RPI – X @ 20

Emerging Thinking Consultation

Embedding financeability in a new regulatory framework

Third party right to challenge our final price control decisions

Electricity North West Response

RPI – X @ 20

Consultation Responses

Electricity North West Response

Executive Summary

The three RPI – X @ 20 consultations have recognised the benefits of the present regulatory framework, sought to improve specific areas to reflect the future investment requirements whilst also introducing consistency across the networks. We agree that it is timely to review the regulatory framework and agree with some, but not all, of Ofgem's proposals. In particular:

We agree there is a need for an evolution of the framework rather than a revolution.

- We can see no justification for undertaking a significant change to an ex post price control
- Recent developments in DPCR5 demonstrate that the investment and consistency objectives can be met via an RPI-X framework

The Ofgem view of outcomes and outputs is consistent with our own long held views

- It is important that the outcomes reflect the wider government energy policy and are aligned with DECC's priorities as the industry's guiding mind
- Utilising outputs as a measure of delivery of the identified outcomes will provide a mechanism to monitor delivery of solutions and provide a transparent mechanism to demonstrate value for money
- A clear framework will be required to amend outcome targets in order to maintain incentives to deliver and invest whilst reflecting changing priorities

We do not think the introduction of longer term price controls is appropriate

- Given the likely pace of change and developments in the sector, and the desire to retain flexibility in the framework, the five year period remains an appropriate baseline
- Whilst regular resets are likely to deliver cost savings for customers, they do so at the expense of investment certainty. This effect could be mitigated by increasing investors' certainty of return by the development of robust, long term principles as to how investment will be remunerated. Ofgem must:
    - define appropriate timescales over which it will seek to ensure financeability
    - commit to using all credit rating agency ratios to test financeability
    - define the approach to rectifying financeability issues

- establish a long term fixed depreciation profile
- set out a clear framework to amend outcome targets

We do not believe the introduction of additional competition in the ownership of network assets is appropriate

- The existing obligations set out in the Electricity Distribution Licence provide a greater level of protection for customers than the measures proposed in the new framework.
- Ofgem's concerns with some of the elements of the present structure are not warranted and are inconsistent with the moves in Project Discovery to facilitate investment.
- Ofgem is concerned that the existing structure has not created ESCOs. Allowing DNOs to operate in this area may encourage other companies to follow.

We disagree with Ofgem's financeability proposals

- The proposals display a lack of understanding of basic financing. In moving to a greater proportion of "slow money" Ofgem assumes that the increased RAV can be financed by additional debt and equity capital. Investors will not simply look at the higher RAV and provide the extra amounts; they absolutely focus on the ability of the borrower to service and ultimately repay, or re-finance, the debt.
- The suggestion that additional capital can be found without maintaining investment grade credit ratings implies a belief that an increasing portion can be found from equity investors and consequently a lower level of gearing would result. This in itself would see a higher cost of capital to be funded by consumers; reversing recent trends.
- The proposal to focus solely on the approach of credit rating agencies is also flawed. The credit rating agencies perform a service by publishing objective analysis which debt providers consider. However lenders and debt investors also perform their own reviews of credit fundamentals.
- A DNO needs to refinance both medium and long term debt obligations and therefore asking lenders to take the very long view is not appropriate.
- The expectation that there is a long list of equity providers (pension funds) which will accept irregular returns and rely upon a very long-term view is unproven.
- The logical conclusion is that the required WACC for energy network companies would increase but the pool of willing debt investors will significantly reduce as you go down the credit curve, certainly to non-investment grade "junk" status, so if the fundamentals change it is questionable whether the required amount of finance across electricity and gas could be raised "at a reasonable price". Ofgem acknowledge this risk in the paper and

undertake to investigate the empirical evidence. We await these findings with interest.

We agree with the proposals for enhanced engagement

- Stakeholder engagement provides wider benefits to network companies.

- Ofgem's proposals don't go far enough – we support the consumer right of challenge. We recommend that the only party able to challenge a price control should be a statutorily constituted consumer representative body. This body would need to consider the interests of current and future customers as well as the public interest in making any challenge.

- We believe that, as the ultimate arbiter of best practice in utility regulation the Competition Commission should be more involved in the price control process more regularly and also undertake the role of gatekeeper to allow a specialist regulatory challenge and ensure an independent public interest test.

Our response to the Emerging Thinking proposals is based upon our recent experiences of refinancing the regulated business at a time of significant market uncertainty, methodological negotiations through the DPCR5, the development of an output based metric, a change in ownership to a similar class of investor targeted by Ofgem and a significant stakeholder engagement programme. These practical experiences have illustrated a number of significant weaknesses in Ofgem's analysis.

We look forward to working with Ofgem to develop a set of final proposals in the summer.

1 Emerging thinking consultation

1.1 The existing framework

1.1.1 Capturing the benefits of consistency

Any future regulatory framework must balance a number of seemingly contradictory objectives including:

- Maintaining high standards of customer service
- Ensuring delivery of key network investment
- Encouraging a long term perspective and innovation
- Ensuring that investors can be attracted into and retained by the industry and
- Ensuring efficiency of delivery

Recent developments in DPCR5, demonstrate that these objectives can be met via an RPI-X framework. We therefore do not believe that there needs to be a fundamental change in the present framework. Analysis of several of the core elements of the RPI – X framework suggests that many of these remain fit for purpose. Evolution of the RPI-X framework should enable the required re-balancing of the priorities.

