

Hannah Nixon  
Office of Gas & Electricity Markets  
9 Millbank  
London  
SW1P 3GE



9 April 2010

Dear Ms Nixon,

**Regulating Energy Networks for the Future: RPI-X@20**

**Emerging Thinking – Embedding financeability in a new regulatory framework**

I am writing on behalf of AMP Capital Investors Limited, part of the AMP Group, one of Australia's largest insurers and investment managers. AMP Capital manages the Strategic Infrastructure Trust of Europe (SITE) which has been investing in European infrastructure assets since 2005 and currently has investments in the UK's water, railway rolling stock, airports and gas distribution industries, as well as investments in infrastructure businesses in continental Europe.

We know that Ofgem's principal objective is to protect the interests of existing and future consumers and we understand its aim is to ensure value for money (VFM) for existing and future consumers. The evidence strongly suggests that the existing regulatory regime has delivered VFM to date for consumers, so before any changes are made to it, the risks and opportunities or advantages need to be carefully assessed to ensure that the success story is continued into the future.

You will appreciate that our comments are framed from the perspective of a financial investor in the gas distribution industry and therefore focus on financing issues. We recognise however that there are other issues and perspectives.

The references in our comments are to the chapters and paragraph numbers in your paper:

Chapter 2:

2.7 We agree that the definition in 2.6 remains relevant for any future regulatory framework. We would note that the cost of raising finance should be included in the allowed return as it is a material element in the overall cost of capital.

In addition to the need to ensure the features in 2.6 there is the rather obvious point that network companies compete in the capital markets with each other and companies from other sectors which implies that the features in 2.6 represent necessary but not sufficient conditions to achieve acceptable financing.

In assessing their appetite for investment in those companies, investors in the capital markets take careful account of, inter alia, the performance of the different companies against their regulatory 'contracts' and the relationship they have with their regulator. Both of these points are important because they represent 'efficiency/relationship' risks for the companies which have to be managed. Investors therefore develop a view about a company's efficiency/ relationship management, based on the regulator's view of the efficiency of the company (but see comments on the role of credit rating agencies, below).

Chapter 3:

3.3 We support the existing approach of 'sense checking' certain financial ratios for a notional, efficient company against those typically sought by rating agencies/capital markets to achieve a comfortable investment grade credit rating and we accept that judgements have to be made in order to do this.

Although the rating agencies received substantial criticism for their part in the financial crisis, our experience is that they have improved their processes to provide better guidance on the credit risk of investments in the new and tighter financial environment. The rating agencies' role in the financial markets should not be underestimated. They are crucial intermediaries between the company seeking finance and the capital markets and although their primary role is to provide guidance to creditors via the issue of a rating, there is a clear link with consumer protection because a company that fulfils its contractual obligations to its creditors is in a far better condition to continue to provide appropriate services to its customers than one which does not. Network companies can try to issue unrated debt, but the relatively high cost of capital involved would not be in consumers' interests or in shareholders' interests.

3.12 The 30/30 iron mains replacement policy in the gas distribution industry, required by the HSE on the basis of the 'precautionary principle' (i.e. the risk, whilst having a low probability, has devastating consequences if it occurs and therefore should be removed) is potentially contentious for the reasons stated in paragraph 3.13. However there is an argument that current consumers are at more risk than future consumers because there is more high risk main to be replaced...as the programme progresses the risk of a disastrous occurrence should decrease, so it may be considered equitable that current consumers pay more. The 50/50 current/future funding approach taken to date is a practical compromise to the funding problem and ensures that the level of funding broadly parallels the risk to which consumers are exposed. The capital markets have now understood and accepted the approach and network companies have taken account of the funding mechanism in their funding structures and we believe that to change it by moving to a different practical, compromise basis would introduce a degree of regulatory uncertainty (change once...change again in the future?) which would affect the cost of capital. To elaborate on this point: if for example, the current/future funding were changed to 30/70, companies would have to borrow more money to fund the replacement programme and/or reduce the dividends paid to shareholders. Additional debt would put existing covenant ratios under stress or even into breach. The requirement to renegotiate higher debt/RAV covenants and issue new debt would need to be supported by an investment grade rating from the rating agencies (which might not be forthcoming) but in any event the cost of debt would rise. Reduced dividends would clearly affect existing shareholders economically, but would also increase the perception of regulatory risk with detrimental long term effects on the financing of the companies. It is hard to see how this would be in the overall interests of consumers.

