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Dear Hannah,

RPI-X@20 Emerging Thinking - Embedding Financeability in a new Regulatory Framework

National Grid owns and operates the high voltage electricity transmission system in England and Wales and, as Great Britain System Operator (GBSO), we operate the Scottish high voltage transmission system. National Grid also owns and operates the gas transmission system throughout Great Britain and, through our gas distribution business, we distribute gas in the heart of England to approximately 11 million offices, schools and homes.

Through our subsidiaries, National Grid also owns and maintains a large number of domestic and commercial meters, the electricity Interconnector between England and France, and a liquid natural gas importation terminal at the Isle of Grain.

We take a keen interest in the development of network regulation, particularly as it affects energy networks. Our thoughts on the main RPI-X@20 "Emerging Thinking" consultation and the 3rd Party Right of Challenge consultation are given in separate responses: this response considers the questions and ideas raised in the "Embedding Financeability" consultation.

RPI-X has served the industry and consumers well, and Ofgem's approach to ensuring financeability has allowed significant investment to take place in energy networks since privatisation. Continuity and consistency over time are important elements of the regulatory framework, and are particularly important if the networks are to be able to make the investments needed to provide the services that current and future customers and consumers require and to support the wider policy objectives in relation to sustainability and security of supply. The current regulatory regime and its stability were important to the industry in enabling companies to access finance even during the height of the credit crisis. Ofgem have acknowledged that "*capital market trust is hard won and easily lost*". Given the past success of RPI-X and the approach to financeability that has been adopted within it, and at a time when a big increase in investment in networks is anticipated over the next decade, Ofgem should exercise great care before deciding to make any material changes to the regime.

This response to the consultation is in two parts: this opening section provides general comments on the issues raised in and by the consultation, and there is then an Appendix which considers the specific questions that are raised in the consultation. These two sections should be considered together, as the general comments are particularly relevant to some of the specific questions raised.

General Comments

The treatment of financial issues so as to ensure the financeability of efficiently-run networks is a critical element of regulation, and is important for consumers, not least because companies would otherwise be unable to invest to provide the performance, reliability and customer service that current and future consumers require. This includes the investments needed to enable reductions in national greenhouse gas emissions and to ensure a secure supply of energy. It follows that Ofgem should not only have regard to the need to secure that licence holders are able to finance their activities (in line with the explicit statement of Ofgem's powers and duties), but should consider that maintaining the ability of networks to access sufficient finance on reasonable terms is an intrinsic element of Ofgem's principal duty to protect the interests of existing and future consumers.

These considerations are particularly important at a time when many energy networks are entering a period of high and increasing levels of investment[1], at the same time that many other industries (electricity generation, water, rail, roads, etc) also have high investment requirements. Attracting the funds for these investments will be a key challenge for the industry, and will require the regulatory framework and returns available to the network owners to be sufficiently attractive for these companies to be able to compete for investors' funds against other industries.

We are therefore pleased that Ofgem have re-affirmed their financing duty in this consultation, and have recognised that efficient, well-managed companies should be able to finance and should be appropriately remunerated for performing their activities. It follows that this financing duty has two separate elements:

- The allowed return that is set in price controls must be sufficient to compensate companies for their cost of capital;
- Companies must be able to continue to raise sufficient finance to perform their activities, including the funding of new investments. This not only requires strong cash flows in the short term, but also confidence that the regulatory regime is sufficiently stable that in the long-term returns will adequately reward investors.

Under RPI-X, and similarly under the enhanced framework proposed in the main "RPI-X@20 Emerging Thinking" consultation, the aggregate revenues allowed to network companies under a price control reflect the cost of running the networks efficiently (including financing costs and depreciation of past investments). Without a rigorous and continuous adherence to this principle there can be no private investment in networks in the longer term. It follows that ultimately all investments by network companies are funded by consumers, and the companies should not be required to make investments which consumers can't (or don't want to) pay for. However, in determining the level of allowed revenues for a particular price control, Ofgem take a view of the costs that should be faced by today's consumers (in the next 5 years), and the costs that can and should be deferred to future consumers.

