

The future of energy regulation in Britain  
11 December 2008

# Financing vehicles/contracts

Chris Bolt

PPP Arbiter and Chairman, Office of Rail Regulation

- Independent regulator with statutory duties and licensing powers
- Price control based on efficient costs and return on RAB
- Revenue controls indexed to RPI – but don't really deserve the label of 'RPI-X'
- Licence obligations provide assurance of delivery
- ... with limited reopeners ...
- ... all underpinned by financing duty
- Appeal to CC on price control (and other licence changes)

- 30 year contracts with 7½ yearly Periodic Reviews between London Underground and three infracos
- Largely output based
- Project financing – so all finance for next 7½ years needs to be in place before start of review period
- No RAB – financing costs are explicitly part of the allowable cash flows
- Test for repricing is the Notional Infraco – which operates in an “overall efficient and economic manner and in accordance with Good Industry Practice”
- Arbiter only gets involved if requested by one or both Parties – but decisions then modify the contract (unless both parties agree to set them aside)

- Appointed by the Secretary of State; can be dismissed only for incapacity, misbehaviour, or not exercising functions in a timely way
- An individual, not a Board
- Operates under statutory duties
- Only exercises functions when requested?
- Only 'appeal' against decisions is Judicial Review

- 95% underpinning undermined effectiveness of lender scrutiny ...
  - ... as did low Materiality Threshold before Extraordinary Review could be triggered (around 1% of contract value)
  - In any case, understanding of the contract was poor – even for those operating it!
  - In particular, London Underground did not manage contract effectively – tried to influence capex decisions while treating the contract as fixed price
  - Extraordinary Review rules undermined incentives (in both short and longer term)
  - London Underground and Metronet thought they could negotiate a deal – left Extraordinary Review far too late
-

- Limited scope for unilateral London Underground change in contract terms – even where the contract is not working!
- Funding gap has become a political issue – cf HLOS/SoFA fully ‘owned’ by Secretary of State
- Periodic Review process as written into contract simply does not work:
  - assumes sequential process – revised terms, revised pricing, negotiation, direction, financing – rather than iterative process
  - consequences of ‘financing impossibility’ onerous for public sector
- Inability of Arbiter to change process?

- Long term contracts are also used successfully to underpin lumpy investment in eg energy (pipelines, unregulated facilities etc)
- But SPVs did not work in rail (except in very special circumstances of Chiltern line)
- A conundrum:
  - price controls assume market power
  - but lumpy investment in competitive markets could be delayed beyond 'optimal' point – giving some degree of market power!

- PFIs and other contractual models (eg SPVs) may work for assets being built from scratch, but don't really work for existing assets/networks – lack of flexibility etc
- Project financing is a serious constraint – corporate financing supported by a RAB is better able to deal with uncertainty
- Regulation is designed to deal with situations where contracts cannot be complete
- Would negotiation with large customers (cf constructive engagement in airports) help, and allow the regulator to focus on areas of disagreement?
- Do the current reviews of airport regulation (CC, DfT) offer any pointers?