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RPI-X@20 Financeability - Current thinking working paper

Dear Scott

We have read with interest Ofgem's 'Current thinking working paper: Financeability', published on 19th May 2010 as part of the RPI-X@20 review and this letter is our response to that paper. We appreciate Ofgem's approach to sharing its updated straw man outside of the formal consultation process – allowing an ongoing dialogue between network operators and Ofgem.

Our response to your emerging thinking publication in January 2010 detailed the concerns we have about some elements of this approach to financeability and its detrimental impact on both customers and investors. The straw man presents some proposals that we find unacceptable, in particular depreciation periods and financeability tests, and these are discussed in more detail below. These proposals will not create the attractive investment climate for debt and equity investors that is needed to meet the huge investment challenge for asset replacement, smart grids and a low carbon future.

Firstly we wish to highlight the parts of your straw man that we support:

Transparency of approach to WACC - a more mechanistic approach to the WACC is welcomed.
RORE – Developed during DPCR5, this is a useful tool to assess outcomes and calibrate incentives and risk. However, it doesn't deal with the timing effect of Ofgem's incentive framework (which does not match cash to regulatory periods) and isn't an alternative to using financeability ratios.
Equalisation of incentives – we support this change for DPCR5, as it encourages longer term decision making by network companies, leading to better networks and more efficient costs for customers.

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The issues around financeability are complex and interdependent and were well explored in both our and other responses to your January paper. Although the updated straw man has given some increased transparency it has not addressed the major concerns that were raised. We have simplified this response into the two areas of the straw man that we find unacceptable:

- RAV and the depreciation period
- Financeability tests and the use of ratios

RAV and depreciation period – impact on customers

Depreciation of the RAV in the straw man is based on the simple premise that the only way to generate inter-generational fairness for customers is to depreciate over the working life of the asset and that, as long as it is NPV neutral, the length of depreciation does not impact on financeability (and the cost of that for customers). We don't agree with either element of this premise and think this approach is too simplistic.

Inter-generational customer costs and the RAV: The RAV is a financial construct which was created at privatisation and the different depreciation periods used since then mean that today's RAV value is not representative of the physical asset base. For a number of reasons, under the current framework, changing the depreciation period to represent actual useful lives will not create the inter-generational fairness Ofgem propose because of:

1. **Treatment of inflation**: Network companies earn a real return on RAV during a price control period, with the inflationary element rolled up into future RAV. This means that current customers are paying lower costs for their assets at the expense of future customers. (The subsequent mismatch of cashflows has an impact on why financeability tests and ratios are a crucial test of whether any price control proposals are financeable.)
2. **Historic depreciation**: The current 20 year depreciation period for DNOs may suggest that current customers are paying more than necessary for assets which future customers will use. However, due to the fully depreciated pre-vesting assets they are also receiving a considerable subsidy from historic customers. Based on high level calculations the current replacement cost would be 3-4 times higher than the RAV, as a result of the RAV value determined at privatisation, providing a significant discount to customers presently.

We don't recommend that Ofgem attempt to correct these real life implications of the RAV, but they do highlight some of the complexities involved in RAV and its depreciation period. Simply addressing one specific aspect of this problem (future depreciation periods) is unlikely to resolve issues of fairness for customers and given these factors we don't think that current or future customers, in the round, will be paying an unfair amount for the cost of distribution. Future customers will also be burdened with paying for replacement of these assets and any changes required by the facilitation of a low carbon network.

Length of depreciation period: The straw man and Ofgem's current regulatory framework presumes that equity investors are indifferent to the timing of cashflows as long as they are NPV neutral. In reality, both equity and debt investors place importance on the timing of cashflows, which can't be removed by an NPV neutral adjustment. If this isn't recognised in Ofgem's approach to financeability then the approach will discourage investment and encourage the pool of potential investors in UK energy networks to narrow.

The straw man also doesn't explore the relationship between the timing of cashflows and the WACC. Oxera's paper for the ENA (*'What is the impact of financeability on the cost of capital and gearing capacity?' Oxera May 27th 2010*) concludes that Ofgem's straw man will materially increase the cost of capital due to:

- Time inconsistency issues (*para. 3.2, page 17*)
- Changes in the efficient level of gearing (*para 4.2, page 23*)
- Term premium requirements (*para. 3.1.2, page 15*)

We recommend that Ofgem review in detail Oxera's report and its implications on the cost to customer of the straw man. Oxera estimate the impact of the term premium and beta effect to be c.60bp and the effect of efficient gearing to be c. 40bp.

Finally, it is important to recognise that part of 'protecting the interests of future and existing customers' is to ensure that efficient companies have sufficient incentive to make the timely investment that future customers need. Even if the WACC was increased to reflect the resulting change in risk and returns following a change in depreciation period, the impact of a decreased investor base (including a lack of future investment) would overall result in current and future customers being worse off.

Financeability tests and the use of ratios

Whilst we welcome the statement in your working paper, para. 3.37, that Ofgem would 'continue to assess financeability in the round' we are concerned that this is a meaningless assessment given para. 3.38 says that the 'onus would be on the company to resolve the situation'. If no intervention is taken to resolve any financeability issues then it is inconsistent with Ofgem's duty to 'secure that licence holders are able to finance the activities which are the subject of obligations on them'.

The use of financeability tests and ratios is important for a number of reasons:

1. **They encourage investment**: we are in a period where networks require high

capital investment and it is during these times that financeability tests are likely to be most significant. If investors feel their return is not sufficient, or the regulatory risk in the long term is too high, then they may be left with the alternative of reducing capex in the short term to address financing issues, which may not be in the best interests of future customers.

2. **They act as a cross-check for the WACC**: We support the more transparent approach to setting the WACC, but given the complexities no approach has been proven to be without weaknesses. The use of financial ratios as a cross check for the WACC should not be underestimated and we recommend this is not removed.
3. **Companies still have to meet the traditional ratios**: Traditional ratios (e.g. interest cover) set out in banking type covenants will not automatically adopt the regulatory approach. Tests on gearing, debt factors, caps on amounts of debt etc. do not take the approach that as long as shortfalls are fixed in an NPV neutral way then all is fine. These ratios respond to the actual level of debt at specific points in time and therefore are vitally important. Pushing cashflows out into the future (whether NPV neutral or not) affects the risk profile and could will lead to higher costs and a potential lack of investors.
4. **They deal with the mismatching of cashflows:** The mismatch of cashflows due to the treatment of inflation (as discussed above) has an impact on why financeability tests and ratios are a crucial test of whether any price control proposals are financeable. First Economics estimate *('Financeability: A Report on Ofgem's RPI-X@20 Project Team's Emerging Thinking'*) that for DPCR5 equity investors are carrying the burden of a £1.5billion inflation gap, the cash for which will not be received until later regulatory periods.

In summary, we support a clear and transparent approach to financeability but Ofgem needs to reconsider their straw man approach on depreciation periods and financeability tests to ensure the effects on current and future customers have been more broadly considered, particularly for periods of high investment. We encourage Ofgem to analyse the documents that have been provided through the ENA from Oxera and First Economics and respond to the issues raised in them.

If you have any questions on the contents of this letter please contact me.

Yours sincerely

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