Adapting the existing ex-ante price control to capture some of the benefits of an ex post control (eg encouraging investment) will minimise any uncertainty for investors. Ofgem has recognised one of the key issues in the ongoing Project Discovery and RPI – X @ 20 consultations – that any policy needs to deliver investment whilst retaining investor commitment. A change to an ex-post price control would need to deliver the investment required whilst protecting current and future customers and retaining investor confidence gained throughout previous price controls. We can see no justification for undertaking such a risky change in the nature of regulation.

Price control periods need to reflect the level of uncertainty contained within the price control. The recent decision to delay the TPCR is an example of Ofgem adopting a sensible approach to the unprecedented level of risk associated with setting a balanced price control package. Given the likely pace of change and developments in the sector, and the desire to retain flexibility in the framework, the five year period remains an appropriate baseline. The small risk that DNOs might not invest in longer term or more innovative projects (especially across multiple price controls) could be mitigated by increasing investors' certainty of return by the developing robust, long term principles as to how investment will be remunerated.

It is important to make use of an appropriate inflation adjustment index in the price control settlement. The removal of inflation from the price control review process allows Ofgem visibility of the underlying costs faced by the business and avoids the need for a premium for managing the inflation risk to be paid by customers. It is appropriate to compensate companies for cost increases resulting from general price shifts. The DPCR5 discussions around the suitability of RPI for indexing revenues highlighted that

there were variations between the movements in costs and the allowed growth term. Movement away from RPI to CPI (as considered by Ofgem) will increase the magnitude of this issue. Whilst the RPI does not perfectly compensate for the changes in the cost base, it does have the advantage of broadly mirroring the movement in labour rates/Average Earnings Index which protects firms against the majority of labour cost movements and ensures that customer bills are linked (in some way) to earnings growth. Our discussions and deliberations during DPCR5 have not revealed a better alternative to RPI.

1.1.2 A new framework based on outcomes

Ofgem's proposed outcomes are sensible and appropriate at a high level. It is important that the outcomes reflect the wider government energy policy and acknowledge the importance of network safety.

It is important to note that as the UK's energy policy evolves, the targeted outcomes may need to be amended and that new or amended outcomes may become appropriate. A clear framework will be required to amend resultant output targets in order to maintain incentives to deliver and invest whilst reflecting changing priorities. This framework should include

- Long Term Principles and Focus
- Sensible and proportionate balances and
- Transparency of approach, action and timing.

1.1.2.1 Long term principles and focus

The network companies are facing the greatest level of uncertainty in their history. Factors such as the low carbon future, unit cost volatility driven by market turmoil, and the availability of finance matched with a significant increase in investment are increasing the risks for networks and their stakeholders. To ensure that these risks are efficiently priced into a price control, regular resets are required.

Whilst regular resets are likely to deliver cost savings for customers, they do so at the expense of investment certainty. To overcome the uncertainty, we suggest that

- Long term financing principles are established (see financeability section);
- Where appropriate, specific terms are implemented for specific investments, particularly where the benefits of investment may occur in a different period from the costs - such as the 15 year return period already in place for the Distributed Generation incentive mechanism;
- Large-scale, long-term projects and programmes are protected, particularly where the costs span multiple reviews;
- Principles established in relation to the treatment of Pensions are adhered to; and,
- Specific low carbon investment enablers attract guaranteed returns.

1.1.2.2 Sensible and proportionate balances

Price controls contain a number of balances between competing elements. The most notable examples relate to intergenerational equity and financeability (as investments made today are spread across a prescribed asset life but need to be balanced with the need for cashflows in the period to pay interest on debt etc). The key to achieving

a sensible balance is to allow a wide discussion of the relative advantages and disadvantages of each issue (mindful of the need to encourage investment) and set a long-term approach.

1.1.2.3 Transparency of approach and action

Ofgem needs to adjust its own behaviours to reflect the demands of the low carbon network investment. The move within DPCR5 to equalise incentives for efficiency between operating and capital example is a good example of the type of regulatory decision which exemplifies appropriate behaviour. Conversely, comparative efficiency approaches that reward NWOs for lowest cost solutions can penalise "first-mover" companies for being relatively more expensive without considering the value that the innovation would bring to future customers.

1.2 An outcomes-led framework

We welcome the adoption of outcomes and outputs in the future regulatory framework. Utilising outputs to deliver the identified outcomes will provide a mechanism to monitor delivery of solutions and provide a transparent mechanism to demonstrate value for money. The linkage between outcomes and outputs will not always be clear however, and care will be required to manage tension between different outputs to ensure network companies deliver a compatible suite of complementary outputs. Great care will also be needed in specifying outcomes and outputs to ensure that the definitions do not preclude innovation in delivery; there is a risk that focussing on delivery of specific inputs and outputs may discourage more innovative means of delivering required outcomes.

We suggest that Ofgem could utilise short, medium and long-term targets but recognise that these targets must be aligned with the incentive framework and may change with differing frequencies (eg enduring safety targets as opposed to improvements based on contemporary customer willingness-to-pay). The recent banking crisis demonstrates how short-term incentives can jeopardise the long-term stability of a sector.

It should be recognised that the use of outputs and outcomes is unlikely to streamline the price control process – at least in the short term - as the same solutions will need to be scoped, requirements understood and changes in scope justified. Ofgem needs to understand that the inherent complexity in scoping these solutions does not necessarily fit with the desire to simplify the regulatory "contract". However, price controls could be streamlined through the early agreement on reporting requirements and the issuance of stable reporting requirements and tables in a timely manner.

