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Dear Scott,

RPI-X@20 Current Thinking Working Paper - Financeability

National Grid owns and operates the high voltage electricity transmission system in England and Wales and, as Great Britain System Operator (GBSO), we operate the Scottish high voltage transmission system. National Grid also owns and operates the gas transmission system throughout Great Britain and, through our gas distribution business, we distribute gas in the heart of England to approximately 11 million offices, schools and homes.

The treatment of financial issues so as to ensure the financeability of efficiently-run networks is a critical element of regulation, and is important for consumers, not least because companies would otherwise be unable to obtain the funds to invest to provide the performance, reliability and customer service that current and future consumers require. This includes the investments needed to enable reductions in national greenhouse gas emissions and to ensure a secure supply of energy. It follows that Ofgem should not only have regard to the need to secure that licence holders are able to finance their activities (in line with the explicit statement of Ofgem's powers and duties), but should consider that maintaining the ability of networks to access sufficient finance on reasonable terms is an intrinsic element of Ofgem's principal duty to protect the interests of existing and future consumers.

These considerations are particularly important at a time when many energy networks are entering a period of high and increasing levels of investment[1], at the same time that many other industries (electricity generation, water, rail, roads, etc) also have high investment requirements. Attracting the funds for these investments will be a key challenge for the industry, and will require the regulatory framework and returns available to the network owners to be sufficiently attractive for these companies to be able to compete for investors' funds against other industries.

Ofgem have acknowledged[2] that their previous position on financeability[3] was one of the two main areas of the RPI-X@20 emerging thinking which has raised greatest concern. The updated straw man which has now been put forward by Ofgem includes some changes from the previous version, in particular the recognition of the role that rating agencies must play in ensuring financeability, and a description of the way in which allowed returns might be set in future price controls. However, it has

[1] In the "Project Discovery: Energy Market Scenarios" consultation (October 2009) Ofgem estimated between £30bn and £40bn of capital expenditure in Distribution and Transmission between 2009 and 2020 (see Appendix 2 page 95).
[2] "RPI-X@20: Summary of responses to Emerging Thinking consultation", Paragraph 1.3, Ofgem, 2010.
[3] "RPI-X@20 Emerging Thinking - Embedding Financeability in a new regulatory framework", Ofgem, 20 January 2010

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failed to address most of the fundamental concerns of the industry that were expressed in the responses to the previous consultation, in particular the feeling that Ofgem's work is too theoretical and needs to be tested against real-world criteria.

As with the earlier straw man, the new document takes as its starting point Ofgem's principal objective to "*protect the interests of existing and future consumers*" and its duty to "*have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations on them*". This duty is then interpreted as meaning that "*efficient network companies should be able to secure financing in a timely way and at a reasonable cost in order to facilitate the delivery of their regulatory obligations*." The current approach, whilst differing in some aspects between networks of different types, is well understood by stakeholders and has been adopted in previous price controls because it is a reasonable way of maintaining financeability. Ofgem should therefore exercise great care before making changes which go against past precedent, which could undermine predictability and the confidence of investors and other stakeholders.

The rationale behind Ofgem's current thinking on financeability appears to be the following:

- Financeability should be judged in the longer-term, underpinned by regulatory commitment - with the proposals in the working paper providing the commitment needed;
- The approach to depreciation and capitalisation should be based on the concept of inter-generational fairness, whereas under the current approach to depreciation and financeability current consumers are paying too much relative to future consumers;
- Provided allowed return, depreciation profile and capitalisation policy are set appropriately and consistently in future determinations the notional company should be financeable, albeit with a reliance on new equity or reduced dividends where necessary – so Ofgem will not advance cash-flows to address short-term financeability problems.

Each of these ideas is presented with little (if any) supporting evidence or reasoning, and on consideration each can be seen to be unsubstantiated.

