SP Transmission, SP Distribution and SP Manweb (SPEN)

Regulating Energy Networks for the Future: RPI-X@20
Embedding financeability in a new regulatory framework

9th April 2010

Introduction and overview

SP Energy Networks welcomes the opportunity to respond to Ofgem's Emerging Thinking on embedding financeability in a new regulatory framework.

Financeability, in practice, requires companies to have and maintain an investment grade credit rating. This is necessary to ensure that companies are able to raise finance from a wide base of investors on competitive terms.

Financial ratios are a well established approach to assessing credit risk and we support their continued use.

Ofgem's proposed changes to its interpretation of its financing duty appear to undermine its assumption that regulated networks are low risk businesses. Moreover, other changes being considered by the RPI-X@20 project, such as stronger incentives for efficient delivery of outputs, would generally also increase risk.

Ofgem have underestimated the potential adverse impact on financeability of timing mis-matches between revenues and financing costs, even for an efficient company with an efficient financing structure. This cannot be simply "assumed away" as Ofgem appear to have done.

Although we support the determination of a set of principles which guide Ofgem's judgements on financeability, these should not preclude taking steps to ensure that network operators remain financeable.

As regards depreciation, any step change to asset lives will lead to a step change in revenues and prices. It is likely that any adjustment to asset lives would therefore have to be smoothed in some way.

We support the development of the Return on Regulatory Equity (RoRE), which was introduced during DPCR5.

1. 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?*

Financeability, in practice, requires companies to have and maintain an investment grade credit rating. This is necessary to ensure that companies are able to raise finance from a wide base of investors on competitive terms.

Ofgem should be aware that depriving network operators of the likelihood of maintaining adequate financial ratios, as required by the major credit rating agencies, would significantly increase the cost of debt and limit the range of investors from which finance could be raised. This would threaten the investment which is required to facilitate the transition to a low carbon economy.

Furthermore, some network operators would face breaching their loan covenants, which would, as a minimum, result in significant refinancing costs. In more serious cases, network operators could be pushed into financial distress. In our opinion, such consequences would be inconsistent with Ofgem's statutory duties and we would expect any parties that are forced into that position to challenge Ofgem's decision.

The Competition Commission in its report on Stansted Airport has recently re-affirmed its view[1] that price controls should be set on the basis of an investment grade credit rating which is sufficient to provide a buffer to enable the airports' financial profile to help them absorb downside shocks. This again justified the targeting of a credit rating that is comfortably within investment grade.

PIMCO, a leading global investment management firm, in a recent note[2] in its Bond Basics series sets out its approach to credit research:

> "When drilling down into a specific sector, it is critical to differentiate between issuers. For this, the analyst uses credit metrics including leverage and interest coverage as well as other industry-related metrics. Credit metrics provide a convenient way to compare issuers. They list key factors for each individual issuer, including:
>
> - Rating
> - Net Debt
> - Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA), last 12 months
> - EBITDA Interest Coverage
> - Net Debt/EBITDA
> - Funds From Operations (FFO) /Net Debt
> - Debt/Cap
> - Five-Year Credit Default Swaps (CDS)

[1] Appendix L, paragraphs 21 and

[2] PIMCO (2009) "Quantifying Risk: PIMCO's Approach to Credit Research, Bond Basics, October

Whether or not Ofgem agree with the views of credit rating agencies has no bearing on the impact of their judgements on the capital markets, which is what determines the cost of debt. For example, a downgrade from investment grade to high yield often has wide implications because of potential guideline violations in investment portfolios: certain market participants would be forced to sell their positions in such a “fallen angel” issue.

2. 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?*

We are disappointed that Ofgem appear to be casting doubt on the need for network operators to maintain an investment grade credit rating. This is especially the case when Ofgem considers it necessary to consult on strengthening the ring-fence surrounding network businesses, which has an investment grade credit rating as a key component.

Financial ratios are a well established approach to assessing credit risk and we fail to see a coherent alternative emerging from Ofgem's thinking on financeability.

From an investor's perspective a potential weakness of published credit ratings is that they are perceived as reacting to events rather than anticipating them. This indicates that Ofgem's assessment should be forward looking but still based on well established credit metrics.

We note the Competition Commission's recently has reaffirmed its view[3] of the need for a buffer in the airports' financial profile to help them absorb downside shocks. We have previously recommended that Ofgem undertake stress analysis of financial ratios when assessing financeabilty. An example of the application of Monte-Carlo modeling to the assessment of financial risk of a regulated utility is contained in section J.6 of Bristol Water's submission to the Competition Commission.

