REGULATING ENERGY NETWORKS FOR THE FUTURE:

RPI-X@20 RECOMMENDATIONS

THE RESPONSE TO OFGEM'S RECOMMENDATIONS FROM

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NORTHERN ELECTRIC DISTRIBUTION LIMITED (NEDL) AND

YORKSHIRE ELECTRICITY DISTRIBUTION PLC (YEDL)

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SUMMARY

General observations

1. CE is strongly opposed to a small number of the changes being proposed by Ofgem, whilst being generally supportive of the RPI-X@20 project.

The price control review and the role of stakeholders

2. We would urge Ofgem to promote enhanced stakeholder engagement within a more realistic regulatory model that distinguishes between those aspects of a network company's programme that ought to reflect the preferences of stakeholders and those aspects where stakeholder consultation cannot be expected to shape the outcome.

3. Ofgem's residual position on third party references lacks coherence. If the arguments of the third party were insufficient to persuade the Gas and Electricity Markets Authority (the Authority) to reflect them in the *Final proposals*, it is hard to see how the arguments could be sufficiently powerful to merit a Competition Commission (CC) reference. On the other hand, if the Authority thought that the arguments had merit, it should prepare a modified set of *Final proposals* rather than waste the time of the CC, the licensee and third parties with a CC reference.

4. Ofgem's draft guidance with respect to the third party veto of price control proposals appears to accord broadly with the present state of the law except in one respect. We do not think that the non-participation of a third party in the price control review could be a relevant question when the Authority considers whether to make a CC reference.

5. Ofgem will have to take care to ensure that it does not operate the appeals policy so as to create a mechanism that conflicts with the Electricity Act.

Determining what network companies need to deliver

6. We agree with the general direction that is signalled in respect of outcomes and outputs.

Encouraging longer-term thinking with the price control

7. The proposal to move to an eight year price control will introduce more risk for licensees. There is also a danger that the current five year price control period will effectively become a four year period. The key to the avoidance of this pitfall lies in

the ability to specify the limits of the proposed outputs mini-review and, equally importantly, the judicious use of re-openers for specific cost risks.

8. We agree with Ofgem that complications are introduced if a different inflation index is used to update the regulatory asset value (RAV) and to adjust allowed income within the review period. The appropriate index to use is the retail prices index (RPI). This has the merit of being consistent with the concept of financial capital maintenance; it therefore ties in with the use of real, rather than nominal, returns in the allowed cost of capital.

Determining the revenue to be raised from consumers

9. We agree with Ofgem about the content of the new business plans and the role that plans should play at a price control review.

10. In principle we agree with Ofgem that there is benefit in differentiating between companies in the assessment of plans and the incentives that apply in the forthcoming regulatory period. However, we believe that for this to bring benefits to the overall process further consideration will need to be given to the incentives that would attach to the fast track option.

11. In principle we are not opposed to third party delivery but compulsory use of third parties gives rise to issues of regulatory oversight and, potentially, of stranded costs that would have to be resolved before it could be incorporated into the regulatory regime.

12. We agree that compulsion would mean that responsibility for compliance must move from the incumbent network operator to the third party and that Ofgem would have to become very deeply involved in the specification and management of the tender and delivery processes. However, we wonder what has led Ofgem to conclude that a Government agency such as Ofgem will be better at procuring the efficient delivery of the investment and the desired outputs than the existing licensee.

Ensuring efficient delivery is financeable

13. Ofgem’s proposals on financeability will significantly increase regulatory risk, increase the cost of capital and undermine important efficiency incentives that are present in the existing arrangements.

14. There is merit in a shorter asset life than the service life of the asset because this will send a sharper signal about the investment consequence of incremental demand, thereby focusing the attention of customers, regulators and licensees on the price consequences of investment

15. Ofgem's proposals to lengthen regulatory depreciation lives will visit on future generations the price consequences of the investment decisions that we are being urged to make today and in the immediate future.

