WALES&WEST UTILITIES

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Dear Hannah,

Regulating energy networks for the future: RPI-X@20 Emerging Thinking on Embedding financeability in a new regulatory framework

The Wales & West Utilities (WWU) response to the Emerging Thinking – Embedding financeability in a new regulatory framework is set out below. This response is in addition to our response on the Emerging Thinking – Main consultation document.

WWU is a licensed Gas Distribution Network (GDN) providing Gas Transportation services for all major shippers in the UK. We cover $^{1}/_{6}$th of the UK land mass and deliver to over 2.4 million supply points. WWU Limited is one of only two Licence Operators that focus solely on Gas Distribution in the UK.

WWU has been fully supportive of the Ofgem review of the Regulatory framework known as RPI-X@20. We have, and will continue to support the workshops and consultation processes as it is imperative that any conclusions implemented are workable and support the outcomes below.

Executive Summary

The RPI-X@20 review should be judged against the success criteria of “Regulatory improvement”. Any move away from the existing framework should demonstrate better facilitation of the desired outcomes. The Regulation framework must ensure:

- Efficient networks are able to finance their licence obligations;
- Networks are able to attract investment from competitive capital markets;
- An equitable sharing of risk between networks and consumers;
- Networks should not be subject to risks they cannot control;
- Networks are accountable to end consumers;
- Networks are incentivised to provide services that stakeholders value;
- Networks that demonstrate excellence are rewarded appropriately;
- Adaptability in a changing environment.

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At this stage, it is very difficult to determine whether the straw man principles proposed in the Financeability consultation will better facilitate the desired outcomes. It will be the practical implementation of the principles that will determine the impact. If applied incorrectly, there is a real risk implementation could introduce significant uncertainty and result in reduced incentives to invest in networks or at least significant, additional, unnecessary finance costs on networks and consumers.

We attach our responses to the consultation questions as appendix 1 but cover our key thoughts below.

Duty of Financeability

We note that Ofgem recognises its statutory duty to:

- Ensure that the licence holders are able to finance their licensed activities; and

- Ensure that companies can secure financing in a timely way and at a reasonable cost to meet the efficient costs of delivering on their regulatory obligations

Networks need to secure finance over the long term from a variety of sources in the equity and debt capital markets. Investors require long term certainty to continue to commit resources to the sector. Without such certainty, the required rate of return will be substantially higher to compensate for risk which may add unnecessary costs to end consumers. This is particularly the case where large scale capital investment is required over several years and multiple price controls. Uncertainty within the regulatory regime, conditions for investment, and the risk-reward return will increase the required rates of return, and hence, the cost of capital (debt and equity).

Networks are financeable if regulatory allowances are sufficient to cover the necessary operational and capital investment and fulfilment of regulatory outputs. Debt and equity financiers need to understand, and be comfortable with the risk-return trade off and the regulatory risk around each subsequent price control. Any regulatory regime needs to balance the needs of consumers (who benefit from investment) with the need for investors (who finance such investment). Striking the appropriate balance is critical to the financeability of networks.

WACC

In arriving at an appropriate WACC, one should take into account the prospective risk of a higher cost of debt and equity to retain and encourage investment in the industry. It is not realistic to set WACC by solely adopting a historical average approach or to ignore risks on the basis that they cannot be quantified with certainty. There should continue to be a tolerance for volatility and uncertainty. The WACC assessment should also take into account the transactional costs of raising finance, which are a material component of the financing cost.

A notional industry WACC remains appropriate for gas distribution. Each company within a sector will need to attract funds from capital markets common to all. However, if regulators need to recognise that some companies may face different levels of risk compared to others within the same industry, then various mechanisms such as specific revenue allowances, incentive mechanisms could be used to deal with issues specific to companies within a sector. Absent of these mechanisms, a differentiated WACC could be used.

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Depreciation

We are comfortable with regulatory depreciation being set in accordance with the estimated economic life of the asset. We are not aware of any current available information for Gas Distribution that would require a change from the existing methodology, which assumes a weighted average economic life for the combined components of the transportation asset of 45 years. The current methodology is transparent and the straight line basis is a well accepted methodology. Given the conflicting uncertainties discussed in the consultation, we believe the current treatment is appropriate. Shorter depreciable lives increases costs to current consumers and increases 'cliff face' risk; whereas longer lives reduce current cashflows, impacting financial ratios. The regulatory framework needs to encourage investment as capital investment is incurred upfront - longer lives adversely impact on cashflows, debt serviceability, equity returns and hence, investment appetite.

