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Our Ref	Your Ref	Direct Line	Date
	5/10 6/10	0117 9332175	8th April 2010

Dear Hannah

<u>Ofgem Consultation: Regulating energy networks for the future RPI-X@20 Emerging Thinking 20th January 2010</u>
<u>Embedding financeability in a new regulatory framework RPI-X@20 Emerging Thinking 20th January 2010</u>

I attach our response to the above documents.

As Ofgem recognises, the RPI-X regime has delivered significant benefits for customers and stable and secure electricity networks. We agree that going forward there are significant new challenges which will require some adaptation or modification to the existing regime in order to stimulate the innovation that will be necessary to meet these challenges.

We welcome Ofgems' continued commitment to the continuation of the current ex-ante regime to meet these challenges. Ofgem's proposals in respect of enhanced stakeholder engagement, equalisation of incentives, richer business plans and a more outputs focussed approach to price reviews as set out in the main consultation document appears to be a sensible response to these challenges. We have contributed to ENA discussion of the main emerging thinking consultation and support the detailed ENA response on the key themes explored in the main document.

The consultation on Embedding Financeability is intended to challenge the way a regulated company is financed and we have some specific comments on this document; in particular our views on the suggested straw men principles for embedding the financing duty in a future regulatory framework as follows.

Financial health tests
One of your key suggested principles is that Ofgem "would specify what [financial health] tests should be used potentially moving away from a focus on those used by credit rating agencies."

Investors use the metrics used by the major credit rating agencies to determine the principles used of their investment, as well as in making individual investment decisions (i.e. investors may have internal rules to only invest in investment grade instruments as well as basing investment decisions on individual companies' ratings). Decisions on rating methodology are made internationally and are intended to be available to international investors. It is therefore possible that, if Ofgem move away from the metrics used by the major credit rating agencies that a regulated UK utility could be declared "healthy" by Ofgem's methodology whilst at the same time being unable to attract the capital required for continuing operations. In such circumstances Ofgem would have to have regard to the credit rating agencies metrics in any event. Therefore, whatever alternative metrics Ofgem develops these metrics must, as a matter of fact, be supplemental to those already in use, and of little importance to investors.

In addition, an announcement that Ofgem were going to base their financeability tests on alternative metrics and not on established rating criteria could lead to investors regarding Ofgem regulated utilities as inherently more risky.

If Ofgem believe that the current metrics used by the credit rating agencies are inappropriate then representations should be made to change the methodologies used in setting ratings.

Allowed return

A base cost of capital allowance should be determined by Ofgem appropriate for a particular network sector which takes into account the relative risk of that sector.

Ofgem should reward those companies that have established a track record for planning and delivering efficiently. In DPCR5 this was taken into account to an extent in the IQI mechanism. A more refined reward/penalty calculation for delivering efficiently is more appropriately taken into account within the IQI/capex/opex allowance mechanisms, rather than as a differential to a base cost of capital allowance.

Network companies face different risks when operating in rural areas rather than urban areas. However, such considerations are more appropriately taken into account within the capex/opex allowance mechanisms using the correct cost drivers, rather than as a differential to a base cost of capital allowance.

Capitalisation policy and equalising incentives

The capitalisation policy and equalising incentives adopted in DPCR5 should be continued thereby ensuring consistency in future electricity distribution price reviews, although it may be appropriate to revise the proportion of totex that is treated as fast money over time.

Calibrating returns

We support the continued development of the RoRE tool initiated for DPCR5.

Yours sincerely

Alison Sleightholm
Regulatory & Government Affairs Manager