RPI-X@20

Questions from the Embedding Financeability in a new Regulatory Framework document

Chapter 2 - What do we mean by financeability?

Question 1: *Do you have views on our ideas on how we might interpret financeability in a new regulatory framework?*

We broadly agree with Ofgem's interpretation of financeability in that efficient, well managed companies should be 'able to finance and be appropriately remunerated', and that the regulatory framework is not there to 'reward inefficiency'. We further agree that the regulatory framework should ensure companies 'can secure financing in a timely way and at a reasonable cost'.

We do however believe that when assessing financeability, equal consideration should be given to both debt and equity.

The consultation refers to Ofgem's principal objective to protect the interests of existing and future customers. In our view this would involve judgments around:

- Balancing between how much cost is borne between current and future customers
- Ensuring there is sufficient incentive to invest in both the short and long term
- Ensuring the overall financing cost to existing and future customers, taken together is optimised through an appropriate funding mix (i.e. not encouraging excessively long and expensive loan lengths)

These 3 areas at times may contradict and therefore the regulatory framework will need to strike a balance between these issues.

We view the balance between existing and future customer interests and financeability as two separate, but related, issues. The consultation paper, however, often appears to address them together. In our view it is important that the distinction is maintained and that both of these issues continue to be addressed in any future regulatory framework.

We also believe it is important to maintain the strength of the ringfence so as not to transfer risk from companies to customers. This is particularly important so that companies remain able to respond to cost shocks (e.g. major storms). Weakening the ringfence or encouraging highly leveraged models may reduce companies' ability to respond to such events.

We would support a clear set of principles being established for both the balance between existing and future customer interests and the approach to dealing with financeability issues.

Chapter 3 - The current approach to financeability

Question 1*: Do you have views on our overview of how financing is considered and assessed in the* *current regulatory frameworks? Are there other aspects of the current approach that we should be considering?*

With regards the current approach we comment on specific areas as follows:

Cost of capital

We agree that the current approach should reflect the cost of capital (WACC), but during DPCR5 there was a lack of a clear and transparent framework as to methodology for calculating the WACC and therefore it is not clear whether this was achieved. Specifically there was a lack of transparency around inclusion of the various elements of the cost (i.e. basis of future cost of debt and equity, costs of issuance and holding capacity etc.)

Financial Ratios

We support the use of financial ratios as they reflect the real issues that companies have to face when raising finance. The types of ratios typically sought by capital markets/rating agencies are most appropriate as it is these markets where finance is ultimately raised. We do believe, however, that the current framework is more focused on debt ratios whereas we would suggest greater consideration of equity ratios (e.g. ROCE, EPS etc.)

Capital markets do not necessarily view alternatives that are NPV neutral as being equal. Other considerations include key financial ratios, timing of returns and risk (i.e. even in a regulated environment returns in the near term are subject to significantly less risk than those in the longer term and investors value this certainty of 'cash now').

We appreciate that there are various methods of ensuring financeability (e.g. asset lives, rate of return and mix of fast and slow money) and therefore an overall financeability test is a good 'sense check' that the overall package will encourage the desired investor behaviour. We would welcome increased transparency over the mechanics of the financeability tests applied.

Financeability Uplifts / Depreciation profiles

Whilst to date no uplifts have been made by Ofgem to achieve financeability ratios, most infrastructure regulatory frameworks have had to bend to meet debt financeability criteria, for example:

- The basis of capitalisation has not remained constant in successive price reviews.
- The cliff face caused by end of pre-privatisation lives has caused a change to future lives to bring forward costs to maintain financial ratios. This challenge raises a number of issues which need to be considered:
    - It will reoccur in DPCR6 albeit to a lesser extent
    - Current customers receive a significant benefit from past customers as they utilise majority of assets which are fully depreciated
    - The asset base will now settle at a lower level in the future with future customers paying less than the replacement cost

As a result of the above, the following considerations need to be made going forward:

- If the depreciation profile is to be changed in the future (i.e. by increasing asset lives) it is important that it is replaced with an alternative mechanism (e.g. capitalisation rates) otherwise the 'cliff face' issue that caused this change to be required in the first place will be recreated.
- In deciding the appropriate capitalisation rates, the impact on equity (ROCE/EPS) should also be considered
- Financeability tests should still be maintained in both the short and long term

Changes made in DPCR5

Equalisation of Incentives

We support the changes that were made in DPCR5 to equalize incentives between Opex and Capex as they align drivers and optimize decision making. Adjusting the balance of fast/slow money has clear implications for financeability and may be a useful alternative mechanism should the approach to adjust the length of asset lives be adopted.

