UK Power Networks

RIIO-GD1 and RIIO-T1 Strategy Document – Consultation Response from UK Power Networks Detailed Comments

1. **Financeability**

    a. The development of WACC for regulated companies

Since privatisation the direction of travel for allowed returns on regulated asset bases has been downward yet shareholders have still been willing to invest in regulated network companies. These two concurrent facts have given regulators comfort to continue to look at reducing the weighted cost of capital and specifically the return on equity invested. We note that this trend is continued in the initial RIIO strategy proposals with the range of the proposed WACC being less than the final DPCR5 settlement of 4.7%. However, there is considerable risk in this approach for Ofgem. If the "floor" in the cost of capital is found or passed the impact on investor confidence would be significant and extremely difficult to recover from. Ofgem appear to take comfort from the lack of reaction from the financial community, yet we would suggest that it will take time for the full impact of the proposals to be understood as the detail emerges over time. We therefore urge Ofgem to use caution in interpreting initial reactions to the proposals and to spend some further time understanding these important stakeholders' concerns and requirements.

We welcome Ofgem's attempt to replace the subjectivity of previous debates about the true cost of capital by introducing transparent mechanisms for tracking the key components. We recognise that there is a level of uncertainty in introducing these measures and therefore welcome the opportunity to debate these further. We would raise the following comments on the proposals:

        i. Cost of Debt

It appears that Ofgem's proposed method for allowing for the cost of debt systematically under-allows for the proposed cost in three ways:

- A short tenor - Ofgem uses 10 year bonds, whereas other (e.g. gas distribution network) investment is remunerated over 45 years, and the average funding tenor of network utilities is much longer than 10 years (18.6 years on average according to page 31 of Ofgem's financial issues paper). Assuming a normal yield curve, a more appropriate tenor would imply a higher cost of debt ;

- An apparent inflation mismatch - Ofgem's methodology is essentially to deflate nominal debt costs at inflation breakevens (by deducting nominal gilt yields and then adding IL gilt yields), and then through the price control mechanism to reflate at outturn RPI. In our view this is unfair as inflation breakevens are systematically higher than expected inflation, because breakevens also theoretically incorporate an inflation risk premium (otherwise there would be no incentive for investors to buy nominal rather than IL gilts), and because many people believe that excess demand verses supply for IL gilts artificially depresses IL yields. Because the networks cannot all fund in 100% index-linked form, it is unfair to penalise by stripping out breakevens in this way;

- No allowance for debt issuance costs - is simply wrong. Debt issuance fees are just as economically real as coupon payments for issuers and banks. Stating that past outperformance is a reason not to allow for this is to penalise the networks for past good performance. Also, if Ofgem is prepared to allow for equity issuance costs, this should equally apply to debt.

ii. Cost of Equity

On the equity side, we also believe that Ofgem's estimated cost of equity range under-allows as:

- it is also founded on a risk free rate assumption which is too short a tenor
- It also strips out inflation breakevens.
- We also believe that the beta range used looks low in terms of the implied asset betas

b. Length of Asset lives

We agree that there is a strong case for reforming Networks financing such that the burden is appropriately shared between current and future customers. However, it is disappointing that Ofgem appears not to have allowed for further consideration to complementary proposals presented by the companies. We have two principle concerns:

- Ofgem's current proposal will require companies to inject equity when future CAPEX profiles are flat. In many circumstances this would be seen as asking shareholders to fund returns against previous investments with new equity.
- Significant further uncertainty is introduced into the regulatory framework as returns on investments already made will be subject to increased long term uncertainty.

We recognise that Ofgem have said that they would ensure that shareholders would be compensated within period for any adverse financing implications. However, by rejecting mechanisms that would allow the revaluation of the RAV to reflect the actual value of the asset base, back ended depreciation profiles or the introduction of the extension of asset lives to new assets only, we believe that there is only one remaining mechanism for equalisation open to Ofgem. This is the rebalancing of fast and slow money. UKPN has modelled the implication of extending asset lives to 50 years in its financing model. These shows, keeping all other parameters equal, an equity investment of £750m over an 8 year price control period would be required. By flexing the ratio of fast and slow money to the statutory proportions of around 30/70 from the current 15/85, there would still be a need for £250m of equity injection. This has all been modelled with an assumption of constant CAPEX investment.

We would also suggest that the external pressure on future regulators to adjust the proportion of fast and slow money, when cash flows are high in future, will be almost irresistible there by increasing the long term regulatory risk to which companies are exposed. Our modelling shows that there are future price control periods when cash flows are high relative to required expenditure. All other things being equal, shareholders should not have these asset based returns put at risk. Of course Ofgem have the option of explicitly factoring this increased regulatory risk into the WACC. However we recognise such an additional cost within the new framework will be difficult for Ofgem. Therefore, without fettering future regulators discretion, we believe that all of the principles of any change to the depreciation policy and adjustment mechanism should be hard coded into the regulatory framework. We would point at the good work that has been done in the area of pensions as an example where this has worked well in previous price control settlements.