Capitalisation policy

Generally, capitalisation principles should align costs with consumer benefits. If consumers receive immediate benefits from a network activity, then it is reasonable that they should fund that activity in the current period. If the benefit is received over a longer period of time, then costs should be attributed over an appropriate period.

The current Replacement Programme within Gas Distribution is unique and benefits current and future consumers. We believe the current 50/50 capitalisation policy is appropriate and reflects a fair balance between current and future consumers.

An increase in the proportion of "slow" funding would increase regulatory uncertainty. Investors and networks would be more reliant on the regulator setting WACC appropriately in future price controls. Consequently, we do not agree with the view expressed in the consultation document that investors should be indifferent as to the speed of money. Any change in "fast" or "slow" funding proportions would need to ensure sufficiency of cashflows to maintain ratios and financeability.

Financial ratios

Regulators (e.g., Ofgem, Ofwat), make reference to "comfortable investment grade" credit rating when assessing financeability. These are generally accepted by industry and regulators as BBB+/Baa1 to A-/A3 (although not absolutely defined).

The regulatory framework must continue to test financeability by reference to generally accepted, independent financial ratios which are applicable across a wide range of industries.

Financeability tests must have reference to the real life ability to raise finance in the capital markets. Accepted and relevant financial ratios provide necessary signals to the credit market. Ofgem should continue to test market accepted metrics in the short term and medium term over the price control period and be cognisant of the longer term impact on ratios. Short term ratios can be as important as longer term ratios, given the need to raise capex facilities around the time of each regulatory reset and the need to frequently renew liquidity/ancillary facilities.

Credit ratings

Credit ratings are necessary to raise finance. Investors also value the requirement of Licensees to maintain investment grade credit ratings. Consequently, there is extremely limited investor appetite for unrated bonds which attract a higher cost of debt. The recent, increased reliance on bond markets means obtaining and retaining an investment grade rating is even more critical than in the past.

Without a credit rating, companies are reliant on the more expensive bank debt market with the risk it may not be able to raise all its financing requirements. With the financial crisis, banks' internal funding charges have increased substantially, forcing a rationalisation of balance sheet capacity and hence, reduced lending appetite resulting in a higher cost of debt.

Investment mandates for the vast majority of debt investors (e.g., pension funds, insurers) require investment in rated debt (with minimum specified credit rating). Investors are extremely reliant on credit ratings. Ratings and pricing are the key determinants of their investment decision. Therefore, in order to raise finance, networks/debt must be rated.

Credit ratings provide an independent view on creditworthiness and financeability. Despite any shortcomings, credit ratings assessments are a necessary tool for investors.

Leverage

In the Financing Networks paper (2004), both Ofgem and Ofwat stated that financing is a matter for companies and shareholders. Capital structure should continue to be the preserve of networks and shareholders and they should continue to be mindful of the financing restrictions within the regulatory ring fence.

Financial markets will and should continue to determine the appropriate level of leverage in a regulated network. Higher leveraged financial structures include creditor protections that require and encourage management and shareholders to act in the best interests of the Licensee - providing additional protections for consumers and lenders.

In summary, there do not appear to be material or real concerns regarding the relatively higher leverage of regulated utilities compared to other sectors. Capital providers value the relative stability of cashflows and appear content with the practice of lending against the regulated asset base.

Return on Regulatory Equity (RORE)

As long as RORE is not used in isolation, it could be used as an additional mechanism in the regulatory framework. RORE may help to highlight the shortcomings of certain mechanisms within an overall settlement.

The key determinant of the cost of equity in the WACC should be a market referable rate of return not RORE. WACC assessment should continue to be based on the Capital Asset Pricing Model (CAPM). Companies need to continually maintain existing and attract new investors. Equity investment is mobile and investors continually compare returns within and between sectors in both the UK and globally. Accordingly, a market based equity return remains appropriate.

