

RPI-X@20***Stakeholder working group on Financeability*****24 May 2010****Ofgem Offices, 9 Millbank, London*****Summary***

On 19th May 2010, we published a working paper on Financeability - as part of the ongoing RPI-X@20 project. The objective of this working paper was to provide stakeholders with more detail of our current thinking on the subject. We presented an "updated straw man," which built on the model initially laid out in our January Emerging Thinking document.

We followed up the publication of the paper with a small academic workshop on 24th May. The workshop was attended by stakeholders representing network operators, energy suppliers, Rating's Agencies, banks, academics and consultants.

The workshop included a series of three short presentations and was followed by a 1.5 hour group discussion on the issues raised in our working paper. The speakers included:

- Professor Julian Franks (London Business School / Director, Oxera), an adviser to the Energy Networks Association (ENA) on financeability,
- Ian Alexander (Cambridge Economic Policy Associates), an adviser to Ofgem on financeability,
- Peter Trafford (Head of Regulatory Finance) at Ofgem.

A PDF copy of each of the three presentations is available on our website¹. The main points discussed in the subsequent session are summarised below.

1) Method for setting the return on capital (e.g. single WACC vs. split cost of capital)

- A suggestion was made that the only way in which large levels of investment can be delivered is by clearly defining where individual risks sit within a regulatory framework and then setting an appropriate return to reflect them. It was suggested that the Regulatory Asset Value (RAV) should be remunerated by the cost of debt while the delivery of opex and capex should be funded by the cost of equity. Upon completion of the projects, assets would then be "sold" into the RAV.
- In contrast, it was argued that while Ofgem's proposals on financeability could be considered "evolution rather than revolution," the split WACC would certainly be a step-change and could scare investors. In addition, the perceived problems of Ofgem's previous approach could be rectified by the "updated straw man"

¹ <http://www.ofgem.gov.uk/Networks/rpix20/forum/financing/Pages/financing.aspx>

proposals, specifically the trailing average approach to the cost of debt, and that a fundamental shift (such as the split cost of capital) would not be necessary. A split WACC could also reduce the power of incentives.

2) Working paper proposal to put the concept of “regulatory commitment” at the heart of any future approach and to introduce a rate of regulatory depreciation that relates to the useful economic life of the assets.

The following points were made about these proposals:

- If regulatory commitment can be given then there will always be investment in regulated networks. However, there was a degree of scepticism as to whether or not regulatory commitment can actually be given e.g. there will always be some risk that a new regulatory team / government could re-write the previous rules/principles – increasing the risk of asset stranding.
- One way to give additional regulatory commitment is through longer-term price controls or mechanisms for elements of a determination to be ring-fenced for a longer period.
- How far can cash flows be pushed into the future and what would be the effect to the cost of capital? If cash flows are pushed out into the future (e.g. through the unwinding of accelerated depreciation) there may be a higher risk for both debt and equity investors - but arguably more so for the latter. This risk might need to be compensated with a higher return on equity as Ofgem would essentially be promising shareholders larger returns in the future at the expense of a decrease in near-term returns. This feedback loop needed to be acknowledged in Ofgem’s “updated straw man” model for it to work in practice.
- Recent conflicting market evidence was raised. 1) National Grid’s recently announced rights issue was cited as an example of a regulated company raising equity to fund growth. The implied cost of equity from this transaction was said to be high - at ~ 10% post-tax, real – although further time is needed for a robust estimate. 2) The rumoured sale price for EDF’s three distribution networks (at a premium to their RAV) could be evidence that the cost of equity is actually much lower than allowed. However, it is probably too early to reconcile these two pieces of evidence.
- Bristol Water’s reference to the Competition Commission was briefly mentioned as another important consideration for Ofgem. In their reference, Bristol Water highlighted Ofwat’s assumption for the company to address any financeability problem by an equity injection. The CC’s ruling could therefore be significant for Ofgem’s updated straw man.
- It was acknowledged that in both electricity and gas there are factors which could push the depreciation rates in either direction. For example in gas, the effect of a possible shorter economic depreciation period could be offset by a higher capitalisation rate for the repex programme albeit there are also arguments for treating repex as an operating cost.

3) The use of credit ratings and the modelling of cash flow ratios during a price control.

- In the working paper, it was stated that financeability would continue to be assessed in the round (although with a longer term focus) and that this would include consideration of cash flow ratios as published by the ratings agencies. PMICR and net debt/RAV seemed the most appropriate ratios.
- Ratings agencies take a 3-5 year view of cash flows and view price controls as "event risk."
- Ratings are becoming more important to investors given banking and insurance regulatory and capital adequacy developments.
- There was some debate about the appropriateness of PMICR. Factors discussed included that it could be more expensive to fix a PMICR "failure" with equity rather than by the regulator making an NPV neutral adjustment; that PMICR is less understood by investors in the energy sector versus those in UK water and that additional ratios should also be considered - as generalist investors compare many different sectors. Also, S&P do not use PMICR.
- Phoenix Natural Gas was cited as an example of where credit ratings agencies had taken a longer-term view of financeability by assigning a comfortable investment grade rating despite the company's weak prospective cash flow. However, spreads on Phoenix's bonds were ~ 100bps higher than for other UK utilities of a similar credit rating. It was suggested that this additional cost represented the value of a regulators track record and predictability although other factors such as the small size of the bond may be contributing to the higher spreads.