16. Overall, moving the regulatory asset life assumption from 20 years to 40 years with effect from 2015/16 would have a clear and significant negative impact on our key financial ratios.

17. To ensure that we could continue to finance the business in the DPCR6 period, some transitional arrangements would indeed be necessary if Ofgem were to implement the financeability components of the RPI-X@20 conclusions.

18. Ofgem's financeability proposals would deny a licensee 'top line' revenue at precisely the time that it needs it to invest in the business, on the strength of a promise that it will be able to recover these amounts when it will not need the cash. The policy is misconceived; the promise of repayment in future years lacks credibility and there is nothing that Ofgem can do to overcome this.

19. Ofgem should allow companies to recover their actual cost of debt if the debt was incurred efficiently at the time it was taken on, even if subsequent market movements make that debt look expensive with the benefit of hindsight. We agree with the CC that the automatic tracking of the cost of debt within a price control period is not consistent with the regulator's financing duty.

Innovation stimulus package

20. We agree with Ofgem about the benefit to be derived from an innovation stimulus package.

INTRODUCTION

1. CE Electric UK Funding Company (CE) is the UK based parent company of the electricity distribution licence holders Northern Electric Distribution Limited (NEDL) and Yorkshire Electricity Distribution plc (YEDL). This paper is the response of CE, NEDL and YEDL to the following working papers published by Ofgem in July 2010:

- *Regulating energy networks for the future: RPI-X@20 Recommendations,* Ofgem, 26 July 2010 (Ref 91/10) (the *Consultation paper*);
- *Regulating energy networks for the future: RPI-X@20: Recommendations: Implementing Sustainable Network Regulation,* Ofgem, 26 July 2010, (the *Supporting paper)*;
- *A Guide to Price Control Modification References to the Competition Commission – Licensee and Third Party Triggered references,* Ofgem, 26 July 2010, (the *draft Reference Guidance);*
- *City Briefing: Introducing the RIIO model,* Ofgem, 26 July 2010, (the *Presentation pack);*
- *Regulating energy networks for the future: RPI-X@20: Recommendations: Impact Assessment,* Ofgem, 26 July 2010, (the *Impact assessment)*;
- *Cashflow profiles and the allowed WACC, CEPA,* July 2010 (the *CEPA Cashflow paper)*;
- *Cost of raising equity,* CEPA, July 2010 (the *CEPA equity paper)*; and
- *Short term relationship between equity and asset betas,* CEPA, July 2010 (the *CEPA asset betas paper)*;

OVERALL COMMENTS

2. CE is strongly opposed to a small number of the changes being proposed by Ofgem, whilst being generally supportive of the RPI-X@20 project. We will concentrate in this response on the areas where we disagree.

3. We have noted in our previous responses to Ofgem's RPI-X@20 consultation papers our concerns that, in a number of respects, Ofgem's proposals represent a fundamental departure from the privatisation model and that Ofgem has not made a compelling case to move away from this model to the extent that was foreshadowed in the 'emerging thinking' publications and is now confirmed as Ofgem's 'minded to position' in the

Consultation paper and the associated publications. In this response we shall concentrate on the aspects of the proposals that are new or were not fully developed in Ofgem's previous RPI-X@20 consultations. In so doing we have structured our response around the chapter headings that Ofgem uses in the *Consultation paper* making reference to the other associated papers where necessary.

CHAPTER 1 – INTRODUCTION

4. We have no comments to make on Chapter 1.

CHAPTER 2 – INTRODUCING SUSTAINABLE NETWORK REGULATION

5. We have no comments to make on Chapter 2 which sets out the overriding objective of energy network regulation which is to encourage network companies to:

   - play a full role in the delivery of a sustainable energy section; and
   - deliver long-term value for money network services for existing and future consumers.

