

Rachel Fletcher
Partner, Smarter Grids and Governance and
Hannah Nixon
Partner, Smarter Grids and Governance
Ofgem
9 Millbank
London
SW1P 3GE

6th Floor, Dean Bradley House
52 Horseferry Road, London SW1P 2AF
+ 44 (0)20 7706 5100
www.energynetworks.org

4 February 2011

Dear Rachel and Hannah

Consultation on strategy for the next transmission and gas distribution price controls (RIIO - T1 and GD1); Open letter consultation on the regulatory asset lives for electricity distribution assets

I am writing on behalf of ENA's TO, GDN and DNO members in response to Ofgem's 'Consultation on strategy for the next transmission and gas distribution price controls (RIIO-T1 and GD1) and to its subsequent Open Letter consultation on the regulatory asset lives for electricity distribution assets which was published on 14 January 2011.

ENA and its members worked closely with Ofgem throughout the RPI-X@20 process and have publicly welcomed many of the initiatives that have been introduced as part of the new RIIO framework for network regulation. We continue to work with Ofgem on the implementation of the RIIO principles in the current price control reviews for transmission and gas distribution and are actively participating in the assorted working groups that Ofgem has set up for this purpose.

We believe that the RIIO framework - 'setting revenues using incentives to deliver innovation and outputs' - has the potential to deliver real benefits to consumers. An important element of this framework is the provision of strong incentives for companies to deliver agreed outputs to help meet the challenges of delivering a sustainable energy sector. The package of incentives that are developed will, when taken together with the overall treatment of uncertainty, determine the risk package for each review. Consequently the financeability framework that is established will need to be calibrated in a risk based context against this package.

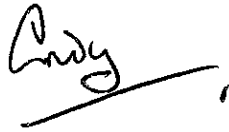
Ofgem's proposals on financeability under the new RIIO framework were first set out in January 2010 in the 'Embedding Financeability in a new regulatory framework' paper. Ever since their publication, ENA has raised significant concerns with them both in written submissions to you and at industry meetings, most recently in November 2010 ahead of the publication of these consultation papers. Indeed, ENA members believe that the proposals which have now been developed for the current RIIO - GD1 and T1 price reviews will be damaging to the companies, significantly reducing their cash flows and ultimately threatening their ability to finance the investment necessary to deliver the UK's carbon reduction targets.

In view of the fundamental importance to ENA members of agreeing an acceptable financeability framework for both of the current price reviews, ENA's response to the consultation concentrates entirely on this issue. We have therefore attached for your consideration:

- A paper which builds upon ENA's previous submissions and concentrates upon Ofgem's proposals for regulatory asset lives and their potential impact on the energy network companies and the wider financial community. It also examines Ofgem's proposals in the light of the recent DECC paper on Electricity Market Reform and the BIS consultation, Principles for Economic Regulation.
- This paper is complemented by a report (attached) by Oxera which is submitted on behalf of ENA members and is an independent assessment of the initial range for the cost of equity for the next electricity and gas transmission and gas distribution price control reviews (RIIO-T1 and RIIO-GD1 respectively).

I trust that you will give our submissions due consideration and we look forward to meeting you soon to discuss the issues we have raised.

Yours sincerely,

A handwritten signature in black ink that reads "Andy" with a long horizontal stroke underneath.

Andy Phelps

Director of Regulation

Energy Networks Association

Andy.phelps@energynetworks.org

Tel: 0044 (0)20 77065118

Draft ENA response to Ofgem's RIIO-T1 and RIIO-GD1 strategy consultations

1. Introduction and conclusions

Ofgem published in December 2010 a considerable amount of material as part of its strategy consultations for the current transmission and gas distribution price reviews (RIIO-T1 and RIIO-GD1). This was followed on the 14 January 2011 with an Open Letter consultation on the regulatory asset lives for electricity distribution assets.