There is also an additional potential risk that electricity network companies are being asked to bare through the separate consultation of the extension of the asset lives in electricity. The proposed change in the deprecation policies in Gas and Transmission form part of the overall discussion of the regulatory framework. This provides the opportunity for these network owning companies to simultaneously discuss the implications of the extension of asset lives and any required correction

mechanism. Electricity network operators will not have this opportunity as they are isolated from the other key elements that will be contained in the RIIO-ED1 proposals.

2. **Business plans**

We welcome and support the additional detail that Ofgem has set out in terms of what it believes constitutes a “well justified” business plan. We also support the principle that the format of the business plan narrative should be each individual company’s choice. We recognise that there is a required leap of confidence for both companies and Ofgem in this bold proposal. Therefore, as companies strive to achieve a fast track rating, this will tend to mean that price control submissions will be larger and the format of evidence will be different across companies. Our support for this proposal is on the basis that Ofgem will put in place the appropriate processes and resources to analyse and assess all companies’ submissions. It is, therefore, important for Ofgem to allow sufficient time in the price control process for this information to be assessed robustly and fairly. This appears to be a real challenge within the current timetables for both the Gas and Transmission reviews.

We note that Ofgem is proposing to apply different levels of scrutiny, dependent on the perceived quality of the companies’ business plans. We agree that from a better regulation perspective it is correct for Ofgem to focus on the areas where they believe the most value will be added. We believe that Ofgem should strive to be as transparent as possible in explaining how it has arrived at the differential levels of scrutiny across companies. This is of course a key tenant of better regulation.

We also support the principle that it is for companies to propose the target levels for the outputs incorporated within their business plans after consultation with their stakeholders. We note the need for the requirements of future customers to be input into this process. We believe that this is an area that will require the companies, Ofgem and Government to work together, as we believe it will be difficult for existing stakeholders to provide views in this area.

We recognise the value in having a view of expenditure post the price control period under review. The additional five years seems a sensible period but it important that Ofgem recognises that the data would be based on top down modelling rather than bottom-up analysis. As a consequence, the financial data and any supporting non financial data would need to be at a broad expenditure level e.g. Asset Replacement. This issue raises an important question about the construction of the price control information for the period under review. With the extension of the price control period to eight years companies will be producing a ten forecast at the initial FBPQ stage. We believe that it is impractical to forecast out to this time period using meaningful bottom-up analysis. We therefore believe that towards the end of the period it would be more sensible for the forecast to be based on top down analysis and that the information template should recognise this.

3. **Information Quality Incentive (IQI)**

We note that Ofgem are proposing a number of significant changes to the operation of the IQI framework.

- Significant tightening of the matrix compared to DPCR5
- Extension of the scope of the incentive to cover the majority of costs; and
- Undertaking the assessment process based on the company’s initial submission compared to Ofgem’s final submission rather than company’s final submission compared to Ofgem’s final submission

We agree that the extension of the scope of the incentive to include the majority of costs is sensible, as it removes an artificial cost boundary. We are concerned with the other two proposed changes. We believe the change in the construction of the matrix may increase the risk on companies. The operation of the IQI incentive assumes that Ofgem's modelling of future expenditure requirements is more robust than the companies. All network companies are facing significant future uncertainty, with respect to developing future plans. This forecasting risk is further exacerbated given that companies will be forecasting out a period of 10 years. It therefore seems inappropriate for Ofgem to move the additional income term to a penalty only framework when the reason may simply be a different viewpoint over how the transition to low carbon economy will affect energy networks, which at present cannot be predicted accurately by any party.

Also in its move to the new RIIO framework Ofgem is embarking on the use of new modelling techniques e.g. totex to inform its view of the efficient level of costs that are then input into the IQI mechanism. Any downside error in these benchmarking approaches is further magnified by the proposed mechanism, as the affected company would also be subject to a negative revenue adjustment due to the operation of the additional income term. In our view, the construction of the matrix does not reflect the undoubted uncertainty that Ofgem has in assessing the validity of companies' business plans. This is unnecessary as Ofgem, through the mid point review which only it can trigger, can alter outputs and revenues.

We do, however, believe that the IQI is an appropriate mechanism to reward companies based on the quality of their business plan. An alternative approach would be to have differential IQI matrices based on the assessment of the quality of each company's business plan. One approach would be to use the DPCR5 framework for companies ranked A or B (Fast tracked companies would still be eligible for an additional reward) and a more punitive matrix for companies ranked C. This is similar to the process that Ofgem proposed at DPCR5 with respect to output measures. We believe that this is more appropriate than using the same matrix for all companies, as it provides a strong positive incentive for companies to strive to submit the highest quality business plan they can.

We believe the proposal to base the IQI assessment process based on the company's initial submission compared to Ofgem's final submission rather than company's final submission compared to Ofgem's final submission needs further consideration. The current proposal is that a change in outputs is the only factor that companies will be allowed to change their initial plan for and not be penalised under the IQI. However, there may be other reasons why it would be legitimate for companies to alter their initial business plans, for example evidence from a Low Carbon Networks Fund trial. In our view it would seem sensible for Ofgem not to be too prescriptive in this area and judge each proposed change on its merits.