3.13-3.17 We support the idea that regulatory depreciation should be based on the estimated economic life of the asset. We understand that currently in the gas distribution industry the weighted average economic life (WAEL) of the different components of the system for transporting gas is 45 years. We are not aware of any reliable forecasts of the gas available to be used in the system (whether from the rapidly depleting indigenous sources or via riskier imports) which is probably the overriding constraint on the economic life of the system, rather than any technical/engineering reason. In addition, environmental issues may place constraints on the use of gas even if it is available. Given these points we can see no reason for increasing the WAEL – this would simply increase the risk for investors that they would have a 'stranded' asset in the future and would increase the cost of capital for the companies which would not be in the consumers' interests (Ofgem could refuse to recognise this increase, but this would drive away investment from the industry). On the other hand, a reduction in the WAEL would increase the costs to current consumers, and arguably reduce the risks to investors of being able to recover their investment, as represented by the RAV. For current consumers to be unaffected by this point, any increase in regulatory depreciation caused by a shortening of the WAEL would have to be offset by a reduction in the allowed return which given individual investors' investment time horizons could be seen as increasing regulatory risk...which ultimately would not be in consumers interests.

At the moment we believe that given the uncertainties outlined above it is better to continue with the current treatment of depreciation in the gas distribution industry for existing assets, but the issue should continue to be reviewed in the light of the developing debate about environmental matters and gas supplies.

3.18-3.21 In our comments under 2.7 above, we noted that investors take account of how companies perform against their regulatory 'contracts'. Generally in practice, the rating agencies as part of their assessment of a company and/or its debt instruments, take account of its management of its regulatory 'contract' (this incorporates operational risk, relationships with the regulator and other stakeholders, performance against regulatory targets and indicators etc.). We have assumed that a company that manages its regulatory contract effectively and efficiently will provide better VFM for consumers than one which does not. Effectively therefore the service performance provided to the consumer is reflected in the rating assigned to the company by the rating agency, which impacts the cost of capital of the company.

However, financial structuring can increase the returns available to shareholders even though performance to the consumer is not optimised – clearly not in the public interest.

We believe that the current system of setting a 'benchmark' allowed rate of return provides an incentive to a company to optimise its capital structure and gain efficiencies for its investors. History suggests that these benefits last for the duration of a price control (allowed returns have reduced over the years) before being passed on to consumers. As the allowed returns have reduced, there has been a perverse incentive to highly gear capital structures to maintain equity returns. However the capital markets provide checks and balances (e.g rating agencies provide guidance on debt/RAV gearing ratios, debt instruments contain clauses on dividend lock-ups, cash sweeps and covenants) to these higher levels of gearing which, though not perfect, have worked – as evidenced by the fact that no network company has gone into administration. In practice we think that setting a benchmark cost of capital for network companies is appropriate given that all network companies compete in the same capital markets and it is in consumers' interests that they are able to obtain finance on the most competitive terms they can get. To 'tilt' the competitive forces which are at work in the capital markets by differentiating the cost of capital could, we believe, have adverse effects with 'lower cost of capital' network companies have greater difficulty finding finance than 'higher cost of capital' network companies. Perversely, this could increase the cost of capital of the former. We believe that poor customer performance, different geographies and

demographics etc. should be addressed by specific penalties and allowances, respectively, and equally there should be cost/revenue incentive schemes to reward excellent customer service.

