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Dear Hannah,

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

Thank you for the opportunity to comment on the above consultation on Embedding Financeability in a New Regulatory Framework. We have responded separately to the main RPI-X@20: Emerging Thinking consultation. We would also commend and support the response submitted by the Energy Networks Association on behalf of the energy network operators (NWO).

Overall, we support much of the direction of the Emerging Thinking conclusions i.e. an enhanced ex ante regulatory framework, and the rejection of both ex post regulation and more radical reforms. This approach builds on the proven success of the RPI-X methodology, as it has developed since privatisation.

However, we have serious concerns about the content of this associated Financeability paper and we cannot support the Strawman set out within. If implemented, in our view, the Strawman would significantly increase business risk and, therefore, cost to customers. It will also threaten investment. This does not seem to us to be going in the right direction, at a time when there is a clear need for high levels of investment in energy networks going forward and a strengthening of incentives.

Ofgem's financeability Strawman

We summarise the essence of the Strawman, as set out in the consultation document, as:

- No financeability adjustments – the assumption being that if the allowed return and the depreciation allowance are set appropriately, then the notional company should be financeable;
- Longer-term assessment of financeability – the intention being to disregard the short term financial ratios, used by the credit rating agencies, when setting price controls;
- Depreciation allowances set to reflect useful asset lives – rather than physical lives or some regulatory construct;
- Allowed revenues set to reflect the riskiness of individual company's revenue and cost streams – based on that company operating in an economic and efficient manner and assuming a notional capital structure.

Alongside the Strawman, the consultation document recognises three key parameters:

- The requirement for a high level of network investment to facilitate the achievement of broader Government energy and environmental goals;
- The need to balance the interests of existing and future customers; and,
- The desire to maintain NWOs as "low risk" businesses.

We discuss each of these elements of the Strawman, and how they fit with these parameters, below.

Financeability adjustments

It is not at all clear from the document what is the perceived problem with the past arrangements for assessing the financeability of price control settlements. Is it financeability adjustments per se, or, given the generally accepted need for significantly higher levels of investment going forward, some objection to the impact on existing customers' bills of such levels of investment and a desire to pass as much as possible onto future customers?

On the first question, there is, in our view, no firm evidence of a fundamental failing in the approach taken to assess financeability in the past. We would agree that there are concerns about one or two cases where arbitrary last-minute adjustments have been made to individual network companies late in the process and we agree that this should be avoided going forward, if at all possible. However, we do not agree that there is a fundamental issue with Ofgem considering the balance of cashflows, prices and investment (through for example setting the appropriate deprecation rate) as part of its judgement on the price control package. Indeed, we consider that such judgements are, and will remain a vital part of the price control process.

On the second question, in our view, the concept and construct of the RAV model already provides the mechanism to balance between current and future customers, all that is required is agreement on the appropriate regulatory asset lives, and we discuss this further below.

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To attempt to arrive at a "right" balance between current and future customer interests is academic and misses the real point about having in place the regulatory framework and incentives to encourage investment. In addition, we would firmly reject any suggestion that current customers are paying "too much" for investments.

The RAVs of the network businesses continue to grow significantly, thus ensuring future customers bear their share of the investment costs and risks. That is, the current growing RAVs are storing up a bigger bill for future customers. We therefore believe that it is difficult to argue that future customers are not "paying enough" when the future liabilities (as encompassed in the growing RAV) are rising. Simply observing that depreciation is shorter than asset lives is meaningless in the context of the more relevant debate about incentivising necessary investment.

Longer term assessment of financeability

It is essential to recognise at the outset that the "financeability" of a price control settlement (i.e. that NWOs are able to finance their statutory activities and obligations), is not the same as "profitability" (i.e. that NWOs can make a reasonable return in the long-run).

In this regard, one cannot simply ignore the role that the credit rating agencies, and the NWOs' licence obligation to maintain an investment grade rating, play. When combined with Ofgem's statutory duty to ensure that NWOs are able to finance their activities, these measures all interact to provide the necessary assurance to the capital markets that these are low-risk businesses and that investment will be recovered, and so maintain the availability of finance at minimum cost.