Individual companies will be responding in detail to all of these consultations. In this response, however, we focus on the high level issues which are giving ENA members most cause for concern. These primarily relate to the proposals for assessing financeability under RIIO, notably the future estimates of the cost of equity, the linked issues of capitalisation/ depreciation and the cost of funding investment in energy networks.

Specifically, we focus on Ofgem's proposed changes to the capitalisation policy for gas distribution and to regulatory asset lives for electricity networks – and on the potential implications of these proposals for consumers via their impact on the cost of funding the operation and development of energy networks.

In summary ENA believes that:

- asset lives of 45-55 years make little sense against the background of the acute uncertainties facing energy industries – not only those relating to the potential decline in the use of gas but also, in a world where energy has again become high on the political agenda, uncertainty about future changes in energy policy;
- especially without adequate transitional mechanisms it is implausible to contend that the changes to RAV capitalisation (in gas distribution) and regulatory asset lives (for electricity networks) as significant as those proposed by Ofgem will not significantly and adversely affect the cost of funding investment in energy networks – in other words, the proposals are not, as Ofgem claims, 'NPV-neutral';
- ENA members have made substantial investments and financing arrangements have been entered into under Ofgem's existing regime. We believe that, despite assertions to the contrary, Ofgem gave little warning of the changes in the financing arrangements that it is now proposing. We believe that this is inconsistent with Better Regulation principles of stability and predictability and will have a damaging effect upon prospective investors' assessment of the energy networks sector.
- Ofgem's proposals for transitional arrangements – including the proposal that any adjustment mechanism should only apply for one price control period – are inconsistent with the approach taken by DECC (in its proposals for electricity market reform) to minimise the regulatory risk facing energy market participants by ensuring that investment undertaken under one regulatory regime will not be exposed to a change of regime;

- against the background of the relatively modest impact of the proposed changes on network prices and the significant impact on energy network company cash flows, Ofgem would seem to be at odds with the principle proposed by The Department for Business Innovation & Skills (BIS) that ‘the framework of economic regulation should not unreasonably unravel past decisions’. The proposed changes to capitalisation and to asset lives are likely to impact on future network funding costs not just through the direct impact on cash flows but also through increasing the perceived risk that Ofgem could, in future, change the existing regulatory regime in other equally fundamental ways and for equally little benefits to consumers.

In the rest of this response, we first summarise what we understand to be the core Ofgem proposition on capitalisation, asset lives, depreciation and financeability and, second, set out what we see as some of the problems with this proposition.

2. The Ofgem proposition

The Ofgem proposition on capitalisation, regulatory asset lives, depreciation and financeability has a number of elements, including the following.

- Regulatory asset lives should reflect (although, by implication, not necessarily equal) expected economic lives of the relevant network assets, not least to balance the interests of current and future consumers.¹
- Taking account of this principle and the uncertainties which relate to the future of energy networks (and, in particular, gas distribution networks), Ofgem is suggesting economic asset lives of 45-55 years for electricity transmission and distribution assets and (as now) 45 years for post-2002 gas assets and no change for pre-2002 assets.²
- All future gas distribution repex will be capitalised into the RAV, as against the current practice of expensing 50% of the cost for revenue purposes.³
- There could be transitional arrangements but only if they were necessary to avoid an efficient company having financing difficulties⁴ or cause ‘excessive disruption to capital markets and/or raise concerns about financeability’.⁵
- In the case of electricity networks, transition arrangement could include, among other options still to be discussed, either a ‘split’ arrangement – in which the proposed lives would apply only to future investment – or a ‘stepped’ implementation where the change to asset lives is made in a series of steps. Ofgem has re-stated its preference for transition arrangements working themselves through in one (eight-year) price control period – which would look to be inconsistent with the split approach.
- In the case of gas distribution, a stepped approach to implementing 100% capitalisation of repex is mooted⁶. Ofgem, however, suggests that its proposal to front-end load depreciation of new assets could partly offset the effects of the proposed change to capitalisation⁷ (which, Ofgem accepts, ‘could have a material impact on GDNs’ cash flows’⁸).