Our experience of the changes made in DPCR5, however, was that whilst the balance of fast/slow money for the industry was maintained, different companies were impacted to differing extents. Any change to asset lives and/or capitalization ratios would need to consider the overall impact on speed of money on an individual company basis.

Return on Regulated Equity (RORE)

We have separately commented on RORE in our response to question 5 in chapter 4.

Chapter 4 - Issues arising with the current approach

Question 1*: Do you have views on our Emerging Thinking assessment of the potential issues with our current approach to embedding our financing duty in the regulatory framework?*

Figure 2 demonstrates that RPI-X has been successful in reducing the cost of capital over a period of time. However, due to the lack of a clear and transparent approach to setting the cost of capital in DPCR5 we are not able to articulate what the 'right' cost of capital is prior to any calibration of returns.

Changing the current approach to embedding Ofgem's financing duty in a way that increases risk to network companies (e.g. by creating sustained periods of negative cashflows) will result in reversing the trend of reducing cost of capital, if investment is still to be attracted. This would have an implication in terms of higher customer prices.

Question 2: *Is there merit in determining a set of clear and transparent principles that guide our judgments on financeability and related policy issues for price controls?*

We agree a clear set of principles would be welcomed in order to ensure a consistent approach to making such judgments and considering policy issues. This should also be complemented by a clear and transparent approach to setting the cost of capital.

Question 3*: How should we strike an appropriate balance between the interests of current and future consumers in determining the approach to depreciation (and assumed asset lives) and capitalisation? What are the potential implications of changing our approach on asset lives?*

Balancing needs of existing and future customers

In principle it makes sense for the life over which customers pay for their assets to be aligned to their economic lives. However, this is a complex area which cannot be simply resolved by addressing a single issue such as future asset lives alone:

- Whilst current customers may be paying more as a result of shorter asset lives, they also receive a significant benefit from past customers as the majority of assets which they utilise are fully depreciated.

- Under 20 year depreciation the asset base will now settle at a lower level in the future. Future customers will pay less than appropriate as RAV will not reach replacement cost under accelerated depreciation.
- The level of investment that is being made in the network is also relevant (i.e. during periods of under average investment current customers will pay less).
- As we move towards a Smart world the pace of technological change means expected lives of network assets are likely to change, this creates substantial uncertainty over what an 'appropriate' asset life should be.

If asset lives were to be extended in order to help to balance the needs of existing and future customers then consideration also would need to be given to achieving an efficient financing cost for customers and ensuring that sufficient investment is attracted to meet network needs:

- If asset lives are extended, additional risk is created over the security of the returns (e.g. a 40 year asset life would have the risk of 8 price controls) and investors would require a substantially higher return to compensate for it. Furthermore, investors would require certainty over this return (i.e. a 'guarantee' that this return would not be eroded over future price controls after the investment has been made)
- Longer asset lives may lead to companies seeking longer term debt to fund their assets, which may increase costs to consumers.
- If returns are not high enough, or significant periods of negative cashflow exist, then investment may not be able to be attracted leading to underinvestment. This would impact future customers given the need to attract investment in order to decarbonise the UK's infrastructure.
- If sufficient debt finance cannot be secured and equity is required to take up any slack, this could result in lower gearing, again adding to a company's cost of capital

With regards depreciation methodologies, our preference would be towards maintaining straight line depreciation as this is aligned with the characteristics of the asset (it's performance generally remains constant over its life if maintained appropriately) and accounting convention. Any decision to alter the depreciation methodology would need to be assessed alongside other factors, such as asset lives and regulatory capitalisation rates as they all have similar impacts on the balance between short and long term revenue.

Any change to the regulated framework would need to be managed by way of transition arrangements to avoid sudden changes in investor ratios being perceived as increased regulatory risk. Clarity over whether changes would be applied only to new assets would be helpful.