CHAPTER 3 – THE PRICE CONTROL REVIEW AND THE ROLE OF STAKEHOLDERS

(i) Stakeholder engagement in the plans of a licensee

6. Ofgem clearly wishes to see more evidence that network companies' plans reflect the preferences of stakeholders. This is a worthy objective provided Ofgem and other stakeholders have a balanced understanding of what may be expected to result from such an enhanced engagement model. The prominence given to the issue throughout the RPI-X@20 project and, indeed, the terms in which its benefits have been described by Ofgem in the various consultations are, in our view, likely to mislead people because the inherent limitations on what can be achieved through stakeholder engagement have been passed over. We set out below four reasons why we think Ofgem has over-simplified or misrepresented the benefits of such engagement.

   - There is an absence of any real consideration of the legitimacy of the different interests that may compete and no rigour is brought to bear on important questions such as *who* is to balance these interests and what considerations should

guide that person in deciding *how* the conflicting concerns should be weighted and balanced.

- There is an assumption that a company's plans will be improved by enhanced stakeholder engagement. But why should that be so? It is easy to imagine circumstances where the well-being of the generality of customers runs contrary to the interests of a well-organised and articulate interest group. Is it not just as likely that a balanced set of proposals may be distorted by the effectiveness of a particular lobbying interest in the engagement process? A process of enhanced stakeholder engagement may help to highlight these conflicts but it would be wrong to expect that it would shed much light on what should be done.

- Ofgem clearly supposes that a network company's plans could properly be significantly varied by the process of stakeholder engagement. Before we make investments we carry out an investment appraisal. That appraisal sets out why the investment should be made. The justification for the investment is almost always grounded in a specific legal obligation: i.e. a failure to invest would leave us in breach of one or more of our duties. Admittedly these duties are often expressed in terms of doing what is 'reasonably practicable' to secure a given objective. However, they are *never* expressed in such a way that allows their meaning to be contingent upon stakeholders' preferences. Breach of such obligations is often a criminal matter. There is simply no scope for a distributor to be influenced by the expressed preferences of any stakeholder in any kind of engagement unless that stakeholder has a special expertise or locus in the enforcement or investigation of such matters. It really does not matter at all what customers, suppliers, trade unions, or even shareholders think about this. The duty remains and cannot be interpreted having regard to such an engagement. But it is duties such as these that determine over 80 per cent of our investment plan. There is relatively little that we do that is not justified by obligations of this kind. Indeed, if we went about our business by investing where Parliament, the Secretary of State or Ofgem had not placed duties upon us, or given us incentives to achieve particular outcomes, Ofgem would rightly challenge such investments. It is therefore very misleading to suppose that a distributor's investment plans could, or should, be materially influenced by the expressed preferences of stakeholders. Ofgem shows

some understanding of this constraint in the *Supporting paper* and says that a licensee should seek to vary its obligations when an obligation conflicts with the legitimate preferences of a stakeholder. It gives the example of the non-discrimination obligation in the carrying out of works for new connections. It is possible to see how a licensee could indeed make a case to be relieved of that obligation if Ofgem were persuaded that this would be consistent with its duties and with the principal objective. However, we are unable to see how it could work in the case of the duties placed on a distributor by the primary statute and by the Electricity Safety, Quality and Continuity Regulations (ESQCR). These cannot be negotiated away through a dialogue with stakeholders and with Ofgem. Yet it is these duties that determine the vast bulk of our costs.

- Ofgem is seeking to accord a significant place to enhanced stakeholder engagement in its scheme for the future. Ofgem wishes to impose a requirement on companies to demonstrate in business plans how they have reflected stakeholders' views, and proposes that companies' performance in reflecting stakeholder views is one area that may be taken into consideration in the overall settlement for each company. Without any consideration of the issues of legitimacy and the weighting of competing stakeholder interests, this becomes a matter of entirely subjective impression. This is undesirable. In our view the degree of regulatory discretion has increased, is increasing and ought to be diminished. Ofgem's proposals will incentivise companies not to do the right thing but to manage a slick engagement process, perhaps even deliberately proposing plans for consideration with a view to altering them so as to demonstrate the 'effectiveness' and the 'genuineness' of the engagement and thereby curry favour with the regulator so that the company is smiled upon when regulatory discretion is exercised. Incentives of this kind are corrosive of the integrity of the regime.