[3] *Ibid*. Appendix L, paragraphs 21 and 22

3. 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?*

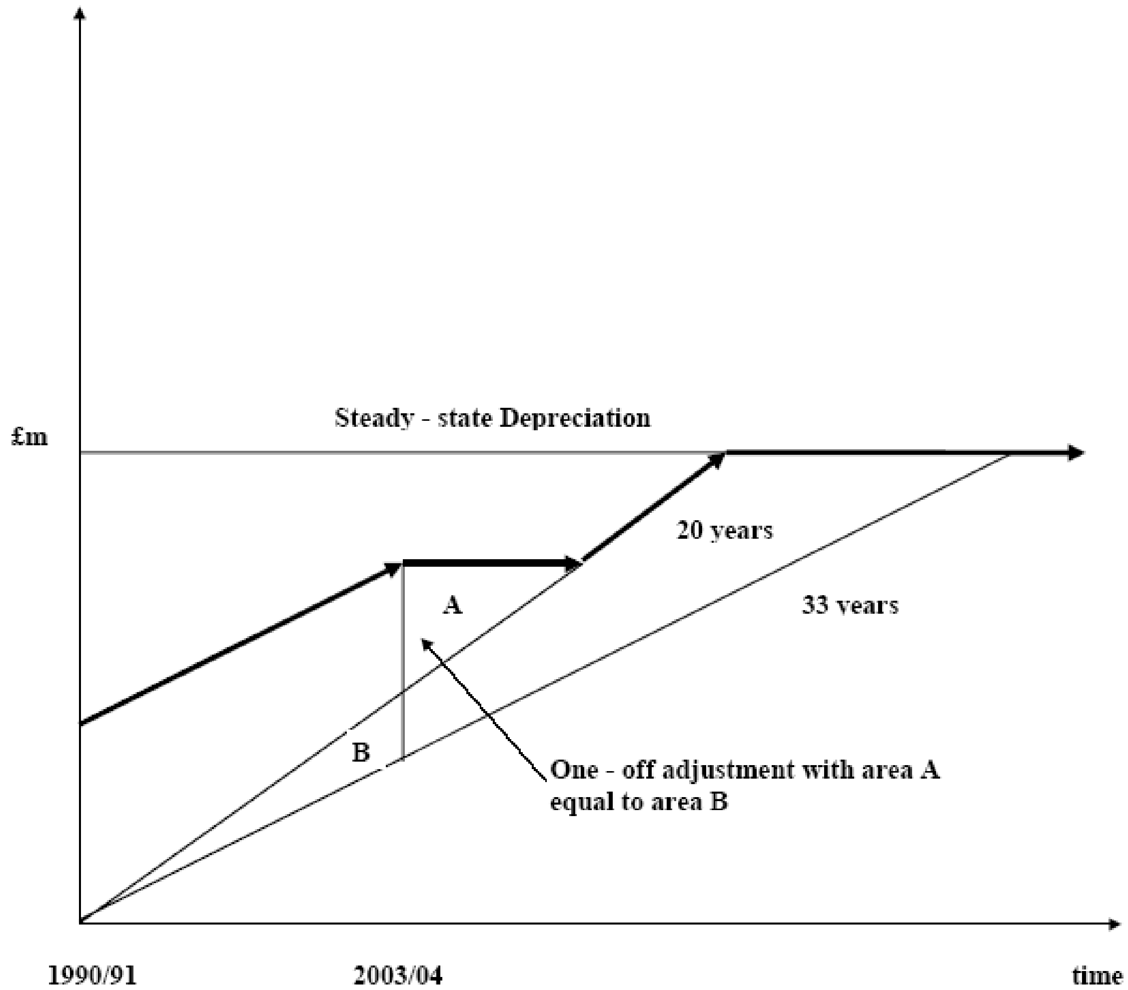
In our view, the main issue surrounds depreciation. This issue has been exacerbated by the initial decision to depreciate pre-vesting assets over their average of their then remaining lives. This created an artificial cliff-edge, which subsequent price control reviews have had to smooth to ensure that financeability is maintained.

This depreciation cliff-edge was considered for electricity DNOs during DPCR3 and Offer decided to accelerate depreciation by shortening lives from 33 to 20 years, once pre-vesting assets had been fully depreciated. The figure[4] below shows a stylized representation of the allowances for depreciation on the basis of a change to a 20 year life for post-Vesting assets with an appropriate adjustment to ensure that in present value terms the impact of the change is neutral.

At the time, Offer acknowledged that the depreciation charge would be higher going forward but noted that the RAV value, on which the return is based, would be lower in the longer term.

