Providing Financeability in a Future Regulatory Framework: Summary of recommendations to Ofgem

Ofgem RPI-X@20 Financeability Workshop

CEPA

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Financeability – Current approach

Credit ratings and revenue advancement

"Financeability" has been interpreted as:

> *whether a company is able to fund its investment programme and meet basic financial ratio tests, based on the way credit rating agencies assess whether a company is investment grade, given the expected cash-flows generated by the regulatory price determination.*

Reflects regulators' emphasis on credit ratings and financial ratios in their assessments

The instruments to correct perceived financeability problems have broadly been:

- NPV *neutral* revenue advancement; and
- NPV *positive* revenue advancement.

The former are broadly preferable to the latter

BUT both can cause problems, particularly with regard to intergenerational equity

Important to understand the root of financeability problems

Financeability – Proposed approach

FCM and a role for equity

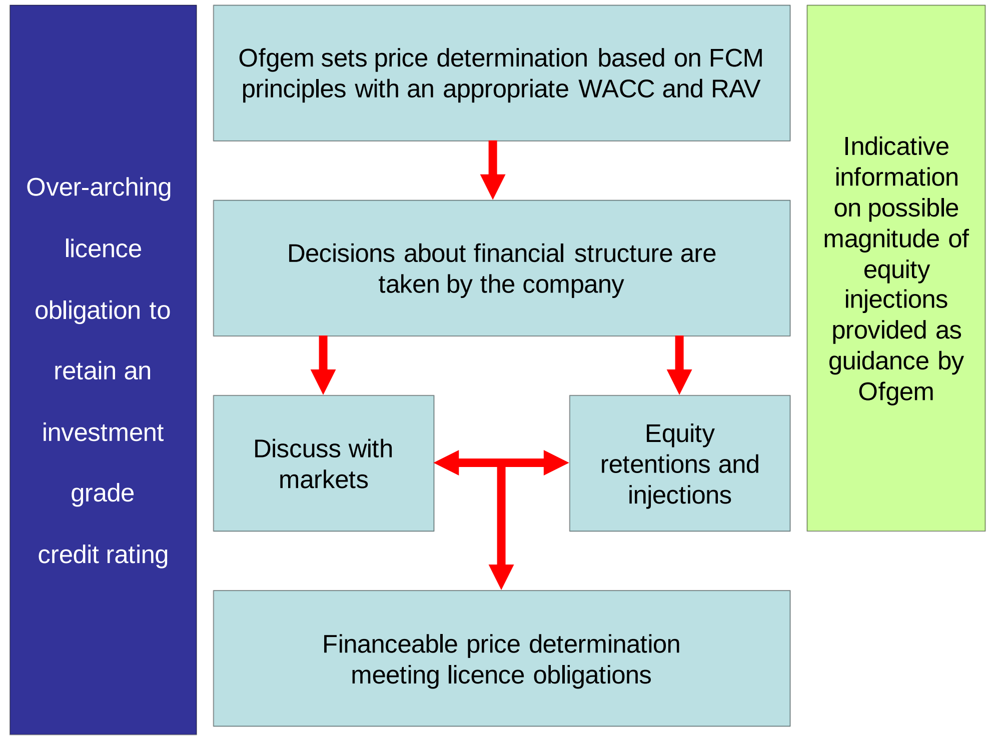
Underlying the approach is a continuing commitment to FCM:

•an appropriate allowed rate of return (WACC),

•depreciation policy,

•a regulatory asset value (RAV) etc.

Indicative estimates of equity requirements would be provided



Role of credit rating agencies

Retaining licence condition requirements

Existing role of credit-ratings:

•licence condition rating requirements; and

•price control financeability testing.

We consider having an investment grade rating is a reasonable minimum condition

Using rating agencies:

- is an effective and cheap way to identify the limits to gearing;
- ensures that the debt of utilities can be held by a wide range of funds, many of which cannot buy non-investment grade paper;
- makes it more likely that financing will be available to companies when it is needed; and
- is consistent with Ofgem's duties to ensure that companies can finance themselves.