We find it, therefore, inconceivable that, in reality, the financeability ratios on which credit ratings are based can be put aside when setting price controls. We are sure that many businesses (and for that matter Governments) would like to be able to ignore the credit rating agencies and many other official bodies, (including, perhaps, regulators!), but this is just not possible in practice. Ofgem may not like the credit rating agencies, but they are still heavily relied upon in the international capital markets and cannot, therefore, simply be ignored (particularly if Ofgem are to retain a financeability obligation which requires network companies to achieve an investment grade credit rating by the very agencies Ofgem seem to regard as irrelevant).

Similarly, much of the case underpinning the Strawman appears to seek to dilute Ofgem's statutory financeability duty, for example, by proposing to set price controls that involve significant periods of negative cash flow, higher asset stranding risk and/or longer payback periods. These all serve to undermine the regulatory covenant fundamental to NWOs being perceived as low risk businesses, and increase the uncertainty about the price control settlement enduring over more than one price control period. Not only should this be strongly avoided but, given the high levels of investment required going forward, Ofgem should be strengthening this commitment, to ensure that NWOs remain a viable and attractive investment proposition.

In addition, much of the Strawman is predicated on NWOs being "low-risk" businesses. However, in our view, this assumption of low-risk businesses is not only inconsistent with the above, but also inconsistent with the higher risk proposals of the rest of the RPI-X@20 project, including: more output measures and the risk of failure outwith companies' control; longer-term price controls at a time of great uncertainty; and, third party appeal rights. All of these lead us to conclude that NWOs will no longer be viewed as low risk, and that NWOs' cost of capital, and therefore costs to customers in general, both current and future customers, will rise.

Regulatory asset lives

The consultation document discusses regulatory asset lives, and the Strawman proposes setting depreciation allowances to reflect useful asset lives. In general, this means extending regulatory asset lives, from the regulatory construct which exists currently.

This needs very careful consideration, and further modelling, and we note that Ofgem have suggested that a further consultation paper will be issued on depreciation methodology. However, we fail to understand how simply extending what is essentially a regulatory construct, which in the first place did not relate to physical asset lives and has already been diminished by accelerated depreciation, can lead to a RAV that reflects useful asset lives, any more than physical asset lives. If the "problem" is that the RAV is too small, then a full revaluation is required.

Put another way, the RAV and current depreciation profiles are a financial construct. In the case of the RAV this reflects previous financial commitments made by investors to the business. In the case of depreciation, this has historically been fixed with reference to securing a balance between remunerating shareholders, incentivising investment and affordability for customers. It too has always been a financial derivation. By contrast, if Ofgem were to apply an operational depreciation profile to the RAV, reflecting assets lives, then it would be necessary to reconsider exactly what that depreciation rate should be applied to.

In particular, it would be inconsistent to apply a rigid, operational, asset-lives based measure of depreciation onto a purely financial construct. Consistency of approach would require re-valuing the RAV upwards onto a modern equivalent asset (or current cost accounting) basis and applying operational (i.e. asset lives) to that newer number. In other words, an operational measure of depreciation will only better reflect inter-generational funding issues if it is applied to an operational and on-going measure of the asset base, which is not the basis for the current RAV. We think moving to such a new measure would be extremely disruptive and, while we have undertaken no detailed modelling, we suspect it would bring us largely back to the current position.

We would also comment that it is probable that there is no single solution for each sector, whether electricity or gas transmission, electricity distribution or gas transportation, and it would be dangerous to assume otherwise. There is no agreement around how long useful asset lives may be, other than they are different for each sector. In addition, risk profiles will differ between sectors, for example, gas transportation costs are more legislation driven with less discretionary spend, and, in particular, we note that there will be some interesting financeability challenges to come in the electricity transmission sector, given the scale of investment required.