There will be much work to be completed to develop a coherent set of outputs measures that are appropriate, measurable, comparable etc, and, as Ofgem note, this will be best undertaken collectively with NWOs.

1.2.1 Linking outputs and outcomes to policy objectives

Ofgem needs to consider how the outputs and outcomes reflect the requirements of Government objectives. Aligning policy with deliverables will ensure that the entire energy sector is working toward a set of common objectives (as described in our recent response to Project Discovery). Ofgem needs to capture more explicit DECC involvement in the setting of high level outputs.

The process of stakeholder engagement will inform future price controls and those discussions will reflect local or regional requirements. It is important that Ofgem considers the role and requirements of regional stakeholders and ensures that such requirements are captured in the framework. This process is likely to lead to an increasingly regional 'flavour' to future planning hence future comparative analysis will need to be calibrated to take into account variations in regional commitments.

1.2.2 Review of Ofgem's proposed outputs

In our review of the proposed outputs we have noted a number of elements that need further consideration. The inclusion of "conditions for connecting to network services" is a strange output measure. The intent behind this measure needs to be discussed further as it appears to be an issue of competition rather than regulatory framework scope. It may be more appropriate to discuss outputs in terms of ensuring sufficient capacity – recognising the need to move to a "connect and manage" approach to distributed generation.

We are also concerned that 'Reliability' is potentially too big a category to be meaningful in its own right. In particular, we need to ensure that reliability under normal and extreme circumstances are appropriately judged and prioritised. As an example, climate change mitigation work is likely to form an increasing proportion of future infrastructure investment but is not picked up in current measures.

As the UK's energy policy evolves, the desired outcomes may need to be amended and new outcomes may become appropriate. It may also be the case that new outputs are developed which better measure progress towards achievement of the overall outcomes. At specified points, Ofgem will need to make a conscious decision on the relative priorities of each of the outputs and outcomes and adjust targets accordingly, taking into account the regional input discussed earlier. In order to minimise regulatory uncertainty, such changes should be effected via a clear, long term framework.

1.3 Incentivising efficient long term delivery

1.3.1 Matching incentives with delivery

The new regulatory framework needs to establish consistent long term incentives. Both Project Discovery and this consultation recognise the need to encourage investment in a solutions–based (rather than network) environment. In our response to earlier questions, we discussed the need for regular price control resets to price efficiently the increased level of risk in the sector and recognise the impact on investor certainty. The establishment of long term delivery incentives is one way in which investor certainty should be created. Ofgem should develop a set of long term principles which will minimise the risks to investors. It may be appropriate to guarantee returns on large infrastructure projects which need to be built irrespective of the output priorities. We suggest that such investments should be guaranteed a long-term minimum incentive rate. Stability of returns encourages long term equity investors to provide investment capital (as set out in the Ofgem financeability consultation).

We recognise that one of the issues with providing long term incentives and specific ring-fenced investments is that the level of complexity of the price controls increases. A complex business environment requires a complex price control framework; this is good for all parties. This places a more overt duty on Ofgem to explain the framework, in plain-English, to the lay audience.

Ofgem also needs to consider how to incentivise a company of the future. The future needs of the networks may be built around a combination of assets and commercial solutions such as purchasing demand side response. This may require different incentive properties to properly compensate the additional risk adopted from non-network solutions.

1.3.2 New Business Plans

We support the use of longer term business plans. The development of longer-term investment scenarios will inform companies of key investments under a range of future scenarios. In DPCR5 ENW set out a 25 year Strategic Development Statement for stakeholders and in 2009/10 has been developing a 2050 vision to inform future investment scenarios. The link between business plans and outputs will allow companies, stakeholders and Ofgem to discuss plans in a common framework.

Our experience in DPCR5 of stakeholder engagement suggests that future business plans will be need to be regionally developed and supported and aligned with DECC's priorities as the industry's guiding mind. This raises a number of issues for the DNOs such as:

- Relative priorities between regional customers must be assessed
- DNOs engage with regional government, businesses, customer representatives and interest groups whilst Ofgem traditionally engage with end customers
- Political administrative regional boundaries do not map to DNO footprints

We are considering whether regional plans could be signed off by a regional specialist panel, comprising of a regional customer body, regional development agencies and other regional stakeholders. We believe that this review process would allow a thorough review of the investment proposals on behalf of current and future customers.

1.3.3 Challenging future plans

Ofgem's assessment of future business plans may need to be substantially different from the approach adopted in previous price controls. We have suggested that future business plans will be shaped around regional customers. Each DNO may be asked by its customers to adopt a different risk profile, depending upon their needs and appetite to adopt commercial arrangements. Future comparative efficiency modelling will need to evolve to take account of variations in NWOs' endorsed investment plans.

We also encourage Ofgem to review its process for completing and comparing business plans. Aligning annual reporting requirements with price control submissions would improve visibility of business plans and reduce the burden of the price control review for both the regulator and the network companies.

It has been suggested that part of the future business plan challenge will depend upon the reputation of the network company. We support these proposals but urge Ofgem to develop a robust rationale for determining reputation.