Financeability and Regulatory Commitment

Financeability requires both short term and longer term considerations to be satisfied. As with any business, short-term cash flow considerations cannot be disregarded, but to ensure financeability a satisfactory position in respect of short-term cash-flow must also be complemented by longer term confidence in the stability and reliability of the regulatory environment.[4] In fact, because a licensee's cash flows beyond the end of the current regulatory period are completely dependent on the outcome of future price controls, any "longer term view of financeability" is <u>entirely</u> dependent on the faith of debt and equity investors that the regulator will in every case set future revenues at reasonable levels such that assets are not stranded (the RAV is honoured), a reasonable level of return can be achieved, and returns to investors are not indefinitely deferred.

However, the working paper fails to give proper consideration to this commitment issue: defining principles that might be used to set the cost of capital (especially when Ofgem would be able to change these again should they so choose) fails to address the real issues of regulatory (and political) risk and commitment which extend over many regulatory cycles and (potentially) changes of government. Investors will be even more dependent on the longer-term cash-flows that are subject to these risks if the changes proposed in the paper are implemented, yet the very act of changing the way Ofgem discharges its financing duty would undermine the confidence that investors can have in the regulatory commitment and whether a "promise" of eventual long-term returns will be honoured. Ofgem's aim, considered more fully in the section below, seems to be to delay and defer costs to consumers, yet this will increase the risk that the charges then needed many years (perhaps 20 to 40) in the future to repay past investments might not at that time seem affordable or acceptable. Clearly, if

[4] A parallel to this reasoning can be seen in the assessment of credit ratings by the rating agencies, which looks at a combination of short and medium term credit ratios as well as a range of qualitative factors, including the stability and nature of the regulatory environment.

such changes were made the cost of capital for the network companies and consequently charges to consumers (in present value terms) would have to increase as a result.

The inability to bind the decisions of future governments and regulators means that regulatory commitment is something that must be demonstrated by Ofgem through its actions and through consistency of approach over time, rather than being something that can be established through a statement of intent alone. Any significant changes to the approach to financeability can be expected to adversely affect the perceived level of regulatory commitment amongst debt and equity investors and rating agencies.

Intergenerational Considerations

It is far from clear that current consumers are paying too much relative to future consumers. In seeking to achieve intergenerational fairness, the approach to depreciation and capitalisation cannot be considered in isolation. The considerations raised in our previous response (and those of others) have not been addressed. These include the following:

- The regulatory approach previously adopted by Ofgem, in contrast to that in some other regulatory jurisdictions, involves setting allowed returns on a real rather than nominal basis (with the RPI element of returns being added to the RAV rather than being included in the allowed short-term return). This has the effect of reducing charges for current consumers relative to future consumers, whereas in other industries companies must generally set charges at a level that reflects their actual (i.e. nominal) borrowing costs. It is a major shortcoming that neither Ofgem's working paper nor the accompanying CEPA paper even considers this aspect of a price control which is critical to any assessment of intergenerational fairness.
- Under the regulation framework applied to energy networks, the RAV is not the current cost estimate of the value of specific assets that make up a network but represents the aggregate cost that has been incurred in making efficient investments on behalf of consumers that has not yet been recovered through network charges – and which the networks can be expected to recover through future charges. As such it follows that there is no rational basis why the timeframe over which this financial asset, the RAV, is recovered needs to be related to physical asset lives. Regulatory asset life (as used in calculating regulatory depreciation) can therefore be seen as a regulatory construct that gives an appropriate level of network revenue during a price control, consistent with the need for efficiently incurred investments to be repaid without stranding, rather than a parameter which should reflect physical or economic asset lives.
- Notwithstanding that regulatory asset life does not, therefore, need to reflect physical or economic asset lives, even on the narrow terms on which the current thinking paper is based the effect of changing asset lives couldn't be considered on a single asset basis, but would need to consider assets installed in many different years (included those which, under current asset lives, are fully depreciated). In considering intergenerational fairness on such a basis, it would be highly relevant that, in electricity, many assets that were installed pre-privatisation are still in operation and contribute to the services received by customers and consumers, yet current customers are benefiting by paying nothing by way of return and depreciation on these assets. Similarly, in gas, consumers continue to benefit from the "privatisation discount" in respect of assets that were installed before privatisation.
- The current treatment of gas distribution repex remains appropriate, and as previously explained by Ofgem fairly reflects the benefits to current and future consumers of the expenditure[5]. In the interests of regulatory consistency and to minimise regulatory risk this treatment should not be changed.