A prime concern to us, from the above, is the implicit assumption that capitalisation rates (through moving to equalised capex/ opex incentives), rather than depreciation, become Ofgem's "preferred" financeability adjustment. During DPCR5 SSE made clear its strong opposition to the introduction of "balanced" or "equalised" capex/opex incentives. In our view, the full implications of this approach have not been fully considered, especially the "odd" incentive properties and their influence on NWO behaviour. This change simply adds another variable, contributing to uncertainty and weakening the incentive to invest. We are again concerned that Ofgem has automatically assumed that "one size fits all" when seeking to replicate the equalised incentives policy across all networks. We do not believe that this is the case and Ofgem should, at the very least, consider the merits (or otherwise) of extending this principle to other network sectors on a case by case basis.

Allowed returns

An important point to be made here is that, under the Strawman, it seems to us that the intention is that Ofgem determines going forward what is a "suitable" financing structure for NWOs and judges when the price control package is "enough". However, there is no discussion of how this fits with current company, financing and finance structures, or how long these would take to change, if it were indeed possible.

When taking into account the increasing levels of investment going forward, the Strawman desire for longer-term paybacks and significant negative cash flow, while yet continuing to expect NWOs to achieve investor grade credit ratings, there has to be an inherent assumption, not only of more debt, but also of more equity being injected into the businesses. In our view, this inevitably puts upward pressure on the cost of equity.

In addition, the suggestion that equity investors exist that are prepared to bear significant periods of negative cash flows is hypothetical. Certainly, it is not our experience that pension funds (quoted as an example in the consultation document) are any more inclined to this proposed model than any other investor; they still require ongoing dividend payments to service ongoing pension liabilities.

The Strawman is so radically different from the current approach that we are concerned whether it will lead some to question whether Ofgem are seeking to force change in NWO ownership and financial structures, based on a hypothetical argument. Many investors and potential investors will no doubt question whether this is the role of the regulator.

Finally, we note that Ofgem in its Project Discovery document express serious concerns about the attractiveness of the UK market for investment and by contrast this Strawman sets out proposals that would make investment in UK networks demonstrably less attractive. As Ofgem highlight in Project Discovery, the energy sector has other big, more attractive investment opportunities competing for finance. Against this background we would question whether now is really the time to put in place measures which mean that network investors face significantly more risk and a longer waiting period for returns.

In summary, in the first instance we are unsure as to exactly what problem Ofgem is trying to solve here. If it is inter-generational funding of investment, we would firstly reject any suggestion this is an issue. Secondly, we would point out that Ofgem's suggested approach of linking depreciation with asset-lives would provide no more scientific an outcome than the current regime (and would be intellectually inconsistent, mixing up as it does financial and operational measures).

If on the other hand, Ofgem's objective is to seek to secure network investment for a lower cash cost to current customers, while we support and understand the objective, we consider that the solutions put forward will simply result in less network investment, a higher cost of capital and hence higher bills, for fewer outputs. Ofgem cannot ignore the rating agencies, nor do we consider that most investors would regard significantly cash-negative network businesses (as implied by stretching depreciation) for an extended period as an attractive concept.

We therefore firmly believe that Ofgem's proposals would have profound negative implications for network investment at a time when Ofgem itself has recognised that the industry is facing a substantial investment requirement.

In terms of a solution, we understand the desire to put in place a "one size fits all" policy and to move away from ad hoc financeability adjustments at price controls. However, we believe that, provided the overall return is set at an attractive level and that depreciation and capitalisation policies result in healthy cashflows consistent with maintaining investment grade credit ratings, there will be no need for one-off company-specific financeability adjustments. This does mean that balancing cashflows, incentivising investment, the need to remunerate current investors and affordability will continue to require the regulator to make trade-offs and judgements at each particular price review about depreciation and capitalisation rates.

I hope that you have found our comments above both interesting and useful. If you would like to discuss any of our issues raised, then please call.

Yours sincerely

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