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Dear Hannah,

Response to Working Paper on Financeability

Thank you for publishing your latest thinking on financeability as part of the RPI-X@20 project. Given the sensitivity associated with such thinking and potential proposals we welcome the transparency provided by papers of this nature. The regulatory framework for energy networks developed in Great Britain over the last twenty years has been, as demonstrated by the initial RPI-X@20 project papers, very successful in delivering for customers. Ofgem's model continues to be regarded as world-leading through developments such as the Information Quality Incentive, which demonstrate that it remains effective and up to date. The very low costs of capital secured to fund energy infrastructure via this regime are secured against an understanding that the regulatory framework is secure and stable, whilst never complacent. The confidence that has been developed over the last twenty years could be very easily eroded. Therefore, as demonstrated by the recent publication from Moody's, the degree of transparency Ofgem have built into the RPI-X@20 review process is essential in demonstrating an open mind and willingness to embrace key arguments, so that confidence is preserved.

In our response to Ofgem's previous consultation on Embedding Financeability we suggested that Ofgem should establish long-term principles for financing and we are very pleased to see this development in the latest paper. Through a consistent and transparent approach Ofgem have established credibility and won the trust of investors in energy networks that a level of total return will be available for a given risk profile. This is the reason why energy network companies have been so successful in securing efficient investment.

We welcome Ofgem's recognition of the value of long-term principles and agree that they can strengthen regulatory commitment. We have consistently argued that these measures, if implemented correctly, can reduce risks and therefore, costs for customers. However, we also suggested that:

- the theoretical model could not be applied to the actual financing requirements of DNOs;
- the proposals are inconsistent with the other proposals in RPI-X @ 20 and the financial ring fence consultation; and,
- Ofgem need to attract and retain investors rather than just compensate them.

The updated straw-man does not contain sufficient developments to address these concerns. Unfortunately, the combined effect of the proposals in Ofgem's current paper does not represent a self-sustaining framework that will enable the desired benefits for customers. Overall the increase in risk that will result from the straw-man would be detrimental to customer's, and all other parties', interests.

Reflecting Reality

We support Ofgem's desire to develop a straw-man that is more effective because the framework is supported by ongoing regulatory commitment. However, given the additional risks presented by many of the other proposals, the additional commitment provided by a set of regulatory principles, whilst welcome, is insufficient to generate the strength of commitment required to attract investors at a reasonable cost of capital. We recognise that it is not possible for Ofgem to bind the hands of their successors. Given this constraint a set of principles will not give the surety that a future regulatory body, faced with the prospect of regulated companies taking large dividends from companies they have previously supported with equity, will allow the extraction of such dividends. During DPCR5 all energy network companies have experienced the review of a set of regulatory principles related to pensions that had been established only three years earlier. We believe that this issue would benefit from further study from a legal perspective, to determine what routes are available to Ofgem to create suitably binding commitments. We ask Ofgem to put themselves in the position of the investment committee of a bank, fund or pension scheme and consider what type of commitment would be necessary to enable investment for, say, 20 years with no ongoing yields at similar costs of capital to those that have been available to energy networks over the last two decades.

The straw-man has the potential to create significant short-term cash flow issues for companies with substantial capital expenditure requirements ie cash flow negative companies. The Ofgem position, that short-term financeability problems should be addressed by companies alone, is apparently supported by CEPA - who state that other companies in unregulated markets have to solve short-term financeability issues to receive rewards at later points in time. We disagree with this analysis. Companies in the private sector are not required to make investments. They do so seeking a competitive advantage with the aim of making super-normal

profits. A regulated business invests to maintain or improve service levels to earn "allowed" returns. If a competitive firm decided not to undertake investment, it may have no impact on its customers. A regulated natural monopoly which fails to invest will have a significant impact on its customers and will consequently, and often automatically, experience significant penalties imposed by the regulated regime.

Financeability problems can be solved by equity, but this solution is financially inefficient and likely to be expensive for customers. We await Ofgem's analysis of the costs of such an approach with interest and note, as demonstrated in Appendix 1, that using the worked example from the working paper it is clear that the magnitude of the equity fix for a given movement in Post-Maintenance Interest Cover Ratio (PMICR) is 13 times greater than the revenue advancement solution.