[4]Offer (2006) Review of Public Electricity Suppliers 1998 – 2000, Distribution Price Control Review: Consultation Paper, page 96, Figure 6.2, May

Depreciation profiles with asset lives tilted to 20 years



The two main approaches that Ofgem has adopted are to accelerate depreciation and to vary the proportion of capital expenditure which is treated as "fast" money (i.e. is effectively expensed). The advantage of these approaches over that adopted by Ofwat in 2004, is that they are present value neutral.

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?*

Capital markets dislike uncertainty and investors charge a premium for the additional risk, so it is in customers' interests for Ofgem to set out clear and transparent principles. However, these need to be consistently applied and sufficiently detailed for stakeholders to be able to predict the outcomes of their application in varying circumstances. Otherwise, uncertainty will remain.

As discussed in Section 3, it is crucial, however, that any generic principles do not preclude taking steps to ensure that network operators remain financeable.

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?*

In principle, successive generations of customers should leave the next generation at least no worse off than the current generation. This requires that the current generation of customers should at least pay for the proportion of assets that they are consuming.

Arguably, the transition to a low carbon economy has increased the uncertainty surrounding both the utilization and expected life of network assets. In such circumstances, a case can be made that shorter lives should be used to measure economic costs.

Any step change to asset lives will lead to a step change in revenues and prices. It is likely that any adjustment to asset lives would therefore have to be smoothed in some way. Possible approaches include:

- Phasing a series of smaller changes over a number of price control periods; or
- maintaining the existing asset life for assets already in the RAV but changing the asset life for subsequent additions to the RAV.

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

In principle, we agree that charges should be cost reflective but we doubt that this should become a major constraint on how aggregate revenues are set. Price signals are primarily conveyed through the relative prices of potential substitutes. Overall, use of system charges constitute only a small proportion of energy prices, which are dominated by energy costs and associated taxes.

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

We wish to see the RoRE analysis developed so that it more accurately matches the costs and benefits. Five year figures can be significantly impacted by the effects of roll-overs from the previous period but ignore impacts in the next price control period.

Also, we are not aware that this measure has yet been widely adopted or even understood by stakeholders and their views should be ascertained.

The scenario analysis undertaken during DPCR5 was of limited value as the assumptions were broad and, in some cases, unrealistic. For example, it is extremely unlikely that a company would earn the maximum reward for all incentive mechanisms in the same year.

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

In DPCR5 Ofgem decided against offering companies a choice of the balance of risk and reward. Although this is an interesting idea, we are not yet convinced that it can be implemented in a way which would improve the outcome for stakeholders.

There are already a number of mechanisms which impact the overall return, including IQI and other incentives, so that the expected return is not the same for all companies.

In the past, differential rates of return have not necessarily reflected differences in underlying performance but have been dominated by events outside of management's control.

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

We believe that the consultation gives adequate coverage of the main issues.

4. Questions for RPI-X@20

4.23. These issues raise a number of questions that we are exploring as part of RPI-X@20. These includes but are not limited to the following:

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?

See answer to Q2

How should we strike an appropriate balance between the interests of current and future consumers in determining the appropriate assumed asset life behind the depreciation profile?

See answer to Q3

How should the views of future consumers be taken into account?

Clearly, future customers are unable to express their views directly. It is primarily for Ofgem and the Government to represent future consumers' interests. In general, stakeholders are likely to reflect their own current interests, which may be to the detriment of future customers.

How *should these views be embedded in our approach to capitalisation and depreciation?*

The overall capital charge must be sufficient to ensure that the business is financeable, which requires an investment grade credit rating.

If balancing the interests of current and future consumers implies longer assumed asset lives, what does this mean for the financeability assessment (particularly if cash flow ratios in the short term are below those assumed by the rating agencies to be consistent with investment grade credit ratings)?

Maintenance of an investment grade credit rating is essential. Forcing a network operator into non-investment grade categories would significantly raise the cost of capital.

If depreciation is accelerated, what happens when the RAV is largely depreciated but the assets still remain useful?

The potential reduction in the depreciation charge from life expired assets should be offset by an additional deprecation charge from new assets, so that the overall depreciation charge remains at an appropriate level. This is necessary to ensure that current consumers face the opportunity cost of continuing to use such assets.

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

See answer to Q4

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

See answer to Q5

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

See answer to Q6

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?*

As previously stated, financeability, in practice, requires companies to have and maintain an investment grade credit rating. We do not see how Ofgem could move away from focusing on the financial ratios used by credit rating ratios without provoking a downgrade, at some point, to non-investment grade.