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RORE may be a reference point and/or a comparative tool within the sector but should not override market based returns. If Ofgem seeks to extend the application of the RORE tool to other sectors, it must establish clear principles in respect of purpose and the calculation methodology. For example, by reference to:

- Efficiencies/returns attributable to non operational items (e.g. financing);
- Capital structure – assessment of the notional capital structure within the regulatory ring fence;
- Cost allocation to avoid distortion between multiple network groups v individual networks.
- Recognition of specific/additional risks faced by companies;
- Recognise returns change over time (e.g., depending on capital programme, market forces, financial markets);
- Enunciate clear principles/guidance regarding “likely performance” against cost baselines or allowed return.

Final Proposals – Mechanism for Review

Given the complexity of price control reviews, and that historically, the full detail of the proposals have tended to only be made available upon release of the Final Proposals, we would welcome a mechanism by which the Networks could discuss with Ofgem, and to the extent necessary, review aspects of the Final Proposals rather resorting to the rather extreme action in a full appeal to the Competition Commission. We believe this would offer a more constructive mechanism to address any uncertainty or issues following the Final Proposals. This is particularly where Networks seek clarity on specific issues rather than re-opening the entire price control which would take up considerable time, resources and could result in additional uncertainty for Networks and their ability to raise finance in the meantime.

Yours sincerely

Steve Edwards
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Wales & West Utilities

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Appendix 1 : WWU Response to the Embedded financeability Questions

CHAPTER: Two

Question 1: Do you have views on our ideas on how we might interpret financeability in a new regulatory framework?

We believe the current approach to embedding Ofgem's financing duty remains appropriate and does not require a major change:

- Efficient, well run companies should earn a rate of return on its RAV that is at least equal to the cost of capital for that class of network; and

- Companies should be able to raise finance (debt or equity) from the capital markets readily and on reasonable terms, therefore avoiding any unnecessary costs to consumers.

This consultation document is the first time that many of the "Financeability" issues have been discussed as part of the RPI-X@20 review. The paper acknowledges there are number of issues such as risk, WACC and CAPM that will be discussed later in the process. These issues are critical to understanding the full scope of the review. Therefore without full consultation on all the issues mentioned in the document it is difficult to form an opinion on how Ofgem might interpret financeability in a new regulatory regime.

CHAPTER: Three

Question1: 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?

Ofgem state the existing approach to financeability has worked well in allowing companies to finance their activities and invest substantially in their networks. Ofgem also state that the existing regime has enabled Licence holders to secure sufficient financing on reasonable terms, delivering real and significant benefit to consumers. We think the current concept of "financeability" is understood by potential investors and that it is generally fit for purpose and could be utilised in a future regulatory regime.

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CHAPTER: Four

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?

We do not share Ofgem's views that the current approach is beset with such material issues that wholesale change is required. No framework will be perfect, but as Ofgem acknowledge the current framework has generally worked well.

Specifically, Ofgem list "Reliance on cash flow ratios" as an issue. The regulatory framework must continue to test financeability by reference to generally accepted, independent financial ratios which are applicable across a wide range of industries. The removal of reliance on ratios could introduce significant uncertainty for any investor and may lead to significant increased cost of finance for end consumers.

We believe the current framework strikes a balance between the interests of current and future consumers. We believe the current depreciation policy, based on expected useful life for Gas Distribution is appropriate.

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?

There is merit in determining a set of clear and transparent principles but it will be the practical implementation of those principles that will determine whether or not a future regime will be better than the status quo arrangements.

The existing UK energy regulatory regime is generally understood by investors and Networks. Many external influences such as the macro economic environment and political environment will change over time and the Network will have no influence over the scale, timing or pace of change. We think, therefore, it is going to be quite a challenge for Ofgem to adhere to a set of principles to apply consistently; and over time across each sector. The existing regime is fairly transparent and whilst one can never predict the future, the existing regime provides some assurance as to the treatment of Networks in future price controls.

We do not think this emerging thinking consultation gives clarity on how the principles will be applied in practice and we look forward to working with you further in this area. We also note there are several topic areas such as risk, WACC and CAPM that will be developed in future work. We would like continued, early engagement with you to fully understand the quantum of any detailed proposals.

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?

Capitalisation principles should try to align consumer costs with consumer benefits. If consumers receive immediate benefits from a network activity, then it is reasonable that they should fund that activity in the current period. If the benefit is received over a longer period of time, then costs should be attributed over an appropriate period.