Essentially, within each price control there are just three sources of funding available to a network: today's consumers (via network charges), lenders, and equity investors. In setting a price control so as to ensure financeability, Ofgem must balance and pay due regard to the practical constraints and reasonable expectations which limit each of these sources of funds. In addition, because the cost of equity and cost of borrowings are passed on to consumers through the price control, it is in consumers' interest for price controls to be set in a way that avoids unnecessary increases in these costs, and for this reason previous price controls have been set so as to allow network companies to maintain an investment grade credit rating and provide reasonable returns to equity investors.

The availability of funds from lenders, and the cost of these funds, is determined by the credit worthiness of the network owner, which in turn depends on the credit ratios used by rating agencies which are not all based on the short term (they typically look also on a 3 to 5 year horizon), the stability of the network company's cash flows, and confidence in the stability of the regulatory regime and the

[1] In the "Project Discovery: Energy Market Scenarios" consultation (October 2009) Ofgem estimated between £30bn and £40bn of capital expenditure in Distribution and Transmission between 2009 and 2020 (see Appendix 2 page 95).

regulatory commitment[2]. Notwithstanding the turmoil in financial markets over the past 2 years, these factors and the company credit ratings that result remain the relevant considerations to lenders, and they cannot be disregarded in setting price controls.

There are also practical constraints on the extent to which equity can be expected to fund new investments, whether in the form of retained earnings or, in certain circumstances, equity injections. Shareholders invest in companies for two reasons, for dividends and for growth, and so credit ratings and the stability of the regulatory framework are important for equity investors as well as lenders. Even long-term investors in utilities want a dividend stream, and if this was disrupted as a consequence of a regulatory settlement the confidence of investors in the regulatory commitment would be undermined, increasing the cost of capital and curtailing the availability of all forms of finance[3]. Regulators must also apply great caution in looking for new equity to provide a solution to financeability constraints, not least because the new investment will only see returns in the long term, and an over-reliance on retained earnings and new equity today would undermine confidence that the regulatory framework will ever provide these returns. It follows that it should only be considered in setting price controls in exceptional circumstances, within the context of the long-term view of funding requirements, and as part of an overall approach which appropriately balances the interests of different stakeholders, and which as a consequence would reinforce rather than undermine the stability of the regulatory framework and the regulatory commitment to investors.

Against this backdrop, with the long payback periods for investment in networks which typically span many regulatory cycles, and given Ofgem's inability to make long-term commitments or fetter their future discretion, the decisions taken by Ofgem in each price control review are critical in re-affirming Ofgem's ongoing recognition of their regulatory commitment. Any change to the regulatory approach to reduce or even eliminate short-term returns against a "promise" of eventual returns in the long-term would increase the cost of capital and as a result charges to consumers, and would make it difficult to raise the funds needed for new investment. Material changes to Ofgem's approach are likely to undermine investor confidence, and a reversal of specific decisions which were taken in the past to address a particular issue which still exists (e.g. to maintain financeability in a given sector) would be particularly damaging and costly. Consistency *over time* is therefore important, and is far more important than making changes to increase consistency across the different energy network sectors, where existing differences were generally introduced to reflect different history, circumstances and requirements.

The "Embedding Financeability" consultation itself recognises that the past approach to financeability has contributed to the reduction in the allowed rate of return over the past 20 years, reducing the cost of financing both existing RAV and new investments, and benefiting consumers. Alongside and contributing to this reduction in allowed return has been an increase in the assumed or notional gearing of the network owners. The approach and the stability it brings have been underpinned by a licence requirement for licensees to maintain an investment grade credit rating, and investors (both equity and debt) have been able to rely on Ofgem taking this requirement into account in setting price controls. This licence condition has, moreover, been confirmed by Ofgem as appropriate in offering protection to consumers in the March 2010 consultation on the "Ring-Fence" conditions in the energy

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[2] The "regulatory commitment" is the implicit commitment made by a regulator on behalf of consumers – both present and future – to pay the (efficient) cost, including financing cost, of investments that have been made for their benefit. The RAV represents the unrecovered sunk costs in these investments, and the regulatory commitment to fund them is implemented through the roll-forward of the RAV and the setting of allowed returns and depreciation at each price control review. This regulatory commitment was reflected in the sixth of the guiding principles for the RPI-X@20 review as expressed in the February 2009 consultation "RPI-X@20 Principles, Process and Issues", i.e. "No stranding of efficient investment: where efficient investment has already been undertaken by network companies and has been included in the regulatory asset base (RAV), we will ensure that suitable funding arrangements are incorporated into any framework adopted at the end of this review."