4. Fast-tracking and proportionate assessment

As discussed elsewhere in this response, the inclusion of criteria for assessing the business plan is very welcome. We believe that this process should be as transparent and open as possible and subject to the minimum level of regulatory discretion.

Earlier documentation referred to companies being ranked A, B or C, and then demonstrated how the 'assessment toolkit' might apply to companies of each ranking. This ranking seems to have been replaced by fast-tracked and non fast-tracked companies with Ofgem being allowed significant discretion as to the level and methods of scrutiny that might be applied to those who are non fast-tracked.

We believe that it would be a better solution if the rationale and detailed requirements for scrutiny are stated explicitly following Ofgem's evaluation of a company's business plan. This would then provide an individual agenda of items which Ofgem and the company could then work through together so as to reach the point where the company has fully justified its business plan to Ofgem.

Ofgem's proposals in respect of the treatment of fast-tracked companies appear sensible. There clearly need to be mechanisms which ensure that a fast-tracked company can not be disadvantaged by agreeing their price control earlier in the process.

Ofgem rightly notes that in the first RIIO price control reviews it will have to make a judgement on a company's track record of output delivery in the absence of the more formal system of output measures that RIIO introduces. In our view, a sensible approach would be to assess performance across the major incentive schemes. To ensure transparency, Ofgem should make its methodology explicit to all companies.

5. Totex Assessment

UK Power Networks remain strong supporters of the proposal to use a forward-looking Totex approach as the key tool for assessing the cost efficiency of business plans. We also recognise that Ofgem may wish to undertake a more disaggregated analysis as a cross-check of the results.

Having reviewed the strategy documents, Ofgem states its continued commitment to this approach, but the material included shows a heavy emphasis towards a more disaggregated approach based on historic data.

There was a commonly-held view at DPCR5 that the cost benchmarking process was extremely time-consuming, resource-intensive and ultimately less than satisfactory in the results it produced. Given this, there appear to be risks in publishing information based upon only two years data as there may be issues over its robustness and comparability.

We note that there is no mention of the necessary adjustments to the cost base in respect of regional cost factors and the impact of either Urbanity or sparsity on operating costs. When one considers the value of these adjustments at DPCR5, it is clear that they will be required before any meaningful regression analysis can be performed.

We have included an additional proposal paper from Professor Chesher as an appendix to our submission. We would welcome an opportunity to discuss this in more detail with Ofgem and in time for the detailed proposals later in 2011.

6. Mid-period Review

Ofgem is right to identify that, within an eight-year price control period, there is scope for the environment within which networks companies operate to change. This may require modifications to, or even additions or removals of output measures. The additional detail provided to describe the decision-making process is very welcome and appears sensible.

Ofgem is right to note that Government policy should be a primary driver of such a change. However we are concerned by the reference to new output measures which might be needed by consumers and other network users. It is hard to imagine such requirements existing which were not known about at the time of the price control review. Equally this would apparently over-ride the priorities laid out in our business plan and agreed with our stakeholders.

Whilst distinct from the mid-period review, we have some concerns around Ofgem's proposal that a change in outputs might be triggered in order that Ofgem can address 'administrative errors' in the price control settlement. It is a well-understood principle that companies accept price controls as a package. As a matter of course, we accept that there will be examples of ready out-performance in some areas and unavoidable under-performance in others.

It seems clear that Ofgem wishes to introduce a mechanism through which it can curb out-performance, which might result from an innovative approach to delivering an output, and yet provides no equivalent vehicle for the companies to challenge, output measures that are proving to difficult/expensive to achieve, for reasons which are out of the control of the company.

This asymmetric approach will potentially make it more difficult for a network company to accept a price control settlements in the round. We would therefore urge Ofgem, to include as part of the March strategy document, further details on the trigger criteria for a mid-period review. This should include an explicit recognition of the criteria that a network owning company would use to ask Ofgem to reopen the settlement.

7. Price Control timetable

We strongly welcome Ofgem's intentions to lay out the price control timetable in detail at the beginning of a review, and where possible to bring forward discussions and decisions to the earliest feasible point in the process.

Having reviewed the timetable we believe that the practicality of applying the proposals and the timeframes being proposed, specifically, there is a risk that stakeholder engagement will be seriously constrained as a result. We note the relatively short period between publication of the strategy decision document, together with the business plan instructions/templates, and their subsequent submission. In our view, a well-managed company will have largely completed their planning activity by April this year, but equally they will need to factor in any implications of the strategy decision document and that may well include re-engaging with stakeholders.

Furthermore Ofgem's proposal that the IQI mechanism will be applied against the initial business plan submission places an even greater incentive to ensure that the processes allow for the July submission to be as good as it possibly can be.

In light of this, it is not clear to us why Ofgem is providing a mere 3 months for companies to finalise the Initial Business plan, but believes it requires 6 months to weigh up whether there are any candidates for fast-tracking. From our perspective, the balance of time should if anything be the reverse, with the companies being granted longer to generate their business plan and obtain the explicit challenge and sign-off from their stakeholders.