The approach and data requirements for comparative efficiency modelling must be developed and agreed prior to the commencement of each price control. This will

enable appropriate data to be captured and audited across the DPCR5 period. The desired end result should be the publication of an annual report from Ofgem, using RRP data that indicates the relative efficiency of all DNOs. This would assist the process of ensuring that these issues are well understood by all stakeholders prior to the commencement of a price control review and provide all parties with have greater confidence in the assessment techniques, data and results.

We recommend that Ofgem develops a model which recognises the difference between value for money and efficiency in infrastructure solutions. The current approach fails to recognise that value for money includes a quality component which needs to be assessed if it represents a longer term flexibility and therefore efficiency. Pricing up the least expensive option may limit a company's choice of solution and encourage less risky infrastructure solutions.

Future plans need to incorporate robust unit cost analysis. In DPCR5, decisions on relative "efficiency" of companies were not made on a like-for-like basis which has led to distortions in the unit prices submitted at DPCR5. If this form of analysis is to be used for setting allowances and is to be used to determine companies' reputation and hence degree of regulatory scrutiny, it needs to be more appropriately calculated.

1.3.4 Competition in delivery

The proposal to open up competition in specific areas of the price control is in direct contrast to the approach adopted in Project Discovery. Both consultations have identified the need to encourage investment in a timely manner. The approach promoted by Ofgem in this paper may result in delays to critical infrastructure. The existing obligations set out in the Electricity Distribution Licence to provide a service "at any Entry Point and in any quantity that was specified by the requester" and to "manage and operate the Distribution Business in a way that is calculated to ensure that it does not restrict, prevent, or distort competition in the supply of electricity or gas, the shipping of gas, the generation of electricity, or participation in the operation of an Interconnector" provide a greater level of protection for customers than the measures proposed in the new framework.

1.3.5 Recognising the need for innovation

Ofgem's introduction of further specific innovation stimulus in DPCR5 is recognised as a positive step towards the development of the future network company. Many of the benefits that will result from these funds will be transferable across regional and sectoral boundaries. We believe that opening up the new funding arrangements to other network and non network companies will encourage the type of innovative thinking that the low carbon network fund is seeking to deliver. We recommend that network operators need to be part of any consortium to ensure that there is a real need for any proposed network solution.

1.4 Cross sectoral solutions for a sustainable energy sector

In Project Discovery, Ofgem are looking to adapt the industry structure to encourage investment and delivery of the Governments obligations whilst the RPI - X @ 20 consultation assumes that the existing industry structure will allow the new regulatory framework to deliver its objectives. It is vitally important that Ofgem understand the

impact and requirements of Discovery on the regulatory framework and the structure of networks.

Ofgem raised an issue in DPCR5 surrounding the connection assets between National Grid and the distribution networks. Ofgem's concern was that there was an inconsistent balance of incentives across the network boundary and that DNOs may prefer to use infrastructure on the transmission network as the costs associated are fully recoverable. The assumption was that customers are paying more than they would do if there was a single network company. The resulting transmission exit charges incentive for DPCR5 produces little value to customers, only extra costs, and encourages investment deferral (which we suggest is against the principles of the new regulatory framework and Project Discovery).

We suggest that Ofgem's concerns with some of the elements of the present structure are not warranted and are inconsistent with the moves in Discovery to facilitate investment. We do not believe that there are significant efficiencies to be attained through a separate contracting approach as companies already contract out large elements of work to meet the efficiencies contained within current price controls.

The proposals imply that the lack of ESCOs and CHP networks results from actions or inactions of DNOs. We disagree with this view. If the guiding mind believes that such enterprises should be encouraged, then the regulatory framework should allow for NWOs to be incentivised to deliver them. Allowing NWOs to operate in this area may be one way to encourage other companies to compete by demonstrating the viability of such enterprises and creating a market.

Ofgem's suggestion to encourage local vertically integrated monopolies by requiring network companies (ie natural monopolies) to lease or divest their assets is not appropriate. The open access regime for use of the distribution network already in place provides a mechanism to enable all of the benefits envisaged by the lease of specific assets. Any local monopoly, with an interest in excluding others from access to its network, would require at least the same level of open access obligations on the purchaser/lessee as currently apply to incumbent network businesses.

2 Embedding financeability in a new regulatory framework

Throughout the embedding financeability paper, Ofgem has focused on an assertion that the current financeability approach is detrimental to customers. We believe that the current approach to financeability has served customers well and that Ofgem may be looking to fix a problem which does not exist. We suggest that

- The theoretical model could not be applied to the actual financing requirements of DNOs.
- Ofgem should establish long term principles for financing.
- The proposals are inconsistent with the other proposals in RPI-X @ 20 and the financial ring fence consultation.
- Ofgem need to attract and retain investors rather than just compensate them.

Our response to the Emerging Thinking proposals is based upon our recent experiences of refinancing the regulated business at a time of significant market uncertainty, methodological negotiations through the DPCR5, the development of an output based metric, a change in ownership to a similar class of investor targeted by Ofgem and a significant stakeholder engagement programme. These practical experiences have illustrated a number of significant weaknesses in Ofgem's analysis.

2.1 Summary of Ofgem's proposals

Ofgem are suggesting that it would be possible to reduce "fast money", by extending depreciation lives and possibly reducing the capitalisation rate, whilst also fundamentally weakening the companies' credit metrics by placing less or no emphasis on cash flow ratios and the levels assumed by credit rating agencies. One intended benefit to current consumers is the impact of shifting a greater proportion of network investment costs to future consumers.