Once the above considerations have been made the need for financeablity tests, which consider the needs of both debt and equity investors, still remains. Applying these tests will help to strike the right balance between asset lives and/or regulatory capitalisation so as to calibrate a framework which is attractive to both customers and investors.

***Question 4**: How much weight should we place on ensuring that aggregate revenues reflect the economic costs of running the network to expose consumers to signals about the cost of providing network services?*

Price Signals

Price signals to customers are clearly an important factor, but one that has not featured heavily under RPI-X. This is because considering this issue in isolation could have a direct impact on financeability. Both these factors need to be considered as separate issues, but it maybe that any outcome has to balance between these.

As discussed earlier there are other factors which are just as relevant in the debate as to whether current and future customers are treated equally and therefore the importance of this overall issue should not be overemphasized.

Incentives

We do not believe that incentives would be weakened, if underperformance could be absorbed without impacting credit ratings, as any rational investor is going to want to maximize their return by optimizing performance against the incentive regime. Decisions to maximize available rewards and minimize penalties will be taken to improve performance not due to the existence or lack of financeability constraints.

If, as a result of outperforming incentives, companies can achieve cash flows above that required to maintain an investment grade credit rating, we do not believe this to be unreasonable.

Reliance on cash flow ratios

We see investor ratios as being important, particularly given the recent paradigm shift with investors being cash constrained and re-appraising how risk is considered. In this world investors will require sufficient cash and debt headroom and the use of financeability tests will become increasingly important.

The consultation states that a reason for reducing reliance on investor ratios is the low level of risk that regulated businesses face. This relatively low risk is partly created by the existence of strong financeability tests and would be substantially increased if asset lives are extended and financeability tests weakened.

In our experience investors focus more on short term performance (i.e. over the current price control period). It is this certainty that means these businesses are low risk. If businesses are cash negative in a current price control the level of risk will increase as longer term returns beyond the next price control are not guaranteed and may be eroded in subsequent reviews.

Whilst we agree that credit rating agencies are not infallible, they are the closest representation we have for what investors require and in our experience the capital place a high degree of trust in these agencies. We believe that in the absence of a credible alternative (we are not aware of any credible alternatives) their requirements should be considered in any financeability test.

Question 5: *Does the approach taken in DPCR5 of using RoRE analysis to calibrate the regulatory package as a whole remain appropriate going forward?*

We see RORE as being useful to assess and model outcomes and calibrate incentives and risk. It is important, however, to remember that the cost of capital is a real cost that needs to be considered in its own right before 'calibration adjustments are made'. We would welcome more clarity over the principles for making calibration adjustments when determining the cost of capital.

Question 6: *Is there merit in providing differentiated allowed rates of return for companies within a given class/sector?*

In principle we would support this concept where risk (in terms of scale or nature of the investment) and therefore the cost of raising debt & equity could be demonstrated to be different between companies or sectors. However, to be workable the methodology for deriving the base WACC and for ascertaining differentiated rates would need to be fully transparent and consistently applied. Specific comments are made below:

- Where differences are directly related to the scale/nature/complexity of the investment and therefore the inherent 'riskiness' we would support differentiated rates. We believe this would be more likely across different sectors rather than across different companies within a sector.
- Re track record – Delivery of performance targets and cost allowances would provide sufficient evidence of robust plans and therefore further adjustments to cost of capital, beyond those included in the current IQI mechanism, would not be required.
- We would support the principle of allowing individual companies options on the balance of risk and reward based upon their risk appetite. Again however, we have concerns around how workable this would be and transparency would be essential. We would however, be keen to explore this further.

Question 7: *Are there other issues with the current approach that we should be considering?*

All the issues where we have concerns have been included in our responses above.

Chapter 5 - Embedding our financing duty in a new regulatory framework

Question 1: *Do you have views on our suggested straw men principles for embedding our financing duty in a new regulatory framework?*

Whilst we support the overall principle that the straw man is trying to achieve, we are conscious that the inter-generational issues are more complex in practice and that addressing them could have direct implications on financeability.