7. To be clear we are not arguing here against the principle or the practice of enhanced stakeholder engagement. We are supportive of Ofgem's wish to encourage network companies to seek out the views of those whom the network exists to serve. However, Ofgem should not expect that stakeholder engagement will have much effect on our asset replacement or maintenance programmes.

8. We agree with Ofgem that some worthwhile initiatives have emerged from, or been validated by, such exercises, especially when carried out by Ofgem. The introduction of the low carbon networks fund is a case in point. That seems to us to be an entirely proper use of an engagement process. In that case Ofgem listened to what people wanted, took into account its own duties, and created a regulatory mechanism designed to encourage behaviour consistent with both of those. The distinction between an Ofgem-led engagement process and the company-led engagement process is important. It is not appropriate for vested interests like ourselves to use a stakeholder engagement process to determine what we should do. We should respond to incentives and obligations which themselves have emerged, or may be assumed to have emerged, from the judgement of a public-interest body. That body may itself have found it helpful or informative to engage with stakeholders. But what is appropriate for Ofgem or the Secretary of State, with their public-interest remit, is not necessarily appropriate for a licensee.

9. We would urge Ofgem to promote enhanced stakeholder engagement within a more realistic regulatory model that distinguishes between those aspects of a network company's programme that ought to reflect the preferences of stakeholders and those aspects where stakeholder consultation cannot be expected to play a significant part in shaping the outcome.

(ii) Third parties and price control references to the Competition Commission

10. In the *Consultation paper* Ofgem sets out its conclusions about conferring upon third parties the right to trigger price control references to the Competition Commission (CC). Ofgem's proposed policy appears to us to have been designed to accord broadly with the present state of the law, except perhaps in one respect (dealt with below) and we have no objections on legal grounds to the text of the *draft Reference Guidance*.

11. The point that we think Ofgem may to need to reconsider is the legality of its intended position that it would entertain requests for a CC referral only from those third parties that had actively participated in the price control review process. We understand that this constraint is designed to encourage the active participation of third parties in the review, but we find it hard to reconcile with the current legal position under the statue. Surely the position is that if there were a good case for such a referral, the Gas and Electricity Markets Authority (the Authority) should make the reference irrespective of

whether the party making the reference had been active in the review. Conversely, a poor or marginal case for a referral cannot be improved by the fact that the party making the request had endeared itself to Ofgem by participating in the review. Those who have participated actively in the review are likely to be better placed to make a good case for the exercise of the referral power because their involvement will have given them deeper insights into the issues that the Authority has had to consider before making the *Final proposals,* but a referral to the CC is the exercise by the Authority of one of its functions under the statute. As such the Authority must be guided in the exercise of that function by its principal objective and its general duties. It is not clear to us that the non-participation of a third party in the price control review could be a disqualification or that the participation of a third party could be relevant to the exercise of that function.

12. We feel sure that in following the approach set out in the *draft Reference Guidance*, the Authority will bear it in mind that it would be improper to create an informal or *de facto* appeal right for third parties where the scheme for licence modification laid down in the statute confers a right of veto over modifications to the special conditions of the licence only on the licensee and the Secretary of State. The interests of third parties are protected by the duty placed on the Authority to consult about the exercise of its licence modification function and its function of making CC references. It would be a misuse of the discretion of the Authority for the Authority to introduce into its processes a policy that amounted to the conferring of a right of veto on parties to whom Parliament gave no such right.