[3] The consultation suggests that a different kind of investor might be willing to forego short-term returns which could ease future financeability constraints, but regulated utility activities do not have the characteristics to attract such investors.

network licences. Clearly, any future move away from the current financeability tests used by Ofgem would need a change to the ringfence condition in network licences, as the networks could not reasonably be expected to maintain a rating which the allowed revenues under a price control did not support, and such a licence change would require very careful consideration and consultation. The suggestion that debt investors in particular, but also equity investors, would be willing to invest in network businesses if price controls were set such that returns were re-phased and the companies failed the rating agencies credit tests is untested. At the least, the perception of risk will be increased and given the lack of a credible alternative to credit ratings, the cost of capital would be expected to increase significantly.

If, nevertheless, Ofgem were to make changes to their approach to regulation and financeability which had the effect of worsening short and medium term cash-flows and delaying returns to investors, there would be a clear increase in the risk faced by the companies. Allowed returns would need to be increased and finance structures would need to be adjusted accordingly, with a reduction in the level of gearing. Apart from the direct and indirect costs, time and practicalities involved, such a change would be a reversal of the trend since privatisation[4], would not be in the interests of consumers, and does not appear appropriate for an energy network business.

In conclusion:

- Ofgem's duties require that Ofgem has regard to the need to secure that licence holders are able to finance their activities, and moreover it is in consumers' interests that Ofgem should ensure that network companies are able to access sufficient funds at reasonable cost.
- The industry is entering a phase in which investment levels are expected to be high, and the resulting need to attract funds is a key challenge for the industry. The regulatory framework must enable the necessary finance to be raised, and it would be unwise to make any changes which would add to any financeability constraints at this time.
- The straw man does not take proper account of the views and interests of debt and equity investors and so would be likely to prove costly or unworkable. It cannot be ignored that debt investors rely on credit ratings, and equity investors (who also look at these ratings) require returns in the short term as well as in the long term.
- Given Ofgem's inability to make long-term commitments and fetter their future discretion, the decisions in price control reviews need to provide ongoing and tangible evidence of Ofgem's continuing regulatory commitment to network owners and their investors. This requires the interests and expectations of different stakeholders to be reasonably balanced in each control, and consistency in approach over time and with past decisions is extremely important in maintaining investor confidence.
- A further consideration in setting price controls could be the desire to balance the interests of current and future consumers. Given the scale of the increases in energy costs that Ofgem and others expect over the next decade and beyond as a consequence of changes in energy demand, security of supply and environmental considerations, it would be unjustified to increase costs to future generations still more through changes to the regulatory framework which delay or re-phase the recovery of network investment costs.
- The current approach, including the basis of calculating RAV depreciation, has been adopted in past price controls because it has been a reasonable way of maintaining financeability. This approach is underpinned by an appropriate and widely understood recognition by Ofgem of the importance that price controls should allow networks to maintain an investment grade credit rating. Care would need to be exercised in making any changes to the approach, and unless Ofgem is able to convince rating agencies (and debt providers who look at their ratings) that the agencies' rigorous and widely applied approach to assessing credit ratings is flawed the scope for making any changes to the approach to ensuring financeability, including the balance of costs between today's and future consumers, will be very limited.

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[4] In successive price controls since privatisation, Ofgem and its predecessors have generally assumed increased gearing for the notional finance structures that have been assumed to be efficient and appropriate for the companies. Most recently, in considering the range of RORE available under DPCR5 Final Proposals, Ofgem considered the returns that would be available with an 80% gearing level.

- Ofgem state in the consultation that "*Any changes will be proportionate and transparent and we will not make change for changes sake*." On this basis, when proper account is taken of the drawbacks and risks of making the changes that are contemplated in the consultation, the basic approach to financeability which Ofgem have applied in the past – and which has allowed substantial investment at reasonable cost since privatisation – must be retained.