Attracting Investors

ENW's two owners are both long-term infrastructure funds. They are predominantly owned by pension funds with some other long-term, low-risk investors such as insurance companies. There is no "private equity" type finance in these funds. We believe that they closely mirror the "targeted investor" described in the Ofgem papers. Our owners have watched the RPI–X@20 debates with great interest and mounting concern. Following specific consultation with our owners we understand that investors such as pension schemes have a clear requirement for steady cash yields to meet their existing and ongoing commitments. Ofgem must recognise that even long-term investors have both short-term cash and long-term growth requirements. Our owners would be happy to discuss the nature and requirements of such investors with the Ofgem team in more detail.

We can see that the proposed straw-man principles will create unacceptable risk profiles for the long-term utility investors which Ofgem are seeking to attract. The proposed mechanisms recognise the need to move risk away from customers (for example - indexing the cost of debt) but fail to recognise the increased operational risk of longer term controls. The cost of increasing the risk profile of the network company is a significantly higher cost of capital with resulting price increases for both current and future customers.

Balancing risks

Ofgem has identified that longer term price controls may improve regulatory certainty for investors. The primary reason for the increased regulatory certainty is that the number of price controls to which investments are exposed to "regulatory ratcheting" is reduced. Conversely, increasing the payback period of the assets by changing depreciation lives will decrease the perceived level of regulatory commitment, potentially negating the benefits from longer term price controls. Additionally, Ofgem's statement that it will periodically review the asset lives further undermines the regulatory commitment.

Incentives under the straw-man

We challenge whether the behaviours which Ofgem are likely to encourage with the adoption of a 10 year trailing average cost of debt are beneficial for customers. If rates climb, which

seems likely, it will insulate customers from the costs of such debt for a considerable period. Whilst this appears superficially beneficial to customers, it calls into question whether Ofgem will have discharged its duty to ensure companies can finance their function, which must be a forward-looking test. An approach that undermined the value of the regulatory duty would be very damaging to confidence in Ofgem and hence the cost of capital.

In the longer term, faced with a regulatory principle of this nature companies are more likely to move to shorter-term debt financing arrangements to seek to mirror the regulatory arrangements, and thereby avoid penalties. It is not desirable for companies to be refinancing more than half of its debt portfolio within a single regulatory period. This position will have significant risk implications for a network company, again increasing the required cost of capital. This position may also appear to be "opportunistic" in that it is being proposed at a time when bond yields are at an all time low. This perception is likely to undermine the level of trust which Ofgem's "regulatory commitment" requires to operate effectively.

Ofgem correctly acknowledge that exposure to incentives increases a company's revenue volatility and suggest that where necessary additional equity should be introduced to manage the effects. We have identified circularity in Ofgem's position on the need for additional equity to deal with revenue volatility. Introducing additional equity requires the strength of incentive mechanisms to be increased in order to retain the incentive properties measured under a Return on Regulated Equity approach. It must be recognised that increasing the strength of the incentive mechanisms will exacerbate revenue volatility, for which the Ofgem solution is further equity injection. This issue demonstrates the need for a range of tools to address financeability issues and why Ofgem must seek to balance the whole regulatory framework, not just address individual issues in isolation.

Testing the package……

It is important to recognise the interaction between Ofgem's position, as set out in the work on the review of the regulatory ringfence, on the value of retaining an investment grade credit rating and the duty to ensure companies can finance their functions. We fully support this requirement as a fundamental step in maintaining access to efficient finance. When combined with a forward looking financing duty, we find it difficult to reconcile how Ofgem can justify a requirement to maintain a specific level of funding without providing sufficient revenues to enable this.

ENW has petitioned Ofgem to use Post Maintenance Interest Cover Ratio (PMICR) as a key ratio test for financeability in our previous price control submissions. Our rationale for this position is that it reflects the requirements of the actual debt markets. Ofgem's inclusion of a PMICR test in future controls is welcomed. Our only concern regarding its use is that Ofgem's default position in the straw-man is that companies with failing ratio tests will be required to inject equity to resolve short term financing issues. Equity injections are a very inefficient solution to resolve PMICR breaches. As previously stated, using the Ofgem worked example, in Appendix 1 we calculated that a company needs 13 times more equity than revenue to give the same change in PMICR.