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The current Replacement Programme within Gas Distribution is quite unique and benefits current and future consumers. We believe the current 50/50 capitalisation policy is appropriate and reflects a fair balance between current and future consumers.

The current available information for Gas Distribution appears to support retention of the status quo arrangements for regulatory depreciation. The current methodology is transparent and the straight line basis is a well accepted methodology. Given the conflicting uncertainties discussed in the consultation, we believe the current treatment is appropriate. Shorter depreciable lives increases costs to current consumers and increases cliff face risk; whereas longer lives reduce current cashflows, impacting financial ratios.

Any changes to asset lives will have an impact on depreciation and RAV and would have significant implications on existing and future financing arrangements

At the time of a price control, the specific issues facing that particular sector should be consulted on. Through this transparent process depreciation lives of assets and capitalisation policies should be formulated. There are many detailed discussions to be had in each sector about the future; and the outcomes should help shape the answers appropriate at that time; and the balance between current and future customer funding. Currently, for gas distribution, we do not believe there is the evidence that supports a change in the approach to depreciation and capitalisation.

Question 4: 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?

It is widely acknowledged that the "Regulatory Asset Value" is an economic concept, which is different to the "Physical" Asset value (i.e. depreciated replacement cost). Further analysis would be required to establish if the depreciated replacement cost would provide more appropriate price signals to users. We believe further work in this area should be carried out with a great deal of caution.

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

During DPCR5 we believe it was only at Final Proposals that industry could see the "Total" income being proposed. The DPCR5 process introduced a great deal of uncertainty for Networks. If RORE is to be used in the future, clear principles must be communicated at the outset and sufficient time must be allowed to review the "total" income position. The robustness of RORE is also dependant on agreement of the underlying data.

RORE may be a reference point and/or a comparative tool within the sector but should not override market based returns. If Ofgem seeks to extend the application of the RORE tool to other sectors, it must establish clear principles in respect of purpose and the calculation methodology. For example, by reference to:

- Efficiencies/returns attributable to non operational items (e.g. financing);
- Capital structure – assessment of the notional capital structure within the regulatory ring fence;

- Cost allocation to avoid distortion between multiple network groups v individual networks;
- Recognition of specific/additional risks faced by companies;
- Recognition that returns change over time (e.g., depending on capital programme, market forces, and financial markets);
- Enunciation of clear principles/guidance regarding “likely performance” against cost baselines or allowed return.

As long as RORE is not used in isolation, it could be used as an additional mechanism in the regulatory framework. It should not override market based metrics. RORE may help to highlight the shortcomings of certain mechanisms within an overall settlement.

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

A notional industry WACC remains appropriate for gas distribution. Each company within a sector will need to attract funds from capital markets common to all. However, if regulators need to recognise that some companies may face different levels of risk compared to others within the same industry, then various mechanisms such as specific revenue allowances, incentive mechanisms could be used to deal with issues specific to companies within a sector. Absent of these mechanisms, a differentiated WACC could be used.

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

We have not identified any further issues for consideration.

CHAPTER: Five

Question 1: Do you have views on our suggested straw men principles for embedding our financing duty in a new regulatory framework?

The practical implementation of the principles presented will determine whether or not the straw man principles will better facilitate the desired outcomes of a new regulatory regime.

We do not believe the straw man principles linked to cash ratios and investment grade ratings will better facilitate the desired outcomes. These proposals may create significant uncertainty and this could result in networks not being able to raise all of its finance requirements or at best; significant extra unnecessary finance costs for networks and consumers.

The application of the straw man principles should also take into account other major industry developments and try to ensure alignment of outcomes. One major example would be “Project Discovery”.

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

The consultation mentions many issues that will be covered at a later date. We think early engagement on any "developing" thinking is critical. The financeability consultation has wide ranging potential consequences for networks, investors and end consumers and we would welcome early and continued engagement with Ofgem on the developing thinking.

CHAPTER: Six

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?

We would welcome Ofgem sharing any other relevant thinking with us as early as possible so that we can fully understand the implications of any proposed framework.

The consultation acknowledges a company may encounter financing difficulties owing to financial market conditions. In light of the recent global financial crisis and ongoing volatility in credit markets, market uncertainty should be address sooner rather than leaving it for consideration in "future work".

We hope that Ofgem have regard to other industry projects and try to ensure alignment with those projects, for example, Project Discovery.