[5] See the Final Proposals for the Transco Price Control 2002-7, Page 4, "The renewal programme is primarily concerned with present safety requirements rather than increasing the network's capacity or functionality for the benefit of future consumers, suggesting these costs should be expensed and met within the price control period. Nevertheless there will be some advantages to consumers in the future as replacement spending will be lower and newer assets tend to require less repair and maintenance."

- As explained in our previous response to “Embedding Financeability”, balancing the interests of current and future consumers requires judgement, is far from straightforward and should be only one of the considerations in weighing up how much cost should be paid by consumers in the short term. It requires an assessment of the value of the services being provided to customers and consumers today and in the future, which is subjective and uncertain.
- Energy costs to consumers today are generally seen as unsustainably low, i.e. they do not reflect the cost of a sustainable, low-carbon supply[6]. Given the scale of increases in energy costs which are expected in the next decade, it would be inappropriate to increase the burden on future generations still more through changes to established regulatory methods which would delay, defer or back-end load the recovery of network investment costs.
- If financeability is to be maintained and networks are to have confidence to invest, it is critical that balancing the interests of current and future consumers is considered within the context that the costs of efficient investments made by networks should not be stranded. Given long-term uncertainties, and to mitigate the potential impact on possibly reduced numbers of consumers/users in the future, increases in asset lives would be ill-advised and reductions may become appropriate at some point.

As well as considering the asset lives that might be used to calculate regulatory depreciation, the current thinking working paper now raises the question of depreciation profiling, i.e. whether different forms of depreciation (such as sum-of-digits, reducing balance or “per unit”) could be used to reflect better the expected utilisation of assets through their lifetime. This additional level of complexity should not be introduced, as it would result in greater uncertainty and potentially subjective adjustments to price control revenues, the often arbitrary nature of which would unnecessarily increase the perception of regulatory risk.

Does an appropriate allowed return and reliance on new equity ensure Financeability?

The working paper[7] repeats the view previously expressed in the January consultation that financeability should be assured provided allowed return, depreciation profile and capitalisation policy are set appropriately and consistently in future determinations. Two initial points arise:

- In recognising the importance of future consistency on financeability, the paragraph implicitly concedes the requirement for consistency with past determinations also. Whilst consistency over time is clearly important, there is nothing special about 2010 as the point in time at which consistency starts to matter. In addition determinations that are in the future today will at some point be in the past, and so a principle that only required future determinations to be consistent can be seen to be meaningless. In reality, consistency, like regulatory commitment, is something that must be demonstrated, and it requires that consistency is maintained with past policy on capitalisation and depreciation policy.
- The paragraph concedes the role that depreciation and capitalisation policy play in ensuring financeability, and consequently the impact that increases to depreciation lives or changes to capitalisation policy could have on allowed returns.

If, as Ofgem appear to propose, depreciation and capitalisation were to be based on a narrow view of intergenerational fairness, this assertion comes down to whether setting an appropriate rate of return is then sufficient to assure financeability. It may be the case that if returns are set high enough sufficient finance could be attracted, but such high returns are unlikely to be allowed in price controls or seen as being in consumers’ interests. In the real world, and for reasonable levels of allowed return, it is self-evident that profitability and financeability are not equivalent. An adequate level of allowed return is a “necessary but not sufficient” condition for financeability, and as explained earlier other considerations (both short and long term) must also be satisfied if companies are to be financeable.