This approach should be balanced with greater engagement to ensure credit rating agencies understand certain features of the regulatory framework

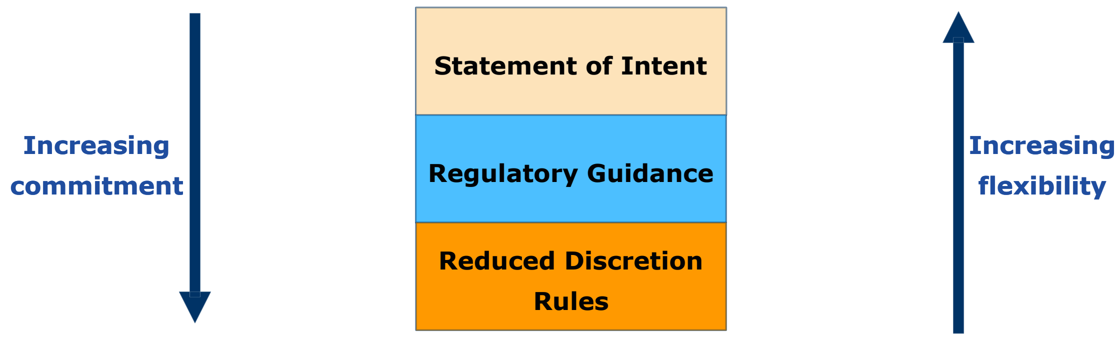
BUT do not see a specific role for credit-ratings in Ofgem's determination of allowed revenue

Regulatory commitment

Continued flexibility to commit

Two ways in which regulatory commitment could be strengthened:

- *ex ante* regulatory rules or statements of principle, methodology etc; and/or
- contractual undertakings that stretch beyond the normal five year cycle.



It is not clear to us that greater commitment is necessary – since significant certainty created by treatment of the RAV etc

BUT is clear that there are options available to strengthen commitment

Depreciation

Getting the charge right

Clarity about what depreciation is doing:

- **Measure of the consumption of the asset**
- **NOT a revenue smoothing solution**

Shift to appropriate:

- **Useful asset lives (dependent on the characteristics of the sector)**
- **Depreciation profile (driven by utilisation, characteristics of consumption)**

Need to determine what the right answers for these are and then update:

- **Periodically**
- **When significant events happen**

Gearing

Setting a financial structure for the long run

Notional gearing should be set on a long-term basis

Set at a level that would be the expected cost-minimising level of gearing over the life of regulated assets (if financed at a constant level of gearing)

We would impose the boundary condition that the level of gearing would at least need to be consistent with the lowest investment grade credit rating

Changes could take place as underlying conditions (such as tax rates) change

BUT changes should be sufficiently significant, say 5%, otherwise the benefits of long-term commitment are lost

WACC – CAPM

The need to retain flexibility

While CAPM seems to offer the best approach to establishing an estimate for the cost of equity, the use of broader market evidence is important

While we can see the commitment benefits associated with a mechanistic approach to CAPM and the cost of equity we do not believe this an appropriate way forward for Ofgem

A focus on the longer-term cost of equity would seem to be appropriate with more discretionary changes at any price determination to capture changes in risk

This would also seem more appropriate given the uncertainty about the precise value of the equity risk premium in any five year period

WACC – Differential WACC

Improving clarity for the treatment of existing capital

Currently the WACC is effectively doing two things:

- rewarding existing capital; and
- providing an incentive for new capital required to meet capex requirements for the next five years.

We consider that provided the rules by which a backward looking rate in a differential WACC is adjusted are clear, any of the following options would be an improvement on the existing slightly ad hoc approach:

- separate WACCs for forward and backward looking elements with rules as to: (i) how the backward looking WACC is set (i.e. linked to removal of headroom); (ii) how forward looking becomes backward looking at the next review; and (iii) how much of the capital structure is presumed to be re-financed each control period;
- a continuation of the existing averaged approach but with clear rules as to: (i) when embedded debt should be considered; (ii) how the backward looking WACC is set; (iii) how forward looking becomes backward looking at the next review; and (iv) how much of the capital structure is presumed to be re-financed each control period; and
- an alternative approach whereby a rolling average WACC is established.

Implementation

Accommodating adjustment

While it may be possible to make a fast move to the new financeability approach given that it has been signalled in different ways, caution is appropriate

Further modelling is needed to determine the need for a phased implementation and the likely length of phasing:

- Transmission
- Gas distribution
- Electricity distribution

If is appropriate to provide a transition period then consider:

- the longer-term move to the use of equity is signalled; but
- short-term revenue advancement in an NPV neutral manner is provided.

The aim would be to unwind the revenue advancement within five to ten years as the new policy is implemented

The Competition Commission may make recommendations on the implementation of Ofwat’s similar approach with respect to Bristol Water

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