Ofgem considers that the fact that regulated utilities are viewed as low risk means that any mismatch in their cashflows, at a particular point in time, though not on average over time, "should not raise financeability issues" and importantly "no adjustment to revenues would be made to compensate where the company faced financing difficulties".

2.2 ENW's response to these proposals

- These proposals display a lack of understanding of basic financing. In moving to a greater proportion of "slow money" Ofgem assumes that the increased RAV can be financed by additional debt and equity capital. Lenders will not simply look at the higher RAV and lend the extra amounts, they absolutely focus on the ability of the borrower to service and ultimately repay, or re-finance, the debt.

- Indeed the suggestion that this additional capital can be found without maintaining investment grade credit ratings implies a belief that an increasing portion can be found from equity investors and consequently a lower level of gearing would result. This in itself would see a higher cost of capital to be funded by consumers; reversing recent trends.

- When considering the importance of financial ratios focusing solely on the approach of credit rating agencies is also flawed. The credit rating agencies perform a service by publishing objective analysis which debt providers take account of. However lenders and debt investors perform the same review of credit fundamentals. Although analysts will look at a 3-year average rather than one single year they will not totally disregard the short to medium term profile. Therefore disregarding rating agencies will not deal with the underlying problems that weaker financial profiles will raise.

- Ofgem's view that regulated utilities are seen as low risk is precisely because of the predictability of their cash flows over the short to long-term and due to the perceived duties of the regulators to ensure financeability. There is therefore a circular argument in that if Ofgem weakens the financial profile and its obligations then the perception of the risk will increase. Ofgem provides no evidence for its statement that these changes "should not raise financeability issues"

- A DNO needs to refinance both medium and long term debt obligations and therefore asking lenders to take the very long view is not appropriate. Consider a DNO negotiating a 3-year committed bank facility against a very weak financial profile over the period and a pending price review with little comfort over the likely profile in the following few years. This is quite a different position to a potential bond investor asked to invest for 30+ years against the very long-term network growth profile.

- The expectation that there is a long list of equity providers (pension funds) who will accept irregular returns and rely upon a very long-term view is unproven. It is also worth noting that the same equity and debt investors that Ofgem need to provide new finance after the proposed changes are likely to have have just suffered a significant value loss to their existing investments in the sector as a result of the market's reaction. This is hardly a strong incentive to them to invest more.

- The logical conclusion is that the required WACC for energy network companies would increase but the pool of willing debt investors significantly reduces as you go down the credit curve, certainly to non-investment grade "junk" status. Therefore, it is questionable whether the required amount of finance across electricity and gas could be raised "at a reasonable price" if the established fundamentals of the existing regime change. Ofgem acknowledge this risk in the paper and undertake to investigate the empirical evidence. We await these findings with interest.

2.3 What is financeability? (a review from a practical perspective)

Ofgem's statutory duty is to allow a licence holder to finance its functions. It is notable that this concept has no definition of timescale or corporate structure. The paper proposes an expansion of Ofgem's current remit and responsibilities (including operating structures beyond the financial ringfence). It is not clear that such changes are in customers' interests. The provisions contained within the current licence ensure that there are significant protection measures in place for customers and that shareholders bear the risks associated with ownership structures. This mechanism has

protected customers from additional risks associated with non distribution activities and has lowered customer-funded borrowing costs.

The interpretation of Ofgem's responsibilities with regard to financeability is one of the core issues of this consultation. The overriding premise in the paper is that Ofgem will determine whether a company is financeable based upon its own measures and ratios. Given that regulated businesses require funding from both debt and equity providers, it follows that these providers must be comfortable with the financeability of the business under any new regulatory framework. Ofgem must undertake a review of financeability which is representative of the actual markets that network companies raise their finance in rather than a theoretical, stylised model.

The concept of financeability has been discussed at price controls as a measure of the viability of the regulated business within the quinquennium. The typical objective of the financeability tests is to maintain a targeted investment grade credit rating, allowing access to the finance markets at efficient rates. The ratings agencies utilise statutory accounting based financial ratios (alongside a number of qualitative measures) to determine a company's rating. It is therefore important for Ofgem to recognise the role of the ratings agencies' ratio analysis when defining financeability as the analysis conducted by the agencies ultimately impacts upon the cost of borrowing for customers. Targeting investment grade credit ratings over subsequent price controls has been one of the reasons why the cost of debt has fallen for utilities in the last twenty years.

It is important to return to these principles throughout the wider discussion of financeability in this paper.

2.4 Lifting the lid on Ofgem's DPCR5 financeability approach

In the most recent price control review, Ofgem effectively utilised a number of measures as mechanisms to optimise financeability. The five main parameters were:

- Cost of capital;
- Depreciation;
- Capitalisation ratio (fast and slow money);
- Revenue profiling; and
- Pensions deficit repair rate.

There are a number of other reasons for setting each of these parameters at the points they were set, but all have an impact on financeability as measured by ratio tests.

The DPCR5 financeability package involved mirroring the DPCR4 depreciation profile and maintained overall capitalisation rates at similar levels to DPCR4 whilst adjusting revenue profiling and pension deficit repair to minimise price rises. If depreciation lives had been extended it is likely that the capitalisation rate would have been changed to generate more "fast money".

At this point, it is important to note that the five mechanisms all contribute to the financeability of the company. Adjusting any individual financeability lever requires an adjustment to another to maintain financeability. This balancing act is vital to ensure companies retain access to markets, customers are protected, and the costs of the borrowing are minimised.