#### Chapter 4

4.7 The danger in using the term 'network sectors' is that they will all be thought of as the same, whether they provide gas or electricity. Yet some of the major business issues that each face are different. Your consultation paper notes some of them: the iron gas mains replacement programme and the connections to off-shore wind farms. Also there are issues such as the age of the different networks and the way in which environmental protection issues will affect them, issues which drive capital investment programmes which have to be financed and also drive the operational risks which the companies have to manage – and these issues change over time, as does the political and economic environment in which they occur – so almost inevitably Ofgem and other regulators have to balance these issues and make judgements (informed by, inter alia, the capital markets – see points about rating agencies) about allowed returns, depreciation, capitalisation.

In our view, whilst accepting that a clear set of principles would be helpful, their application in practice would be crucial – and it should be remembered that investors have become accustomed to the current role of Ofgem and are likely to regard change in the regulatory framework as an increase in risk until they can see how it works in practice....which could require several years of experience.

4.9 See our comments under 3.12 and 3.13-3.17 above.

4.10 With regard to the gas distribution industry, the existing gas supply area as a percentage of the total area of the country is high (80%-90%+). It may be possible to argue that investment in new gas distribution networks (not investment in replacement assets) is relatively low with regard to the overall number of consumers and that therefore a practical solution to the issue of the long term use of the network would be to shorten the assumed asset lives of new investments and spread the 'extra' cost across all consumers. Clearly this would involve a cross subsidy from one group of consumers to another, but the costs of the few would be spread over the many – this might be particularly appropriate where network extension was to alleviate fuel poverty or for environmental reasons (to reduce the burning of more environmentally harmful fuels).

If it is accepted that the limiting factor on economic network life is the availability (and possibly the permitted use) of economic gas supplies, then it is likely that in the future there will be a 'stranded' asset problem. The solution you have suggested with regard to new investment might alleviate the worsening of the 'stranded' asset problem.

Our comments on reducing WAEL are as noted in 3.13-3.17 above, but we would add as an alternative view that a possible mitigation to the 'stranded' asset problem would be to review the 'current best view' available of the economic useful life of the (existing) assets every five years, in line with price control reviews, and set the regulatory depreciation based on a straight line approach for the next five years. On the assumption that gas supplies will become scarcer and more expensive, this would imply increases in regulatory depreciation every five years. This would mean that as the forecasts of gas supplies became clearer, the consumer might pay more (if supplies decreased) which, on the one hand would incentivise better use of energy and energy efficiency measures (consistent with reduced energy supplies), but on the other hand might reduce the 'stranded' asset risk (by depreciating the RAV at a faster rate). This would have the opposite effect to that noted in paragraph 4.11 in respect of straight line depreciation.

4.15-4.20 We support the current system wherein Ofgem sense test regulatory settlements against the financial ratios assumed by the independent credit rating agencies. As noted above (3.3) in our experience the credit rating agencies have strengthened their processes and we do not think it is helpful, or even relevant, to refer to e.g. Enron and the credit crisis. In the context of network companies, the reality of the market is that investors (particularly debt investors) generally expect a company/company's debt instruments to have a credit rating from at least two agencies, without which the price of debt is considerably higher ( and without which the debt may not even be available).

4.21-4.22 We do not agree with differentiating the cost of capital, as noted under 3.18-3.21 above. We would also note that there are alternative approaches to incentivising a network company to plan and deliver efficiently.

#### Chapter 5

With regard to the 'straw man' principles, as noted above we are not in agreement with those related to cost of capital and financial ratios. We reiterate our view that credit ratings are important. With regard to the other principles we advise

that uncertainty of any kind can unnerve investors, particularly regulatory uncertainty caused by the introduction of a revised regulatory framework. As RPI-X@20 advances it will be crucial that communication with investors is frequent and transparent to mitigate the uncertainty.

If you require clarification of any of the views or opinions expressed in this letter, please let me know.

Many thanks for the opportunity to respond to your consultation,

Yours sincerely

A handwritten signature in blue ink, appearing to read "Rob Verrion", with a stylized flourish at the end.

Rob Verrion,

Head of European Infrastructure Asset Management, AMP Capital Investors Ltd