¹ Ofgem (2010), ‘Consultation on strategy for the next transmission and gas distribution price controls – RIIO-Ti and GD1 financial issues’, December, para 2.2 – this paper hereafter referred to as ‘Financial Issues’.

² Ibid., Figure 2.6, page 15.

³ Ofgem (2010), ‘RIIO-GD1 Overview paper’, December – hereafter referred to as ‘GD-1 Overview’.

⁴ ‘GD-1 Overview’, para 8.10.

⁵ ‘Financial Issues’, para 2.40.

⁶ ‘GD-1 Overview’, para 8.11

⁷ Ibid.

⁸ Ibid., para 8.5.

- In any event, Ofgem does not believe that the resulting substantial lengthening of the duration of cash flows for gas distribution will significantly impact on the cost of financing energy networks, albeit that it is open to opposing arguments on this issue.⁹

3 Problems with the Ofgem proposition

The problems with the Ofgem approach are that:

- there is considerable uncertainty about the long-term future of energy networks, not least because of the exposure of those networks to future changes in government energy policy;
- given this uncertainty, lengthening regulatory asset lives (either explicitly for electricity networks or through requiring all investment in gas distribution assets to be capitalised into RAV) will increase the risk associated with owning and investing in energy network assets which will, in turn, impact on the cost of finance;
- Ofgem's proposed change of approach to duration of cash flows is inconsistent with the desirable requirement that network regulation should be predictable – which will compound the financing implications of increasing the duration of cash flows;
- the proposed approach to transitional arrangements further compounds the problems, whereas it could usefully look to the proposed transitional arrangements suggested (in relation to generators) by DECC in its proposals for electricity market reform.

3.1 Economic asset lives, regulatory asset lives and uncertainty

Underlying Ofgem's position on asset lives are two propositions.

- Regulatory asset lives should equal expected economic asset lives.
- Economic asset lives can be determined with an acceptable degree of certainty, even when the lives in question are judged to last for many decades hence.

Taken by itself, the first proposition is not unreasonable. However, taking the proposition by itself is to ignore why the current regulatory regime includes 50% capitalisation of gas distribution repex and 20-year regulatory asset lives for electricity networks. Both of these positions were reached because of financeability concerns which arose not from actions by the energy networks themselves but because of changes in the environment in which they operate – first, the HSE requirement for comprehensive replacement of cast iron low pressure gas mains and, second, Offer's decision in the 1990s to adopt a rectangular depreciation profile for pre-privatisation electricity network assets. This policy background would suggest that, at the very least, Ofgem should adopt adequate transitional arrangements (covered in 3.4 below) – otherwise, Ofgem's proposed change of policy looks to be arbitrary and likely to create uncertainty about Ofgem's future decision making.

However, the problems with Ofgem's proposed asset lives (and, by extension its proposals for the capitalisation of gas distribution repex) are more fundamental than this and ignore the nature and extent of the uncertainty which surrounds the *expected* (i.e. mean) economic lives of energy network assets. Back in the 1980s and 1990s, the UK philosophy was for different energy sources to fight it out in a competitive market – to reverse the protection afforded to, for example, domestically produced coal. In this sort of world, there was plenty of uncertainty – viz. the persistent failure of fossil prices to track anywhere near virtually any forecasts.

⁹ Ofgem (2010), 'Consultation on strategy for the next transmission price control – RIIO-T1 Overview paper', December, para 8.18.

However, the current position is much more uncertain than that. As is made very clear in DECC's consultation on electricity market reform¹⁰, competition between energy sources will not be decided just by the market (which remains as uncertain as ever) but, to a very large extent, by government policy – with the current subsidy, market reform and regulatory proposals being based on, amongst other things, views on the role played by fossil fuels in climate change and on the importance of the UK and other European countries incurring substantial costs of investing in currently uncompetitive energy sources, regardless of the policies to be pursued in other countries.