…..and resolving the issues.

In our earlier submissions on the financeability straw-man, ENW has noted that there are a suite of levers available to resolve short term financeability issues. These mechanisms include depreciation policy, the Weighted Average Cost of Capital, capitalisation policy and revenue profiling. Any adjustment to one of these tools will result in financeability issues unless another mechanism is adjusted. In the past the main reason why depreciation policy has been chosen as a method to resolve short to medium term issues is that the impact on customers is NPV neutral.

Ofgem's desire to reflect the economic life of the assets in the depreciation profile needs to be carefully considered. The future asset lives of the networks are unlikely to be of the same magnitude as the current asset base. The development of active networks and smart grids will require greater use of operational control technology and new commercial solutions. This type of asset has an operational life span of 7 to 12 years and in some cases depreciation is even more rapid. With a changing asset base, establishing a long-term average asset life will not be an easy task. Whilst we recognise that there may be a mis-match between depreciation lives and asset lives which could change over time, we would strongly suggest that the present depreciation profile is the most appropriate. Using a back-end loaded depreciation profile will push a disproportionate amount of returns on, and of, capital to future customers when they will also need to fund network improvements.

Ofgem's proposal to use economic asset lives to set depreciation policy from a principled position indicates that another one of the financeability levers needs to be adjusted to maintain credit ratings. The straw-man suggests that companies should be forced into making equity injections to meet financeability tests – this solution effectively drives a change to the notional gearing assumption in the WACC. Lowering gearing will increase the cost of capital and would appear to substitute an NPV neutral measure with an NPV negative mechanism from a customer's perspective, which does not seem to be in customer's interests.

Instead, we suggest that the capitalisation rate may the most appropriate tool. The regulatory capitalisation rate is another NPV neutral mechanism and is not linked to the statutory capitalisation rate which has a significant impact upon financeability (as measured by the ratings agencies). In contrast to depreciation rates, the capitalisation rate can be fine tuned more precisely to solve financeability issues.

In summary, whilst we support publishing a set of regulatory principles on financeability, the enhanced regulatory commitment will not balance the substantial increase in risk and resulting cost of capital due to:

- using expensive NPV negative equity fixes to solve financeability problems;
- the potential removal of regular cash yields;
- back-ward looking, 10 year average cost of debt indexation; and,
- periodically reviewing depreciation lives.

Instead, a more balanced position could be maintained by:

- seeking to strengthen the regulatory commitment;
- continuing to take a forward-looking view to determining the cost of debt; and,
- utilising NPV neutral capitalisation ratios to address financeability issues.

If you wish to discuss any of the points raised please do not hesitate to contact me.

Yours sincerely,

Paul Bircham
Regulation Director

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Appendix 1

Ofgem Example - Comparison of FFO Interest Cover with PMICR

	Company A	B
RAV	4000	4000
Gearing	65%	65%
Debt	2600	2600
Equity	1400	1400
Vanilla WACC	4.7%	4.7%
Actual CoD	3.6%	3.6%
Interest Expense	93.6	93.6
Revenue Calculation		
Fast Money	300	300
Slow Money	150	75
Allowed Return	188	188
Allowed Revenue	638	563
FFO	338	263
FFO / interest	3.6	2.8
PMICR	2.0	2.0
Extra Equity to get +0.1 on PMICR		
Increase in PMICR	0.1	
PMICR	2.1	
Post Maintenance FFO	188	
Therefore interest	89	
Reduction in Interest Equivalent to +0.1 on PMICR	4.4	
Reduction in Debt needed to Generate	123	
Extra Revenue to get +0.1 on PMICR		
Increase in PMICR	0.1	
PMICR	2.1	
Interest Expense	93.6	
Therefore PMFFO	197	
Increase in PMFFO	9.4	
RATIO: Cash injection / revenue increase	**13** times	