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[6] For example, in “Project Discovery: Energy Market Scenarios” (Oct 09), Ofgem estimated increases in wholesale gas and electricity prices between 2009 and 2025 of between 50% and 100% (see Figures 3.18 and 3.19).

[7] Paragraph 3.36 of “RPI-X@20 current thinking working paper, Financeability”, Ofgem, 19 May 2010

The working paper makes clear[8] that under Ofgem's current thinking any financeability problems that do arise can and should be solved by recourse to new equity or reducing dividends, rather than by Ofgem advancing cash flows. However, this thinking is also flawed: there are clearly many circumstances where new equity (and/or reduced dividends) should not be seen as the solution for financeability problems, for example where financeability problems result from the mismatch between "real" returns that are allowed under a price control and actual (i.e. nominal) interest charges[9]. It should also be taken into account that equity injections both have a cost (transaction cost and impact on required returns) and take time. The reservations over relying on shareholders/equity to maintain financeability that were expressed in the responses to the previous "Embedding Financeability" consultation have not been addressed.

Shareholders invest in companies for two reasons, for dividends and for growth, and so credit ratings and the stability of the regulatory framework are important for equity investors as well as lenders. Even long-term investors in utilities want a dividend stream[10], and if this was disrupted as a consequence of a regulatory settlement the confidence of investors in the regulatory commitment would be undermined, increasing the cost of capital and potentially curtailing the availability of all forms of finance. Regulators must apply great caution in looking for new equity to provide a solution to financeability constraints, as there is clearly a "reasonableness" limit to how much equity investors can be expected to invest to solve these constraints. It follows that even if Ofgem wanted to move towards a greater reliance on equity as the partial solution for funding increased network investment where this leads to RAV growth, it would be ill-advised to reduce the depreciation (increase the asset lives) on electricity network assets at the same time, adding to the level of new funding that would be required.

It is in the interests of consumers that the energy network sector remains sufficiently attractive to investors (both debt and equity investors) for the required level of future investment to be funded. With the proposed changes outlined in this updated strawman, which will result in delayed returns to investors, increased long-term exposure to regulatory and political risk, and a more prescriptive approach to setting allowed returns, there would be increased risks around the ability of networks to secure finance efficiently.

Impact of Straw Man on Cost of Capital/Allowed Returns

It is self-evident that investors are not indifferent to a re-profiling of returns, particularly where the proposed changes would result in an increase in regulatory (and political) risk. The interviews with investors that are reported in the Oxera report for the ENA[11] provide evidence to support this view. This Oxera report shows that even before the issues of increased regulatory risk are taken into account, the mere act of delaying returns to investors can be expected to materially increase the cost of capital, and the increased exposure to regulatory risk (including what Oxera call the time-inconsistency problem) that would be a consequence of the ideas in the current thinking paper could be expected to make an even larger contribution to the overall increase in cost of capital. In the original "Embedding Financeability" consultation, Ofgem committed to investigate the premium that investors (debt and equity) would require if cash-flow profiles were re-phased and delayed.[12] However, the current thinking working paper makes no reference to this work. Without this analysis

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[8] Paragraph 3.38 of "RPI-X@20 current thinking working paper, Financeability", Ofgem, 19 May 2010

[9] There is likely to be a practical limit to the borrowings that network companies can raise as index-linked debt at reasonably attractive rates, although even if all borrowings were index-linked the issues caused by the real/nominal mismatch would not disappear, as nominal borrowing costs have to be booked to the income statement whether the coupon rate is real or nominal.

[10] The "Embedding Financeability" consultation (January 2010) suggested that a different kind of investor might be willing to forego short-term returns which could ease future financeability constraints, but regulated utility activities do not have the characteristics to attract such investors.

[11] "What is the impact of financeability on the cost of capital and gearing capacity?", Oxera report prepared for the Energy Networks Association, 9 June 2010

[12] Paragraph 4.19 of Ofgem's paper "RPI-X@20 Emerging Thinking - Embedding Financeability in a new regulatory framework", 20 January 2010

the overall increase in costs to consumers (in NPV terms) that would result from the changes envisaged in the straw man cannot be justified.