13. The policy with respect to third party appeals as set out in the *Consultation paper* and the *draft Reference Guidance* appears to be the residue that is left after the Authority has considered and rejected both the formal and more explicit mechanisms for conferring third party rights and the alternative approach of constructive engagement. We struggle to understand the logic of this residual position. Since Ofgem appears not to envisage making a CC reference at the request of a third party that had not been an active participant in the review, we find it hard to construct a scenario where Ofgem would not already have considered the views of the third party in preparing its *Final proposals*. If the arguments of the third party were insufficient to persuade the Authority to reflect them in the *Final proposals*, it is hard to see how the Authority

would find the arguments sufficiently powerful to merit a CC reference. On the other hand, if the Authority thought, even at that late stage, that the arguments had merit, it should surely prepare a modified set of *Final proposals* and put these to the licensee rather than waste the time of the CC, the licensee and third parties with a CC reference that could be avoided if the licensee were prepared to accept a modified set of *Final proposals*.

14. In short, having rejected constructive engagement and a formal third party veto, the position that Ofgem is left with appears to lack coherence.

15. On a point of detail, it is not clear to us how Ofgem would treat third party requests for a CC referral with respect to a company that had been 'fast tracked'. Perhaps Ofgem supposes that in the case of a company that had succeeded in persuading Ofgem that its track record of delivery and its business plans were sufficiently impressive to merit fast track treatment, no third party would call for a CC reference. We do not think that would be a safe assumption to make because the interests that may request a CC reference may do so on grounds that stem from fundamental opposition to Ofgem's approach to the price control review or to the licensee's business plans, however well-conceived Ofgem may consider these to be. We suggest that this aspect requires further thought.

16. We have considered the implications for the *draft Reference Guidance* of the recent Department of Energy and Climate Change (DECC) *Consultation on the Implementation of the EU Third Internal Energy Package*. It is not clear to us whether the statement that DECC proposes to change the procedure for licence modifications so that Ofgem's decision can be implemented subject to appeal by the licensee to an appropriate body is confined to the collective modification process (i.e. to the standard conditions of the licence) or whether it extends to the special conditions (which are not subject to the collective modification process).

17. This is relevant because DECC states that its intention is that third parties affected by the regulator's decision would have the right to bring a judicial review (i.e. not a right of appeal on the merits of the case).

18. Our confusion over DECC's position arises because the opening words used by DECC to introduce its proposal indicate that the changes will apply to the collective

modification process, but later DECC suggests that the proposal includes 'all Ofgem licence modification decisions.'

CHAPTER 4 – DETERMINING WHAT NETWORK COMPANIES NEED TO DELIVER

19. We agree with the general direction that is signalled in the *Consultation paper* in respect of outcomes and outputs. Accordingly, we agree that the regulatory regime should focus on the desired outcomes and on the delivery of outputs related to these outcomes. Moreover, we agree that it is timely to move to a more outcomes-led framework and have been active supporters of the concept throughout DPCR5. This change in overall direction should enable Ofgem to put more emphasis on allowing companies that are performing well to set their own course.

CHAPTER 5 – ENCOURAGING LONGER-TERM THINKING WITH THE PRICE CONTROL

(i) The proposed eight year duration for the price controls

20. We concur with Ofgem's view that the existing regulatory framework is geared towards encouraging network companies to minimise costs in the short term and that this may not always be consistent with providing value for money over the long term. We can see the merit of extending the price control beyond five years if this can be done without giving rise to adverse consequences. However, we continue to urge caution because the history in the water sector, and our own experience since privatisation of the pressures that are brought to bear on regulators, suggest that a full price control period of eight years, with a mini-review after four years (to adjust for changes in outputs), may be difficult to sustain. In practice the interim review will be hard to insulate in the way that would be required to secure the incentive benefits of an extended price control period. In particular, where outputs have become more onerous but prices of inputs have fallen, is it plausible that Ofgem would deliberately allow a licensee to recover amounts in excess of the expected cost of meeting the combined effect of the previously agreed settlement and the new outputs? The problem here is partly the asymmetry of the position. Where a licensee is out-performing the initial price controls but the outputs have become more onerous we find it hard to see how Ofgem could isolate the out-performance from its consideration of whether to allow a mini-review and, if so, from its consideration of the additional income to be allowed to

cover the new outputs. On the other hand, we see no difficulty in believing that Ofgem would hold a licensee to the original bargain in circumstances where the costs of meeting that bargain had increased.

