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RPI-x@20 consultation – Local Grids and RPI-X@20
Ofgem
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9 April 2010

Dear Hannah

Embedding Financeability in a new regulatory framework (ref 6/10)

Thank you for the opportunity to comment on the straw man proposals on financeability.

The proposals represent a significant change to the application of Ofgem's financing duty by not taking into account short term financial ratios when applying this duty to an efficient company with a notional capital structure consistent with the cost of capital. Yet such ratios are critically important to the network operators in their ability to raise finance at reasonable rates in the capital markets. To propose such a radical change there must either be clear structural problems with the current approach or the future environment will be so different that the current approach will become outdated or ineffective.

From the analysis set out Chapter 4 of the document Ofgem does not make a clear case supported by strong evidence that either of these circumstances apply. Indeed from the evidence presented it could be argued that the current approach has worked effectively for customers over time and has been able to withstand the recent crisis in the financial markets. Ofgem does itself a disservice if it considers that the current approach is not transparent and predictable. In fact the opposite is true. Investors consider the UK regulatory environment stable and predictable. This is an important factor to consider when proposing radical changes and investors can freely move capital across global markets.

Whilst not expressly set out in Chapter 4 Ofgem has concerns over the levels of leveraging in the sector which has in some instances contributed to very significant premiums to RAV being paid to acquire network operators. This is a longer term structural issue which does merit separate consideration and potential measures to address. NGN believes it is important to keep a significant proportion of equity investment in the sector because such investors can take a more holistic view of the company, bring in relevant operating expertise and be better able to absorb short term financial disturbance than pure play financial investors. However, we are not convinced that the straw man proposals are the right way to address this particular concern and believe other regulatory measures should be considered. For example, a specific incentive mechanism whereby customers received a share of any benefits from leveraging above that assumed in the costs of capital. The value of such benefit could be based on the differential between the cost of debt and equity with a graduated scale whereby the higher the leveraging the greater share that went to customers.

One reason we consider the straw man proposals are not the right way to address this concern is that of long term regulatory commitment. It is very difficult to see how Ofgem can practically guarantee long term returns against its own actions in say ten years time or any actions that may be taken by future governments. There is no track record of such commitments in the UK. Indeed precedents from other UK regulated industries (e.g. airports) reinforce the view that long term commitments are very difficult to guarantee over their full term. Investors would therefore be asked to make a judgement on whatever commitment Ofgem was able to make at the time. The returns that either debt or equity investors are likely to require in such circumstances would in our opinion be significantly greater than the current levels seen in the sector. Indeed from our experience it is highly questionable whether such a commitment coupled with poor short term financial ratios would enable any funds to be raised from the debt markets. There is a significant danger that the straw man proposals will both raise the costs of financing investment and in the extreme severely restrict access to finance to make investment.

Generally NGN agrees that there is more uncertainty about the future role and investment requirements for networks given the environmental and sustainability agenda. However, we do not see that such uncertainty justifies a radical change to Ofgem's approach to financeability. We see no evidence to support the proposition that the future environment requires such a change. However, this uncertainty does leads us to question why Ofgem would seek to reduce its flexibility in regulating price control settlements by attempting to fix depreciation to assumed asset lives. Specifically for gas distribution any such move would lead to significant concerns about gas network operators' ability to fund the 30 year iron mains replacement programme.

Before Ofgem implements the straw man it needs to consider very carefully how network operators are likely to respond. Where financial ratios are poor there will be pressure to reduce investment to increase cash generation and reduce the need for additional funding. This will weaken the incentive for investment in direct conflict with the UK environmental policy objectives which require increased network investment.

Whilst not specifically relevant to the financeability duty we are concerned that the RPI@20 review is jumping to a number of conclusions regarding the future of the gas distribution networks. It is by no means clear that it will be efficient in either cost or environmental terms to make massive investments costing billions of pounds to facilitate the transfer of domestic heating from gas to electricity. What is known for the immediate future is that for the vast majority of domestic customers it is significantly cheaper to heat their homes with gas and that this generates less Co2. The incidence of fuel poverty also increases in communities without access to mains gas. Ofgem should also be considering scenarios in which more not less investment is required on the gas distribution networks.

Please let me know if you would like any clarification on any aspect of this response. Our response can be regarded as non-confidential.

Yours sincerely

Stephen Parker
Regulation and Commercial Director