Assessing Financeability

In assessing financeability Ofgem must reflect the approach of rating agencies and look at a range of ratios over the short and medium term (as well as a range of qualitative factors). The proposed approach (i.e. to focus on PMICR and net debt/RAV) described in the working paper at paragraph 3.43 appears inconsistent with the actual approach of the agencies[13], as well as with Ofgem's practice in previous controls and the approach of other regulators. It would not be possible for Ofgem to assess financeability and whether price controls allow companies to maintain an investment grade credit rating (consistent with their licence requirements) using different, or a more limited set of, ratios than the agencies who actually determine these ratings.

Ofgem's current thinking working paper suggests that focus should be switched to a different ratio (PMICR) from those used in recent price controls because, unlike these other ratios, it wouldn't be affected by the changes to regulatory depreciation that Ofgem consider in the paper. However, it is precisely because different ratios respond differently to different changes that a range of ratios needs to be used. Therefore, Ofgem must continue to reflect the approach of the agencies and look at a wider range of ratios, including FFO/Interest and RCF/Debt which as recently as DPCR5 were described by Ofgem as "key credit metrics"[14], and FFO/Debt (which was considered in TPCR4[15]).

However, in assessing financeability it is insufficient to look only at credit rating ratios and the position of debt investors, as the values of the financial ratios that are relevant to equity investors must also be considered. Price controls must allow reasonable values for these ratios to be maintained, if significant increases in the cost of equity are to be avoided and if the raising of new equity is to play any part in solving any financeability constraints. Ofgem's modelling of a price control needs to take into account the dividends that equity investors expect and require (or otherwise allow a significantly higher cost of equity), and must pay as much attention to the ratios which concern equity investors (dividend yield, dividend cover, etc) as the credit rating ratios. In assessing whether a price control offers a reasonable and financeable settlement, Ofgem must always assess the adequacy of these equity investor ratios.

If the ideas in Ofgem's working paper were implemented, a network company which was faced by significant increases in capex might, in the absence of accelerated regulatory depreciation, need to raise new equity to maintain appropriate debt to RAV levels. It is clear that this would lead to an increased cost of equity, and the impact on the cost of debt should also be carefully assessed. Debt investors would be unlikely to be completely sanguine about lending to a company that had a continual equity raising requirement, particularly where this requirement has not been the case historically. Care would need to be taken when using historical indicators to assess future costs of debt and equity in such an untried and untested environment.

Proposed cost of capital methodology

The current thinking working paper describes a methodology for setting the allowed return in future price controls. Whilst it could be helpful to define some aspects of the approach in advance, as explained earlier this would not meaningfully address the real issue of long-term regulatory commitment.

The allowed return is an important element in a price control but the settlement must be considered in the round with the other elements of the control which, if not acceptable to the companies concerned, can be referred to the Competition Commission.

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[13] Not all agencies use PMICR, but all agencies use a range of ratios as well as considering other factors such as the stability and nature of the regulatory environment.
[14] DPCR5 Final Proposals, "Allowed revenues and financial issues" document, Paragraph 6.19.
[15] TPCR4 Initial Proposals, Appendix 9 – Financial Issues, Table 9.3.

The methodology that is described appears to be broadly consistent with the approach that has generally been adopted in the past by Ofgem, but we have the following comments:

i) the overall price control settlement must recognise the distinction between the WACC and the allowed return, which must reflect those risks which are not explicitly taken into account in projected cash flows (e.g. the asymmetry that results from a post-investment future efficiency review);

ii) consistent with past precedent, we would support the continued use of real rather than nominal returns (with RPI being applied to the RAV), provided the effects of this approach are fully taken into account in setting other aspects of the price control and the effect on financeability is not overlooked;

iii) we support the continued use of a single allowed rate of return, provided this is set appropriately;