Recent history suggests that views on climate change and the policies to deal with it do not have a life of 45-55 years. Thus, at a time of (arguably) unprecedented uncertainty about future energy markets, future energy technologies and future energy policies (all of which were, in effect, acknowledged by Ofgem as a large part of the reason for initiating its RPI-X@20 review), investors in energy networks are being asked to wait for 45-55 years to get a return on their investment, with the only qualification being an unspecified degree of front-end loading for the depreciation of gas distribution assets.

In its Financial Issues consultation paper (Figure 2.7), Ofgem further suggests that long regulatory asset lives are used in other jurisdictions, including:

- electricity distribution in Victoria, Australia;
- electricity transmission in the Republic of Ireland;
- electricity distribution in the Republic of Ireland;
- the GB water industry.

The fact of these precedents does not, by itself, advance the argument without knowing other information about these industries but, in any event, at least the last three of these would not, in fact, seem relevant to Ofgem's position.

This is because:

- the electricity distribution and transmission networks in the Republic of Ireland are owned and operated by a state-owned company which, as such, is somewhat shielded from the capital market pressures which apply to privately owned regulated networks – the same effect in GB being observable in effect of the government guarantee of Network Rail's debt on the cost of that debt;
- the same applies to the water industry in Scotland;
- in addition for water, the risks of economic asset lives being less than technical lives – more specifically, the risk of the water industry ceasing to exist in something like its current form – would look to be significantly lower than for energy networks.

In sum, in an uncertain world where uncertainty tends to increase the further one looks into the future, the lengthening of average regulatory asset lives for gas distribution and for electricity transmission and distribution networks will inevitably expose equity and debt investors in those networks to greater risk.

¹⁰ DECC (2010), 'Electricity Market Reform Consultation Document', December – hereafter referred to as 'Electricity Market Reform'.

3.2 Implications of this increased uncertainty for cost of financing

In its Financial Issues consultation, Ofgem says (para 3.54) that it remains open to arguments that increased duration of cash flows will increase perceptions of risk (and, therefore, the cost) of investing in energy networks. However, it also quotes Europe Economics' suggestion that the fact that the betas for the owners of electricity distribution networks did not react to the shortening of regulatory asset lives in DPCR3 suggests that there should not be any significant effect from the proposed lengthening.

Drawing this conclusion from the DPCR3 experience suggests a degree of misunderstanding of the historical context in which regulatory asset lives were shortened – and this applies to both the change for electricity distribution in DPCR3 and to the similar later change for electricity transmission. In both cases, Offer's earlier decision to apply a rectangular depreciation profile for pre-privatisation assets meant that the end of this profile implied a very substantial and sudden reduction in the cash flows to the businesses – cash flows which had been assumed in the setting of previous price controls.

As a result, there was a general expectation that Ofgem would act to mitigate the impact of the ending of depreciation revenue in respect of pre-privatisation assets, i.e. a general expectation that Ofgem would, in effect, act to maintain the status quo in terms of expected cash flows. This was indeed what Ofgem did and the lack of market reaction was exactly what would have been expected as a result of the status quo being maintained. Indeed, one might have expected rather significant negative share price reactions if Ofgem had failed to act in the way that it did.

Ofgem also quotes Europe Economics' analogous conclusions to the lack of reactions of various oil companies to changes in tax allowances in the North Sea. However, again, it is not clear that this demonstrates what Europe Economics seems to think that it does. Even leaving aside the question of the materiality of North Sea revenues to the companies in question, the more fundamental issue is that UK government changes in the North Sea tax regime have typically been designed to make future (i.e. marginal) investment more financially attractive. As such, the changes had little or no impact on the NPV of cash flows from past investment which would make up the bulk of the foreseeable cash flows for most companies (in other words, a version of grandfathering). To the extent that this was not the case (i.e. to the extent that changes affected past investment), it is arguable that the frequency of changes (Europe Economics highlights changes in 2002, 2004, 2006 and 2009) might lead investors to attribute little value to any particular change, not least on the basis that the change could itself re-occur.