We have supported a number of the proposals contained within DPCR5, including the use of a fixed capitalisation rate. The adoption of these mechanisms in RPI – X @ 20 is a sensible extension to the regulatory framework. The ratio of fast to slow money in DPCR5 was set to equate to DPCR4 rates and whilst this may not be the appropriate rate for long term sustainability or cost reflectivity in each sector, fixing the capitalisation rate should reduce the distortion of investment incentive rates.

Financeability in the new framework needs to recognise its role as an enabler of future investment. There is too much focus from Ofgem on the need to compensate rather than to attract and retain investors. The current Ofgem approach could be described as setting the minimum level to retain investors (especially at DPCR5). This change in mindset (as discussed in previous chapters), is one of the key developments required for the movement towards a low carbon energy sector.

2.5 Long term dangers for customers with the current approach

Ofgem's assessment of the issues raised with the current approach appears to be reasonably balanced. We agree that some of the previous decisions surrounding financeability have lacked transparency and predictability and that a clear, defined set of principles would reassure investors, especially if the principles were in some way linked to widely accepted credit rating agency ratios.

Ofgem's analysis of the incentive impact of accelerated depreciation is oversimplified. In its latest price control the profiling of revenues, combined with the relative fast and slow money balances, left numerous companies with weak ratios in the first years of DPCR5. Any underperformance of regulatory targets in the first years of the price control (when they are most likely to occur) has a significant impact upon the financeability of a company. The most attractive element of the current treatment of depreciation is that there is a consistent approach across price control periods and price stability for customers. Any future approach must recognise that the asset lives of today are not the same as those of the future. Networks may develop and use a combination of short life smart assets or commercial solutions to deliver outputs. These will have considerably shorter lives than the physical assets which are utilised today but it is important that the future framework should not distort the choice between physical or virtual network solutions; equalised regulatory treatment will encourage appropriate decision making.

The Ofgem position to ignore credit agency cash flow ratio analysis to sense check regulatory settlements is the most concerning element of the RPI – X @ 20 consultation for all network company investors. Suggesting that investors will ignore the credit rating agencies' analysis when network companies are seeking finance from debt or equity providers is a highly theoretical argument and unreflective of any known element of the current investor community. Ofgem will be unable to demonstrate that it has discharged its duty to ensure licence holders are able to finance their activities if they disregard the ratios of the credit ratings agencies. Irrespective of the reliability of the agencies, they are the only practical benchmark for debt providers and are essential to gaining access to finance at the most efficient rates.

A key principle should be that all financial ratios of all main rating agencies should be used to test financeability. Ofgem's reluctance to recognise and adopt Post Maintenance Interest Cover Ratio (a key utility ratio for investors) is a key failing in the current financeability approach. Financeability is judged on a statutory accounting basis and it could be argued that the current approach of monitoring a selective group

of ratios on a notional company on a regulatory basis is unlikely to satisfy Ofgem's legally defined obligations.

It may be appropriate to look at RORE as a method for calibrating relative incentive values but it should not be used to measure performance. Our analysis of DPCR4 suggested that our real outperformance was approximately 6% against Ofgem's analysis of 11%. The difference reflects the highly theoretical approach adopted in the RORE modelling.

RORE analysis represents a short term view of efficiency. In line with its other consultations which are looking to address long term issues, Ofgem needs to take a longer term approach and attitude to efficiency and rewards.

One of the core issues with the use of the RORE model is that there is an inherent difficulty in rewarding intent rather than results. Given that the new framework should allow companies to experiment with new solutions, measuring performance via a mechanism such as RORE will merely determine who has been successful from a short term profit maximising point of view. A company could hypothetically be progressive, innovative and future- orientated but only achieves average results compared to a company who has adopted a more traditional or short term business model. This imbalance could be redressed via the introduction of specific input based incentives for innovation and long-term approaches that reward intent as well as results.

Ofgem's proposal to vary the cost of capital across the sector raises a number of issues. From a cash point of view, companies should be completely neutral (assuming that the calculations are correctly applied) as Ofgem should provide rewards either through the incentive mechanisms or via a WACC uplift. However, the cost of capital is an important marker to the investment community and external agencies. Flexing the cost of capital for individual companies will appear to be an added layer of complexity for no tangible benefit.

2.6 Critique of the strawman

So far, this chapter has looked at the issues with Ofgem's current approach to financeability. Whilst there are some concerns with the current approach, the DPCR5 model is much more preferable than the package proposed in the strawman. In this section we will review the proposals.

We are concerned that Ofgem's publication of the embedding financeability, Project Discovery and ring fence protection for regulated business consultations produce a number of inconsistencies. The three publications should be supporting energy policy with a regulatory framework which minimises uncertainty in order to attract and retain investors to allow the construction, development and operation of the future energy networks. At present, the Ofgem view of financeability is representative of its efficiency driven mindset. There is also a need for consistency between encouraging greater innovation and risk taking whilst seeking very low returns. This profile is unlikely to attract a low risk investor. It is notable that Ofgem are still proposing to use the investment-grade credit rating as a form of customer protection in the ringfencing consultation. To provide revenues to network companies that fail credit rating financeability ratios whilst simultaneously expecting the maintenance of investment grade credit ratings is an inappropriate framework to encourage long term investors. We suggest this implies a big shift to equity funded business models. This is not within Ofgem's power and produces a relatively inefficient solution for customers.