iv) on cost of debt, the proposed approach based on a trailing average value is similar to some of the evidence which Ofgem has considered in recent controls. However, a method based on past values may not be appropriate in all circumstances, and previous price controls have recognised the value of taking different evidence and ways of estimating the cost of debt into account. As with any change that is contemplated, it is important to avoid unintended consequences.[16] We also note that previous assessments of the relative merits of indexing the cost of debt have generally concluded that this is not in consumers' interests;

v) on cost of equity, we support no change in the approach previously used, i.e. use of a range of techniques, including CAPM. However, we note from Oxera's paper[17] that CAPM is unable to explain how cost of capital might vary with duration or profile of equity returns, and so could not be used to estimate the increased cost of equity if other ideas in the current thinking paper were implemented;

vi) the proposed approach appears to involve determining the gearing of the notional financial structure from the risks that a company is exposed to. However, this linear approach to setting the gearing would appear overly simplistic, particularly given that the amount of risk that companies will be exposed to will be decided by Ofgem based on judgement. In practice, other considerations will affect the appropriate gearing, including the impact of gearing on cost of capital, impact on financeability, the need to recognise that changing gearing carries a cost and takes time, and the need to take the views of investors (both debt and equity) and rating agencies into account.

Other Comments

A reservation with the capitalisation approach adopted in DPCR5 is whether it achieves its aim of equalising incentives. However, if Ofgem decide to continue with this approach, we agree that the percentage of total network expenditure added to the RAV should reflect each company's expected spend[18].

The current thinking working paper supports the use of RORE to calibrate an overall price control package. As explained in our previous response (to Ofgem's January 2010 "Embedding Financeability" consultation), we believe it would not be appropriate to have a disproportionate focus on a single measure or aspect of the control. RORE is a measure of return, not of financeability, and should not be seen as a substitute for ensuring that an efficient network is financeable.

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[16] Figure 2 in Ofgem's "RPI-X@20 current thinking working paper, Financeability" (19 May 2010) raises certain questions which themselves illustrate some of the practical difficulties that would need to be addressed before a pre-determined method for setting cost of debt could be introduced. These include: whether different bond issues can be readily compared, for example where these have different tenor, may have been issued below par, or were issued by companies having different gearing; the most appropriate way of adjusting nominal to real for these issues; and whether it is appropriate to consider a trailing average cost of debt for 10 yr bonds only.

[17] "What is the impact of financeability on the cost of capital and gearing capacity?", Oxera report prepared for the Energy Networks Association, 9 June 2010

[18] Paragraph 3.29 of "RPI-X@20 current thinking working paper, Financeability", Ofgem, 19 May 2010

Notwithstanding this, we would welcome the opportunity of working with Ofgem to address a few concerns we have with the way in which it is calculated.

The responses to the "Embedding Financeability" consultation previously received by Ofgem were generally opposed to main elements of the straw man and provided good reasons why they should not be implemented. This response to the current thinking working paper provides further good reasons not to implement the changes. If, in spite of these strong arguments from across the industry, Ofgem were to seek to implement the ideas presented, great care and caution would need to be exercised in respect of the timing and phasing of implementation. The ideas, if implemented, could have significant effects on the cash flows and financeability of some, if not all networks[19]. As the CEPA report observes[20], "*Good practice and pragmatic concerns mean that signalling a major change in policy and providing sufficient time for the new policy to become understood and implementable are important.*" In the executive summary of this paper, CEPA question whether the time to DPCR6 would give financial markets sufficient time to adapt to the new regime, and considers whether there should be a longer transition period with "*a partial solution for DPCR6 and the full new regime for DPCR7*". This is where theory meets reality: signalling an intended change may (or may not) allow markets to get comfortable with the proposed approach. This recognition by Ofgem's own consultants of the need for caution highlights the risks of adverse consequences and supports the view that the changes that have been suggested by Ofgem should not be implemented.

