity, bigger spreads
- Are utilities a safe haven?

Gearing – consistent notional gearing assumption across all DNOs. 3 out of 14 had gearing > 57.5% as at 31/3/07

Overall – recent transactions in regulated utility sector have been at significant premia to RAV. Can this be explained by expected outperformance on opex/capex/incentives or is this an indicator of excess returns allowed?

Cost of capital - issues and questions

Are there relevant insights to be gained from recent utility transactions at a large premium to RAV?

What is the impact of recent events in debt markets on utility financing? Should we introduce debt triggers or index the cost of debt allowance to market movements (Q2)?

What factors should we take into account to determine the appropriate level of gearing (Q8)?

Following GDPCR , we intend to look at relative risk between different types of energy networks

Financeability and financial modelling – context

DPCR4 financial indicators:

Funds flow from operation (FFO) / interest not less than 3x

Retained cashflow to debt not less than 9%

Debt to RAV not higher than 65%

TPCR – equity injection allowance for Scots TOs – use it or lose it basis

GDPCR – took index-linked debt into account in financeability assessment

GDPCR- fully populated financial model published – high level data only

Financeability and financial modelling – issues and questions

Should we consider financeability adjustments if we are satisfied the cost of capital is appropriate (Q3)?

Is it appropriate for Ofgem to be making commitments on investment and financeability over the longer term (Q4)?

We intend to publish a fully populated financial model (as per GDPCR) – is there support for this (Q6)?

Is there any merit in profiling allowances to create a smooth trend for allowed income (Q7)?

Pensions – principles

Pensions principles set out in 2003 and applied in successive price controls:
includes:

- Attributable Regulated Fraction Only
- Efficient & Economic Salary and Pension Costs
- Stewardship - Ante/Post Investment
- Adjustments for Under Funding / Over Funding
- Early Retirement Deficit Costs for companies to pay
- Deficit Recovery over remaining service life of actives

In practice, attributable pension costs close to pass-through

Pensions – context

Increase in assessment of liabilities (longer lives, cohort effect)

Decrease in valuation of assets (ASB's advice to use risk-free rate)

Result – ongoing contribution rates rise, deficits grow (or surpluses shrink)

Ongoing contribution rates : DPCR 4 – 14%-20%, TPCR 24% -32%, GDPCR 31%-39%

Pensions – issues and questions

Cross-networks consultation to review pension principles as applied in price controls since DPCR4 – due July

Have our pension principles worked well? Are they still appropriate in a climate of increasing contribution rates and required payments to close deficits?

RAV – context

DPCR4 – complex methodology used to counter issues arising from variation in accounting policies across DNOs

- 100 per cent of net non-fault operational capex (incl. 38% of indirect costs)
- 23.5 per cent of opex plus fault costs
- 57.7 per cent of pension costs

Depreciation –20 year asset lives for post-vesting assets, with smoothing to counter impact of vesting “cliff-face”

RAV – issues and questions

What has been the impact of our capitalisation methodology in DPCR4?
Setting aside the impact of the cost of capital, do the DNOs' RAVs reflect the underlying enterprise value of the business?

What are the alternatives for calculating RAV?

Does our depreciation policy need changing?

Taxation – context

Ex ante allowance for DPCR4: £318m p.a.

Fixed allowance – DNOs bear cost and keep rewards of tax variances, including those arising from changes in tax /capital allowance rates

Recent changes to both could be worth > £100m/year to DNOs

Tax clawback policy for excess gearing where both gearing and interest paid exceed that assumed in setting allowances

Taxation – issues and questions

DNOs benefit substantially from recent changes to capital allowances – should we introduce an adjustment mechanism for material changes in the tax regime (Q5)?

Should we continue with our tax clawback policy for excess gearing (Q9)?

Breakout group questions	Q1	Q2
Are there relevant insights to be gained from recent utility transactions at a large premium to RAV?	1,2	9
Should we introduce debt triggers or index the cost of debt allowance to market movements?	3,4	8
Should we consider financeability adjustments if we are satisfied the cost of capital is appropriate?	5,6	7
Have our pension principles worked well? Are they still appropriate in a climate of increasing contribution rates and required payments to close deficits?	7	5,6
What are the alternatives for calculating RAV?	8	3,4
Should we introduce an adjustment mechanism for material changes in the tax regime?	9	1,2

The logo for Ofgem, consisting of the word "ofgem" in a white, lowercase, sans-serif font, centered within a solid orange rounded rectangle. The background of the slide features a collage of images: solar panels on the left, a hand holding a document on the right, and a blue scalloped object at the bottom left.

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