Ofgem's suggestion that the regulatory framework should be designed to encourage a specific type of investor is inappropriate. The proposed strawman model will have implications for the future financing structure of a network company and on the required cost of capital. The number of pension funds is limited and it would be inappropriate to assume that the entire portfolio of pension fund investments will consist of utility companies. Therefore, utilities will continue to rely upon the debt markets for finance. Debt investors need assurances that adequate cash flows will be available to service interest payments. The resulting dependence on debt markets suggests that the proposal to look at long term returns is unrealistic as debt holders look at the ability of companies to pay interest costs across the length of the loan. We believe that equity investors would not be willing to participate under the proposed conditions. There is usually a requirement for steady short term cashflows/dividends to be returned to equity providers throughout the term of an investment.

Given the need to encourage investment, specifically encouraging the divestment of network companies by the current investor community is likely to delay necessary investment.

There is a need to return to the core principles of investment finance. If we are to encourage investment and innovation in the sector, the cost of capital should represent the allowed return on investment of the asset base. The use of the RORE analysis to erode the allowed returns on the RAV merely increases the risk for investors, which pushes the required cost of capital up and dissuades investors from providing future finance.

There is a danger that Ofgem's proposal to move to a marginal or economic cost based method for determining allowed revenues will fail to reflect the historic investment incurred. We suggest that, as in the case of customers, there is a need to balance the requirements for current and future investors. There needs to be considerable weight placed on the appropriateness of cost reflectivity and avoid opportunities for short term behaviours brought about by responses to political interference. Ofgem's proposal to encourage network companies to create innovative price signals for customers will be significantly limited by the introduction of the common charging methodologies for the DNOs.

One of the dangers of the proposed economic life approach is the assumption is that the assets will be used and fully depreciated. This is not necessarily appropriate as there will be differing views of economic lives of assets depending upon the changes in the energy delivery model. It may be appropriate to set a long-term rate to provide certainty to the investment community rather than risk a shifting return of capital profile. As we have already stated, depreciation lives form an important part of the financeability balance. In DPCR5, if asset lives had been lengthened, the balance of fast and slow money would have needed to change to provide adequate cash flow because of the limitations on cash imposed by the revenue profile. The uncertainty over the future use of assets demands that the current customers should bear a considerable portion of any cost.

Ofgem's future definition and approach to financeability is more likely to deter the type of investors that Ofgem are seeking than attract them. The combination of increased risk, longer term returns and low cost of capital is unlikely to be attractive to any class of investor (aside from Governments). Ofgem needs to understand the implications of the business model which the proposed framework would encourage.

2.7 What should be done?

Three key components need to be included within the future regulatory framework relating to financeability.

2.7.1 Long term principles

We think there is value in establishing a set of key principles for financeability. Providing principles in key areas of a price control is one way to improve investor certainty which will help network companies to attract investment. It is important that the principles are broadly accepted by the companies and investors and suggest that Ofgem should test any proposed principles or metrics on a wider group of both debt and equity providers to ensure that the principles are attractive (or at least broadly acceptable).

The following long term principles should be adopted

- **Ofgem must define appropriate timescales over which it will seek to ensure financeability.** As part of the review of Ofgem's interpretation of its responsibilities to investors, it should include defining the long term responsibilities of a regulator to provide appropriate financing. There is a concern that Ofgem could make short-term decisions that potentially damage the long-term viability of network businesses.

- **Use all credit rating agency ratios to test financeability**

- **Establish a long term fixed depreciation profile**

- **Define the approach to rectifying financeability issues**

2.7.2 Sensible balances

There needs to be a sensible balance between the needs of current and future customers, current and future investors and the responsibilities of the networks. In terms of the DPCR5 settlement, the decision was made to maintain depreciation lives and capitalisation rates but adjust the revenue profile and pension deficit repair and WACC. These combinations of parameters were balanced to allow companies to finance their functions, albeit with some ratio constraints in early years. Ensuring that there is appropriate cost reflectivity in charges will help to minimise the impacts of the inevitable increase in energy bills whilst honouring the investments of the past (including pensions) will encourage future investment.

2.7.3 Transparent use of financeability tools

To reduce investor uncertainty and risk, Ofgem must comply with its statutory duty in a transparent manner. Recognising the aforementioned financeability levers need to be balanced, we suggest that using depreciation, capitalisation rate and revenue profiling are the most simple and transparent mechanisms to ensure financeability. Any movement in any of the levers need to be clearly understood by the investment community and that any shift needs to be managed in small steps to avoid issues like the depreciation cliff face.

2.8 Next steps

It is important to reflect on the work conducted in both DPCR5 and in the lead up to the emerging thinking consultation. A number of proposals have been incorporated but it would be fair to suggest that the RPI – X @ 20 review has largely concluded that modifications to the present framework rather than a complete overhaul of regulation is the most appropriate response to the future challenge. Ofgem's proposals on financing are totally out of step with this.

It is important to recognise that the network companies are competing with other GB utilities and internationally for both debt and equity finance. Whilst the relative transparency of the regulatory framework has historically provided the network companies with a competitive advantage internationally, the proposals contained within the consultation and the inappropriate risk-reward balance carried by equity holders are likely to erode this benefit and require a premium to be paid.