Conclusions

In conclusion:

- The current thinking working paper recognises the importance of regulatory commitment to financeability, but has failed to make any proposals that address the real issues of regulatory risk and commitment.
- Ofgem do not have the means to deliver reductions in future regulatory risk as they cannot fetter their own future discretion or the actions of future governments. An acceptable level of perceived regulatory risk therefore relies on a track record of reasonable price control settlements and consistency over time with past decisions.
- The intergenerational balancing of costs is affected by many different factors, including the regulatory decision to provide real rather than nominal returns. It requires judgement, and is far from straightforward. The case to delay the recovery of network costs so that more of the burden falls on future consumers – who are already expected to face significantly higher costs for secure, low carbon energy – rather than current consumers has not been made.
- An adequate level of allowed return is a necessary but not sufficient condition to ensure financeability, and in some cases deficiencies in cash flow metrics require cash flows to be advanced.
- In assessing financeability under a proposed price control, Ofgem will need to reflect the approach of the rating agencies and look at a wider range of ratios, not just net debt/RAV and PMICR.
- Given the importance of the sector remaining attractive to investors if the anticipated investment needs are to be met, price controls must allow dividends to be maintained. Equity investor ratios are therefore important, as well as debt cover ratios, and so must also be considered and maintained at acceptable levels in Ofgem's future assessments of financeability.
- Without any robust analysis of the overall increase in cost of capital and consequential increase in costs to (present and future) consumers (in NPV terms) that would result, the changes envisaged in the straw man cannot be justified.

In summary, to assess whether a proposed financeability framework is viable, it is necessary to consider whether the framework would provide a sufficiently attractive investment proposition for new

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[19] For example, the CEPA report "RPI-X@20: providing financeability in a future regulatory framework, May 2010", which illustrates, for 4 DNOs, the significant impact on 3 key financeability ratios of changing the asset lives used in calculating regulatory depreciation from 20 years to 40 years.

[20] Ibid, paragraph 11.5

(and existing) investors. Ofgem's straw man relies on certain key propositions, but for each has failed to make a sufficiently supported case: (i) the willingness of equity investors to accept deferred and protracted returns has not been proven; (ii) with such a profile of returns, the willingness of equity investors then to provide significant new equity when needed is unclear, (iii) under such a framework, investors would be expected to require high, speculative-level returns. It does not seem feasible for Ofgem, through future price controls, to impose this financing model on the energy networks, particularly at a time when they are facing increased investment demands, but even if it were feasible it is hard to see how the resulting requirement for such increases in allowed returns would be in the interests of consumers.

For some companies, the ideas presented could result in (i) reduced or zero dividends for many years, and/or a requirement to raise new equity to maintain an investment grade credit rating and support new and existing borrowings; (ii) a reliance on cash-flows many years in the future to deliver eventual returns (after perhaps 40 years), where these cash-flows are subject to significant long-term regulatory and political risk; and (iii) no basis for any confidence that the eventual level of returns will adequately compensate for this cash-flow profile and level of risk. These characteristics would risk making the sector unattractive to investors, raising the cost of capital and calling into question whether the investments needed to deliver a secure and sustainable energy supply in the future could be funded.

By way of contrast, RPI-X has served the industry and consumers well, and Ofgem's past approach to ensuring financeability has allowed significant investment to take place in energy networks since privatisation. Without confidence in the regulatory framework and regulatory commitment it will become increasingly difficult to fund the future investments in the industry that are needed, and the cost of funding these investments will rise, to the detriment of consumers. Continuity and consistency over time are important elements of the regulatory framework, and the current approach to financeability is well understood by the capital markets and investors on which the sector relies and will continue to rely. Given the past success of RPI-X and the approach to financeability that has been adopted within it, and at a time when a big increase in investment in networks is anticipated over the next decade to support the wider policy objectives in relation to sustainability and security of supply, Ofgem should exercise great care before deciding to make any material changes to the regime.

Yours sincerely,

[by email]

Paul Whittaker
UK Director of regulation