For this reason it is essential that financeability is given a high level of importance as a principal duty and that the ring fence is maintained so as not to transfer risk from companies to customers.

We comment specifically on the straw man proposals as below:

Allowed Return and Depreciation

In principal we support the straw man proposals in respect of allowed return, but we would want to understand more how the risk profile of the company would impact the allowed return.

Setting the depreciation allowance to reflect average expected useful lives is a complex area and creates a number of issues [see chapter 4; question 3]. Our key concerns if such a change were to be made would be:

- Financeability issues including impact on equity investor ratios would need to be addressed. Otherwise the increase in uncertainty for investors would require a higher cost of capital and some form of 'guarantee' over future returns. This would add overall cost to the customer
- It is questionable as to whether the change would really benefit future customers as other 'financeability adjustments' (i.e. timings of revenue) would be required to ensure companies continue to attract investment.
- In a time of significant technological change, how would the appropriate asset lives going forward be determined?

Given these issues further analysis and consultation would be required before a workable solution can be achieved.

We believe the financeability tests to be essential as part of Ofgem's principle duty and are surprised that the 'strawman' suggests moving the emphasis away from ratios used by credit rating agencies, but does not propose any alternatives. Credit rating agencies are the closest proxy we have to what our investors consider and we would be reluctant to move away from these ratios unless credible alternatives are proposed. As previously stated we would welcome more consideration of 'equity ratios'.

We have concerns that the proposals set out in paragraph 5.12 are inconsistent with Ofgem's financing duty and also with the stated approach in the 'ring fence' consultation.

We also believe that reducing Ofgem's financing duty would lead to increased costs to existing and future customers, taken together for the following reasons:

Efficient debt terms: If asset lives longer than 20 years are applied companies may look to mirror these asset terms with their debt maturities in order to minimize cash flow issues. This could result in more expensive longer term debt rather than a more appropriate funding mix.

Risk to investment grade credit ratings: If investment grade credit ratings cannot be maintained this would be a major disincentive to investors. Under these circumstances company's costs of raising capital would increase through more expensive costs of raising debt.

Increase in equity finance: If companies cannot raise the required debt finance from capital markets due to losing investment grade credit ratings then equity would be required to pick up the slack, this would result in lower gearing and therefore a higher cost of capital being required. Additionally this would create a strong driver on companies to underspend allowances and spend the minimum required to keep the network functioning rather than investing in a future decarbonised network

Regulatory risk: We disagree with the statement that there is 'negligible regulatory risk'. This is clearly not the case as there is a significant amount of regulatory risk, particularly when considered over a prolonged period. This is highlighted by the unexpectedly low cost of capital in DPCR5 as well as the risk of further changes to the regulatory approach (including this current RPI-X @20 review).

Historically, the existence of a strong financeability test focused on the short term has been key to keeping risk low. If this test was to be removed and a company is facing several years of cash negativity before returns can be realized then risk would be substantially increased.

<u>Capitalisation policy and equalizing incentives</u>

We support the approach of equalizing incentives. However, we are aware that under DR5 we did not believe the split between fast and slow money to be appropriate for all companies. It is therefore important that any lengthening of asset lives is considered alongside the percentage of fast money for each company to ensure that the price control results in companies being financeable in both the short and long term and provides sufficient incentive to all investors.

<u>Calibrating Returns</u>

We are supportive of RORE in principal. We have separately commented on RORE in our response to question 5 in chapter 4.

Question 2: *Are there other issues and models that we should be considering for our summer 2010 recommendations?*

We have no additional issues to note

Chapter 6 - Further issues and next steps

Question 1*: Do you have views on the issues that we will need to consider as we develop the detail on financial issues in a new regulatory framework for our summer recommendations?*

On an overall basis we are satisfied that the areas covered by the original paper and our response are appropriate. We would specifically wish to highlight.

- Financeability is, as per the statutory obligations, key but important the regulatory framework doesn't discriminate between debt and equity i.e. use of indicators, capitalisation rates
- Where investment injections are required, returns need to be attractive for new investment and include transaction costs
- Clarity would be appreciated on how any changes to asset lives would be considered alongside regulatory capitalisation and regarding what the transition arrangements might be

Other than these important points, the remaining issues / challenges seem appropriate.