Whilst there are strong reasons to support the basic approach to financeability that has been applied in past controls, if Ofgem's preference at the conclusion of the RPI-X@20 review is to make changes these can only be implemented through future price control reviews. As such, they would become considerations to be taken into account in formulating the overall structure and content of the price control settlement, which, as with any price control, would need to be acceptable to the network companies covered by the settlement.

We would be happy to expand on any of the points made above.

Yours sincerely,

[by email]

Paul Whittaker
UK Director of Regulation

Appendix – Comments on Specific Points and Questions raised in the Consultation

Please note: the comments in relation to these questions should be read alongside the general comments included above in the first part of this response.

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 agree that financeability requires that efficient, well-managed companies should be able to finance and should be appropriately remunerated for delivering their activities. We also agree that financeability includes the requirement that the revenues, profits and cash flows available to efficient network operators are such that they can secure financing in a timely way and at a reasonable cost to meet the efficient costs of delivering on their regulatory obligations. In practice, this requires allowed cash-flows to be sufficient to maintain an investment grade credit rating and provide reasonable returns to equity investors. If the cashflows and resulting financial ratios under the regulatory framework were not sufficient to allow an efficient business to raise capital to fund necessary investments in the network, Ofgem would have failed in its duties.

However, some of the ideas set out in subsequent sections of the consultation are not compatible with these considerations.

In addition, whilst it may be that *in some cases* it is not in consumers interests for Ofgem to "*bail out*" a network company that has encountered financial difficulty as a result of its own actions, it would appear inconsistent with Ofgem's financing duty for Ofgem to fail to take action if companies were to face financial distress for reasons beyond their control (where this should not be judged with the privilege of hindsight), or where companies had managed their activities reasonably and responsibly in the context of the overall regulatory framework. The failure of the consultation to clarify this point may have the effect of increasing regulatory risk and consequently the future cost of capital, which would be contrary to the interests of (future) consumers.

The assessment of financeability in future reviews needs to recognise that network operators have established financing structures that have developed under the incentives of RPI-X regulation: in a real and practical sense there would be a time and a cost to unwind these arrangements and it would be inappropriate for any network operator to be penalised in any way for the choices they had made in the past in response to previous price controls. This would, moreover, be inconsistent with the "no retrospective action" guiding principle of the RPI-X@20 review.

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?

The consultation considers the main features of the current regulatory framework which affect financing, including the checks that are carried out to make sure that a "notional efficient company" can maintain a comfortable investment grade credit rating and provide reasonable returns to equity investors. However, it should be noted that:

- Equalising incentives – the capitalisation of a fixed percentage of "totex" that was adopted in DPCR5 was intended to equalise incentives between different kinds of spend. The level of capitalisation was set to add a similar percentage of costs to the RAV as in the previous control. If Ofgem decide to retain a similar approach to DPCR5 in future price controls, the capitalisation rate should be set to reflect the mix of capex to opex that is expected, rather than being set in an arbitrary way which could have implications for financeability. Since the intention of this approach is to equalise incentives, it would be inappropriate to introduce further distortions by deliberately setting the capitalisation percentage at a level which did not reflect the anticipated spend. (A further reservation with the approach adopted in DPCR5 concerns whether it actually achieves its aim of equalising incentives.)