Instead, and even if it is concluded that the technical corporate finance arguments (Brennan and Xia etc) have been, to date, somewhat inconclusive, one is still left with the question of whether investors, as a whole, would be indifferent as between cash flows accruing over a 20 year period and, with the same internal rate of return, over a 45-55 year period. Leaving the financial technicalities on one side, it is hard to believe that investors will exhibit such indifference. At the very least, indifference would require a high degree of certainty to attach to those longer term cash flows and, for both market and political reasons, this certainty does not exist for energy markets.

It is especially hard to believe that investors will be relaxed about the extra risks associated with longer duration uncertain cash flows if one assumes that 'risk-free' assets will, in the foreseeable future, again earn something closer to historically normal returns and thus reduce the ferocity of the 'search for yield' (and attendant yield compression) which has characterised a period of global savings glut – not just because of the unwinding of quantitative easing (whose likely effect is acknowledged by Europe Economics) but also because of the longer term forces in capital markets (in particular, the likely increase in global investment) described in a recent paper from the McKinsey Global Institute.¹¹ Especially in a world of longer duration price controls, such longer term issues can no longer be ignored.

3.3 The proposed changes to capitalisation and depreciation and implications for regulatory predictability

In its recent consultation on Principles for Economic Regulation, the Department for Business, Innovation & Skills (BIS) suggests that 'the framework of economic regulation should not unreasonably unravel past decisions'.¹² The underlying rationale for this is that lack of regulatory predictability will itself increase risks of investing. Thus, Ofgem risks compounding the effect of increased cash flow duration in a world of inherent uncertainty by increasing the uncertainties associated with its own future decision making.

Ofgem either has defended itself or could defend itself against the accusation of unpredictable and unreasonable unravelling of past decisions in a number of ways.

- At least in relation to the proposed change in asset life for electricity network assets, it has suggested that it has not adversely affected the 'legitimate expectations of investors' because 'we have signalled for some time that the 20-year regulatory life was subject to review'.¹³ In its recent Open Letter on regulatory asset lives, Ofgem has pointed to the regulatory life of assets being raised as an issue in its DPCR4 final proposals.¹⁴
- The changes could be defended on the basis of a strong consumer interest in the change.
- Ofgem could defend the changes on the basis that the changes which BIS had in mind were ones which affected rates of return – and that Ofgem is not proposing a change in rate of return but an 'NPV-neutral' re-profiling of revenue.

In our view, none of these arguments is sufficient.

- At best, the argument about reasonable warning have been given would apply only to new investment – which would point to the 'split' transitional arrangement (covered below under transitional arrangements), a linkage which Ofgem seems to recognise in the Open Letter. In addition, what was less obviously flagged up in earlier Ofgem publications was the changed approach to financeability itself (for companies to sort out through equity injection/ retention) which is what gives the change in asset lives its potential financial impact and which was not proposed until January 2010 in the paper 'Embedding financeability in a new regulatory framework'.

¹¹ McKinsey Global Institute (2010), 'Farewell to cheap capital? The implications of long-term shifts in global investment and saving', December.

¹² BIS (2011), 'Principles for Economic Regulation', January, page 5.

¹³ 'Financial Issues', para 2.47.

¹⁴ Ofgem (2010), 'Open letter consultation on the regulatory asset lives for electricity distribution assets', January 14th.

- The argument for a strong consumer interest in the change does not seem strong. First, Ofgem has a duty to balance the interests of existing and future consumers and it is not clear that existing consumers, already benefiting from the discount between net replacement cost and RAV incorporated into initial RAV valuations of pre-privatisation assets, have a strong case for further assistance at the expenses of future consumers. Second, the modelling carried out by CEPA et al in their paper on asset lives does not seem to suggest a great consumer benefit from the proposed changes.
- The argument that the changes are NPV-neutral is obviously one with which we disagree for the reasons given above in this and previous responses.