We agree with the Competition Commission that there needs to be a buffer which allows the financial profile of the regulated entity to absorb adverse shocks.

Any adjustment to depreciation lives should be implemented in a way which avoids a step change in revenues.

It seems likely that, at some time, an industry-wide approach would place undue stress on a particular company's financial profile. In such cases, Ofgem may need sufficient flexibility to adopt a company specific solution.

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

We would support the development of RoRE and its application to realistic scenarios. Particular attention should be paid to the matching of costs and benefits, which do not completely fall within the five year price control window. For example, a high apparent RoRE in one price control period can result from carry-overs from the previous price control period, rather than performance within the current price control period.

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 derivation of the headline cost of capital for DPCR5 was unsatisfactory both in terms of process and justification. Ofgem's initial range was too wide to be helpful and it remains unclear on what basis Ofgem chose a point within that range. We would expect Ofgem to adopt more transparent procedures in future.

Under our straw man, the allowed return would reflect the riskiness of a company's cash flows. We recognise that assessing this is not straightforward. The methodology for this assessment is not a subject of this paper. However, it is one that we will revisit in depth for our summer 2010 recommendations to Authority. In particular, we will need to consider:

- Whether changes to the regulatory framework proposed under RPI-X@20 change the risks facing networks companies and, if so, how this impacts the cost of capital;

Investors require sufficient return for the risks that they bear. If investors' perception of risk increases as a result of proposed changes to the regulatory framework, then the cost of capital will increase.

- Whether any change in the level of risk facing network companies is sufficient to mean that a company might need to consider changing its investor base and, if so, the transition arrangements necessary;

There would be substantial costs if companies were forced into changing their investor base.

It would also increase investors' perception of regulatory risk, as it would raise the possibility that they may be forced into disposing of their assets on disadvantageous terms, especially if an imbalance of sellers and buyers arose.

- Whether it is appropriate to retain our approach of setting a single allowed return for all companies within a sector;

At present, the expected return already varies across companies depending on the expected outcome of a variety of incentive mechanisms.

- Whether it is appropriate to retain the weighted average cost of capital (WACC) approach to setting allowed returns or whether there is merit in alternative methodologies such as a split cost of capital.

We support the continued use of WACC. There would be substantial practical difficulties with implementing a split cost of capital.

- Whether there is merit in indexing the allowed return or some part of it;

We agree with the Competition Commission that utilities are generally better placed than customers to manage interest rate risk.

Furthermore, there are substantial practical difficulties in implementing indexation, which have not yet been satisfactorily resolved. These include choosing the appropriate measure of the cost of finance on which to base the indexation and adjusting allowed revenue. In addition, companies may choose to track the index rather than seek to obtain the lowest cost of finance.

- Whether there is merit in locking in the allowed return for some investments for the life of those investments;

This approach has been proposed for off-shore transmission projects and, if successfully implemented, could be considered on a wider basis.

- Whether the capital asset pricing model (CAPM) framework that currently frames our assessment of the cost of equity remains appropriate;

We support the use of the Dividend Growth Model (DGM) as a cross-check on the cost of equity derived from CAPM.

It appears, however, that the CAPM framework is increasingly used as a framework for discussion of the cost of equity rather than as a basis for calculation. Ofgem should be more transparent about the basis on which it determines the cost of equity.

- Whether our approach to gearing remains appropriate, particularly in light of the highly geared structures observable in the regulated utility sector;

Ofgem should avoid encouraging network operators to adopt highly geared structures.

- Alternative methods for equalising the incentives between capital and operating expenditure;

DPCR5 developed a means of equalizing incentives through the implementation of IQI. We support this in principle.

- How revenues might be profiled over time.

There is a case for smoothing revenues over the price control period as customers and users dislike volatility in network charges.

6.2. In assessing the appropriate depreciation profile, we will also need to consider:

- The appropriate assumed average useful economic life for each sector, including whether there are elements of the asset base that should be subject to an alternative depreciation profile;

At present, there is a single RAV which simplifies modeling. Having different deprecation profiles for some asset classes would require more detailed modeling and the historic information may not be readily available. However, this may be one area that could be explored as a means of mitigating financeability cliff-edges, which are potentially created by moving to a "useful economic life" basis.

- Whether the straight line approach to depreciation remains appropriate;

Alternatives to straight line deprecation are rarely used in the UK and would require very detailed modeling.

- The impact that a step change to a depreciation profile that reflects economic asset lives would have on consumer bills and therefore the implications for transition.

Any adjustment to depreciation lives should be implemented in a way which avoids a step change in revenues.