- Depreciation – if capex requirements are constant over many years, the method of calculating depreciation (asset life, and straight line vs annuitised) makes no difference to the level of depreciation included in allowed revenues **so long as it is applied consistently**. Differences in the level of depreciation under different methods do arise where there are changes in RAV additions in different years, as a result of the variations in spend being smoothed over different durations, but such differences will generally be smaller than the step changes that can be caused by changing the depreciation method itself. These step changes can be considered to be distortions, and as a result there should be a presumption against changing the method of calculating depreciation unless this is needed to reflect some other change or set of circumstances, for example to allow for the "cliff edge" when pre-vesting assets became fully depreciated, or where uncertainty over the long-term use of parts of a network arises.[5]
- Treatment of gas distribution Repex – the Final Proposals for the Transco Price Control 2002-7 explains that Ofgem adopted the approach of adding 50% of repex to the RAV (with 50% expensed) for a number of reasons, of which financing was only one. However, the main reason, as was explained in the Final Proposals (page 4), was one of principle and remains valid: "*As replacement expenditure is projected to increase significantly a key issue becomes the method of financing this enhanced level.* ***The renewal programme is primarily concerned with present safety requirements rather than increasing the network's capacity or functionality for the benefit of future consumers, suggesting these costs should be expensed and met within the price control period. Nevertheless there will be some advantages to consumers in the future as replacement spending will be lower and newer assets tend to require less repair and maintenance. To deal with these tensions****, ensure that Transco is able to finance its activities and ensure that price reductions are sustainable beyond the next price control period,* ***50 per cent of replacement spending over the next price control period will be expensed in the year that it is incurred and 50 per cent will be treated as capital and added to the regulatory asset base***."
- Credit ratings: the need to maintain credit ratings is an important element of the current framework and demonstrates Ofgem's regard to its financing duty. Whether or not credit ratings are infallible is not a basis on which to relax the financial ratios used as a cross-check by Ofgem in ensuring that a price control comprises a financeable settlement. If anything, any fallibility of the agencies as claimed by Ofgem (see for example Paras 4.16, 4.18 and 4.20 of the consultation) should encourage Ofgem to use a more stringent set of metrics in this cross-check rather than not to use them at all. Credit ratings are assessed using a widely accepted approach in all industries, which works in almost all circumstances. It would be inappropriate to reject them on the basis that under exceptional circumstances and the failure of a class of exotic financial instruments, and the resulting effect on a very different industry (financial services), they may have failed to anticipate the failures of a small number of organisations.

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?

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[5] The well-understood and established reduction in the asset lives for post-vesting assets in electricity distribution was introduced to avoid the "cliff-edge" issue. This adjustment could be viewed as introducing one distortion to cancel out the distortion caused by the assumed value and depreciation treatment of pre-vesting assets, and was necessary for depreciation and aggregate revenues to continue at a reasonable, sustainable level rather than see a short-term, unsustainable reduction. To change the treatment of post-vesting assets now would be an arbitrary decision which would introduce a further distortion for which there is no such compensating factor or adjustment.

We note Ofgem's view that the existing approach to financeability has allowed companies to finance their activities, invest substantially in their networks and that under this approach the allowed cost of capital has fallen over time, benefiting consumers.

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

The current approach, whilst differing in some aspects between networks of different types, is well understood by stakeholders, and if applied consistently over time will continue to be predictable. Changes to the approach could undermine predictability and the confidence of investors and other stakeholders. It is also important that any changes should be consistent with the guiding principles for the RPI-X@20 review, in particular "*no retrospective action*" and "*no stranding of efficient investment*."

There could be some merit in developing a set of clear and transparent principles for policy areas where judgements are applied, though any benefit would be limited given Ofgem's inability to fetter their future discretion. Much greater benefit would be derived from Ofgem continuing to demonstrate their regulatory commitment through the setting of reasonable price controls that fairly balance the legitimate interests and expectations of different stakeholders, including investors and providers of debt finance, which in many cases would require the consistent application within each sector of the approach adopted in previous price controls.

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?

The question of how to balance the interests of current and future consumers needs to be considered within the context of an overriding consideration to ensure that the aggregate revenues over time recover the cost of efficient investments that have been made by networks, which should not be stranded. Changes to asset lives and the approach to depreciation could affect financeability, increase regulatory uncertainty and result in a higher cost of capital.

It is far from clear that current consumers are bearing too much cost (relative to future consumers). Moreover, where changes in the broader energy industry (for example to address environmental or security of supply considerations) create uncertainty over the useful economic life of assets, it would be appropriate to reduce asset lives: this would mitigate the potential impact on possibly reduced numbers of consumers in the future, who might otherwise then be exposed to very high network charges, and would reduce the need to increase returns and thus charges in aggregate over time in recognition of the increased risks faced by networks.

The comments above (on Chapter 3 Question 1) clarify the reasons for the current treatment of repex in gas distribution, and explain why this approach remains appropriate in balancing the interests of current and future consumers.