3.4 Transitional arrangements

Ofgem accepts that there is a case for transitional arrangements to mitigate perceptions of increased regulatory risk. However, it has repeatedly suggested that any transitional arrangements should work themselves out within the next price control period. At the same time, it has acknowledged that the ‘split’ approach – in which the new asset lives would only apply to future investment – is a possible approach (and one which would clearly not work itself out in one price control period).

In our view, any transitional arrangements should start from the principles underlying a split approach – in other words, the desirability of ‘grandfathering’ regulatory arrangements in respect on investments which have been undertaken under an existing regime. A robust argument for adopting such an approach is indeed offered by DECC in its recent consultation on electricity market reform.

‘Grandfathering: the Government recognises the importance of honouring commitments given to provide generators with a particular level of support, as part of maintaining investor confidence.’¹⁵

Thus, generating plant which has been built on the basis of the Renewables Obligation (and, indeed, plant which is being planned on this basis but not yet built) will continue to operate under the existing regime.

Similarly, in discussing the introduction of an Emission Performance Standard (EPS), DECC states:

‘One of the unavoidable risks in the energy sector is regulatory: at any point during the operating life of a power station, Government may change the regulatory environment and undermine the economics of a power station, forcing early closure with implications for the investor’s finances. However investors will gauge the overall regulatory risk in the UK, based on Government behaviour and a series of discrete, individual decisions. Where investors perceive actions are taken against one set of generators, they will become increasingly nervous and might choose not to make new investments in the UK because of their perceptions of the regulatory risk. For example, decisions taken by the Spanish Government over summer 2010 to retrospectively reduce levels of renewable subsidies has affected levels of investor confidence in Spain and indeed across other European countries.’

Another way of helping to ensure investor confidence in the UK energy sector would be to apply the principle of grandfathering, which is widely used in regulatory regimes, including the Renewables Obligation. In its simplest form, the principle of grandfathering, when applied to an EPS would mean that the level of the EPS in place at the point that a power station is consented remains the level which is relevant for the economic life of that power station, i.e. if Government decided to lower the level in the future, say to reflect advances in CCS technology, the EPS would only be at the lower level for plant consented after date of that decision.’

¹⁵ ‘Electricity Market Reform’, page 122.

*Without such protection in place, the regulatory risk around investing in new fossil-fuel power stations might prevent any new flexible plant being built, creating a risk to security of supply. The Government's initial view is, therefore, that the EPS be grandfathered, for a period linked to the period of time investors would expect to see a return on their capital investment.*¹⁶

Thus, DECC is trying to introduce regulatory safeguards into the relatively high-risk world of electricity generation just at the time that Ofgem is at least considering a rather more cavalier approach to supposedly low-risk energy networks.

The grandfathering argument, when applied to assets, applies much more easily to the changes which are being proposed for electricity networks than to the changed approach to capitalisation being proposed for gas distribution networks. However, the principle of grandfathering is not just about assets, it is about 'arrangements' which have been entered into under a particular regulatory regime. Such arrangements could, in particular, include financing arrangements which have been entered into on the basis of a particular profile of expected future cash flows. At the very least, such considerations argue for transitional arrangements which substantially cushion gas distribution networks from the cash flow consequences of changes to repex capitalisation – and this would mean not limiting such arrangements to one price control period.

4. Conclusion

In summary:

- the financial framework which Ofgem is proposing (longer electricity asset lives, increased capitalisation of gas distribution repex, possible short-term transitional arrangements but lasting for only one price control period) would inevitably lead to increased financing costs for energy networks (both because of the direct impact on cash flows and because of the increased uncertainty which would be engendered in respect of future Ofgem decisions) and, therefore, to increased long-term costs for energy consumers - and should, therefore, not be implemented in the form proposed;
- any material change in the existing regime should, at the very least, have transitional arrangements which are based on the principle of grandfathering of existing assets and take account of financing arrangements which have been rationally and efficiently entered into under the existing regime. Such arrangements should last longer than one price control period.

AP/04.02.11

¹⁶ Ibid., pages 72-73.