3 Third party right to challenge our final price control decisions

3.1 The DPCR5 model

As part of the DPCR5 negotiations, the DNOs were required to actively engage with stakeholders to discuss the regional investment requirements for the next five years. This formalised approach to stakeholder engagement is a welcome addition to the future regulatory framework.

Our experience in the DPCR5 process has led ENW to conclude that

- Stakeholder engagement provides wider benefits to network companies. Our recent work on demand side management and the low carbon network fund has been built upon the DPCR5 platform.
- Stakeholder views can identify relative priorities on non-core investments (flooding, worst served customers, HILP).
- Stakeholders are happy to defer to the companies' experience for the requirements of the network.
- Stakeholders do not agree with each other.

When considering the role of third party challenge in the future regulatory framework, it is important to draw on these lessons.

3.2 A review of the arguments

Ofgem's analysis of the advantages and disadvantages of a third party right of challenge raise a number of key issues. The first issue surrounds the role of the Competition Commission (CC). The analysis mentions the role and responsibilities of the CC but fails to recognise that no electricity network company has been to the CC for a price review referral since 1995. We acknowledged in our acceptance of the DPCR5 final proposals that our decision was finely balanced and one of the key reasons for accepting was the uncertainty created by a CC referral. The CC are the final arbiters of all price control decisions and we suggest that they should be given additional involvement in the future regulatory framework as it will provide greater regulatory legitimacy and consistency across price controls.

Ofgem's analysis suggests potential for delays and increased uncertainty created by the introduction of a third party right of challenge. We do not believe that this needs to be the case. We suggest that if the right of appeal was built into the existing price control review timetable with appropriately defined challenge timescales, then the level of uncertainty will not materially increase or delay investment.

We also disagree with the assertion that there will be an increased regulatory burden on companies and Ofgem from an increased challenge process; appropriate screening of challenges will ensure that worthwhile challenges are explored by the appropriate body.

The issue of regulatory capture (by both network companies and interest groups) is one area which needs to be addressed in the future framework. It is important that Ofgem remains independent. The inclusion of an independent review of a price control is vital to ensure that the settlements retain their impartiality.

3.3 Our preferred approach

Ofgem's spectrum of options captures the key decisions which a possible third party right of challenge would need to consider. Some of the options raise a number of interesting debates surrounding the responsibilities of Ofgem and the network companies in any challenge process.

3.3.1 Gate keeper

Our analysis of the relative merits of a third party challenge leads us to conclude that Ofgem should not be considered for the gatekeeper role. We believe that the Competition Commission should undertake this role as it would allow a specialist regulatory challenge and ensure an independent public interest test.

3.3.2 Who can challenge?

We believe that allowing the CC to act as gatekeeper will remove some of the issues surrounding the appropriateness of groups who challenge the price control.

We recommend that the only party able to challenge a price control should be a statutorily constituted consumer representative body. This body would need to consider the interests of current and future customers as well as general public interest case in making any challenge. The responsibilities of the existing consumer advocate would need to be expanded to allow this; we believe this would require a change to statute. Such an approach would allow smaller bodies and individuals to petition the consumer advocate and provide them with the support they need to make any justified challenge to the regulator's decisions.

3.3.3 Grounds of challenge

Our analysis suggests that any challenge must be centred on the public interest of final customers. It is also important that the decision is based on both current and future final customers. The Competition Commission is best placed to judge the challenge independently, improving regulatory accountability and transparency.

3.3.4 Nature of challenge

The judicial review process adequately addresses the requirements for a challenge based on the price review process. We therefore conclude that the third party challenge process must be merits based only.

3.3.5 Scope of challenge

As gatekeeper, the CC can use its discretion on the scope of the challenge. This will allow the CC to address specific concerns with the proposed controls or review the entire package. The CC must also be mindful of the need to reopen the price controls

for all companies if an appropriate challenge is made eg an appropriate challenge on the comparative efficiency approach.

3.3.6 Outcome of CC reference

The current framework allows the CC to make the final decision on the price control. We can see no reason why this should change under the new framework.

3.3.7 Challenge of timings

One of the identified disadvantages of the third party challenge was the uncertainty introduced by the potential challenges. We believe that if a challenge window is included within the price control timetable, no material increases in uncertainty would occur.

3.3.8 Costs

This decision needs to be appropriately considered given that the framework should not disallow stakeholders from participating on the basis of resources. We recommend that stakeholders should face their costs and the costs of the CCs initial assessment up to the point of appeal. If the CC accepts the challenge as being legitimate, then the public interest need has been established and the ongoing costs should be socialised.

3.3.9 Implementation

We do not agree with any of the options identified by Ofgem. Our suggestion is that the process should be built into the price review timescales in order to result in no additional delay to the implementation of a price control.

3.4 Our conclusion

The future framework should include a consumer right of challenge. The DPCR5 process has benefited from a wider perspective from stakeholders and we believe that the implementation of a third party challenge into a price control will improve regulatory consistency, legitimacy and remove any concerns relating to regulatory capture. The specific inclusion of the CC will also reduce the risks associated with subsequent references.

A key stakeholder for all parties is DECC. The proposals contained within Project Discovery highlight the need for a guiding mind. Ongoing stakeholder engagement provides a richer picture, but the final decisions and trade-offs will need to be made and some stakeholders will always be disappointed. Therefore we need to have greater involvement in the process as the guiding mind. It is vital for the success of both Discovery and RPI – X @ 20 that the conclusions in each are consistent.