More generally, balancing the interests of current and future consumers requires judgement, but it is far from straightforward and should be only one of the considerations in weighing up the costs that should be paid by consumers in the short term. It requires an assessment of the value of the services being provided to customers and consumers today and in the future, which is subjective and uncertain. Moreover, balancing the interests of existing and future consumers needs to be considered in the round and take account of a wide range of costs, risks and uncertainties, rather than being applied to individual decisions, although even on specific issues the considerations are likely to be far from straightforward. For example, depreciation cannot be considered in isolation for a single category or generation of assets but needs to take into account all the assets that are used to provide services to customers, including those pre-vesting assets which are already fully depreciated. In this regard it is relevant that the RAV should not simply be considered to be the sum of the depreciated value of a collection of assets: rather it reflects the indexed value of past efficient investments that a network has not yet been allowed to recover from customers or consumers. Particularly given

Ofgem's move to equalise incentives and, under the approach adopted in DPCR5, capitalise some operating expenditure in the RAV, the concept of the RAV as being made up of assets with a particular economic life becomes increasingly inappropriate.

Finally, it should be noted that energy costs to consumers today are generally seen as unsustainably low, i.e. they do not reflect the costs of a sustainable, low-carbon supply. In such circumstances, it may be more appropriate to consider balancing the interests of different generations of consumers in the context of the likely longer-term trends in overall energy charges, rather than in relation to network asset charges in isolation. Given the scale of the increases in energy costs that are anticipated[6] will result from future energy demand, security of supply and environmental considerations, it would be ill-judged to increase the burden on future generations still more through changes to established regulatory methods which would re-phase and delay the recovery of network investment costs. However, reductions in assumed asset lives, particularly if these were needed to maintain financeability and so enable necessary network investment to take place, could be justified.

Question 4: How much weight should be placed on ensuring that aggregate revenues reflect the economic costs of running the network so as to ensure that consumers and users face appropriate price signals?

Under RPI-X (and under the enhanced framework proposed in the main "RPI-X@20 Emerging Thinking" consultation) the aggregate allowed revenues reflect the cost to the network companies of running the network efficiently (including financing costs and depreciation of past investments). Without this principle there can be no private investment in networks in the longer term.

In the absence of other considerations it would be preferable for network charges to send appropriate price signals to network users (which in some cases would reflect the marginal cost of using and investing in the network), but this is only one of the factors that must be taken into account in setting these charges:

- even without other considerations, it would not be possible in practice to achieve this aim because of the range of different network users and the variety of circumstances and decisions they face.
- it is in any case unclear to what extent the absolute level of network charges influences the decisions of network users and consumers, or whether the relative levels of charges are more important, for example in influencing decisions on the location of new generation.
- it is expected that significant increases in the investment in networks will be needed to meet future demand, sustainability and security of supply requirements. If setting appropriate price signals was seen as an important consideration in setting network charges, the consequence would be that today's consumers should pay charges which more reasonably reflected the cost of the infrastructure that will be needed to support a sustainable energy infrastructure as a whole, rather than a cost which relates to the current network assets. On this basis, the charges for network users and consumers are likely to be higher and to increase more quickly.

As explained above, aggregate revenues should be set to reflect the cost to network companies of running the networks efficiently, and should not be set with price signals to users or consumers in mind. A preference for consumers and users to face appropriate price signals may be a consideration in deciding how these aggregate revenues may then be split between different charges, but in practice these network charges should then be scaled as necessary in order for the aggregate revenues recovered through the charges to match the total allowed revenues.

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

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[6] For example, in "Project Discovery: Energy Market Scenarios" (Oct 09) Ofgem estimated increases in wholesale gas and electricity prices between 2009 and 2025 of between 50% and 100% (see Figures 3.18 and 3.19).

In response to the proposed use of the RORE tool to calibrate returns, we recognise and support Ofgem's aspiration to assess company performance objectively against a range of criteria that collectively reflect consumers (or customer) interests, and then to structure price controls such that well performing companies are rewarded more highly. The appropriateness of using RORE for future price controls can only be judged in the context of the overall regulatory framework and of the outcome of future price control settlements which must be considered in the round, but it would not be appropriate to have a disproportionate focus on a single measure or aspect of the control. RORE is a measure of return, not of financeability, and should not be seen as a substitute for ensuring that an efficient network is financeable. The regulatory approach needs to recognise that reliability and continuity of services is of paramount importance to consumers, and thus price controls need to ensure the continued financeability of the networks.

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

See comment below in relation to Chapter 5 Question 1.

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

Most of the issues that relate to Ofgem's financing duty and the need to ensure that energy networks are financeable have been considered in the answers to the other specific questions raised by the consultation, and in the initial general comments 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?

The straw man principles do not provide a workable basis for ensuring the financeability of the energy networks in future price controls.

Considering the separate aspects of the straw man in turn:

- Companies exposed to different risks may face different financing costs, and these differences should be reflected in a price control although the size of the differences in allowed returns between different networks operating in a particular sector are likely to be small. Differences in the balance of risk and reward available to network operators should also be reflected in the allowed returns. Other factors, such as a company's track record or the degree of scrutiny a regulator chooses to apply to a company, do not provide an objective reason for allowing different returns.
- The depreciation method can have an effect on short-term cash flows and consequently could affect financeability, and so where possible applying a consistent approach over time is important. The case to align asset life to economic life has not been made, and whilst the economic life may be a ceiling on asset life for depreciation purposes, shorter asset lives for depreciation purposes can be more appropriate. The comments above (see Chapter 4 Question 3) explain why it would not be appropriate to increase assumed asset lives or otherwise delay recovery of investments, although some reductions to the depreciation lives currently used may be appropriate where wider changes in the energy market may result in an economic useful life which is shorter than the currently assumed asset life. For similar reasons the straight line approach should not be replaced by an "annuity" profile for depreciation (and in addition there are further reasons why the annuity approach is less preferable, not least because of the complexity and lack of transparency which it would bring).
- Ofgem needs to continue to assess the expected financial health of an efficient network company under future price controls, and does not have a free hand in deciding what tests or metrics should be applied. Debt (and equity) investors look at credit rating agency metrics and ratings, which provide an independent and well-resourced assessment of company financeability. Ofgem will

need to continue to assess the ratios and ensure that future price controls will allow the companies to maintain an investment grade rating and provide reasonable return to equity investors.

- The consultation recognises (Para 5.9) that timing mismatches in cash flows may make a company not financeable even if allowed return and depreciation allowances are set "appropriately". The view (see Para 5.11) that such a problem can be assumed away is wrong, so setting a price control which resulted in such a problem would be inconsistent with Ofgem's statutory duties.
- It would be unwise of Ofgem to rule out the use of adjustments to revenues to compensate for financing difficulties (Para 5.12), unless (in the context of specific price controls reviews) alternative ways have been found to ensure that networks and future investment requirements will be financeable.
- Comments on the approach to capitalisation policy and to calibrating returns are included above (see Chapter 3 question1 and Chapter 4 question 5).

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

The existing regulatory approach to financeability has been applied consistently and allows both profitability and financeability to be considered in the context of each price control settlement. It provides a workable approach which acts in consumers interests, and should be retained. Given the investment needs the networks are expected to see in the years ahead, changes should only be made where there is a clear and unambiguous case in their favour.

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 2010 recommendations?

The "straw man" is not workable in practice and does not provide a basis for ensuring the financeability of the regulated energy network companies. There are a range of more detailed financial issues which could be considered in the next stages of the RPI-X@20 process, though decisions on many of these can only be taken in the context of individual price control reviews. Either way, detailed financial issues can only sensibly be considered in the context of the financing duty and the overall regulatory framework.

There are various important issues listed in Paragraphs 6.1, 6.2 and 1.9 of the consultation that need full consultation and engagement with stakeholders. The summer 2010 recommendations should not represent a near final position on these given that these consultations have not yet commenced.

The existing regulatory approach to financeability provides a workable approach which acts in consumers interests, and should be retained.

If contrary to this, there are any material changes to the regulatory framework, these will need to be phased in over time to allow the network owners to adapt and to minimize the impact and cost on consumers and other network users.