21. The asymmetry problem is exacerbated by the fact that, since a refusal to conduct a mini-review would not involve any licence modification, the licensee would have no ability to force a CC reference where the Authority refused to consider a mini-review. The obvious way to restore symmetry would be to make a provision that would enable the licensee to give notice of the disapplication of the entire control with the limitation that the disapplication could not take effect before the end of the fourth year. But this is precisely the mechanism that underpins the current five year duration, so we are back with the same problem of the mini-review. We have been unable to find a solution to this problem that does not lead back to something that is effectively a four-year review period.

22. In summary, therefore, the danger is that the current five year price control period effectively becomes a four year price control period. In our view the key to the avoidance of this pitfall will lie in the ability to specify the limits of the mini-review and, equally importantly, the judicious use of facilities such as re-openers for specific cost risks. We conclude that a move to an eight year price control period would add to the risks of the licensee but, provided this is accompanied by judicious use of uncertainty mechanisms, including re-openers for costs that are particularly hard to encapsulate within a revenue driver, we can see that the higher cost of capital may be justified by the superior incentive qualities of a longer price control duration.

(ii) The choice of inflation index

23. We note that Ofgem is proposing, at least for the time being, to continue to use the retail prices index (RPI) as the basis of the indexation of the regulatory asset value (RAV) at a price control review and of the indexation of allowed income within the review period.

24. We agree with Ofgem that complications are introduced if a different index is used for these two purposes. Moreover, we believe that the appropriate index to use is the RPI. RPI has the merit of being consistent with the concept of financial capital maintenance

(FCM); it therefore ties in with the use of real, rather than nominal, returns in the allowed cost of capital.

CHAPTER 6 – DETERMINING THE REVENUE TO BE RAISED FROM CONSUMERS

(i) The place of well-justified plans and outputs

25. We agree with Ofgem about the content of the new business plans and the role that plans should play at a price control review. This implies a world in which:

- credible plans play a larger part in determining regulatory allowances (at least for some companies);
- benchmarking plays a correspondingly smaller part (at least for those companies with credible plans); and
- Ofgem allows the incentives present in the regime (rather than regulatory assessment) to drive efficiencies.

26. We further agree that the incentive framework should focus on the delivery of outputs rather than the delivery of the individual components of the business plan and that Ofgem should ensure value for money by providing network companies with a package of incentives to look for the likely lowest-total-cost solutions over the long term.

(ii) Fast track reviews

27. In principle we agree with Ofgem that there is benefit in differentiating between companies in the assessment of plans and the incentives that apply in the forthcoming regulatory period. We remain of the view that Ofgem should commit to a binary solution: i.e. a company whose business plans and track record were satisfactory to Ofgem should have its business plan funded without further adjustments, but a company whose plans did not pass that test should go through a full price control review process.

28. We are supportive of the proposals that would enable companies with a good track record of delivery and well justified plans to complete their price control reviews more quickly. However, we believe that for this to bring benefits to the overall process further consideration will need to be given to the incentives that would attach to the fast track option. In particular, Ofgem would have to reconsider its traditional approach,

which is to take a very hard – some would say implausibly hard - line during the early stages of a review, only to soften its position to arrive at a more reasonable position at the *Final proposals*. We do not suggest that this is necessarily posturing or the assumption of a negotiating position; it may well be that Ofgem's initial views represent its genuine perception of the issues at an early stage in the review but that this position moderates as it comes under scrutiny and the Authority benefits from the comments received, arguments made and information provided during the course of the review.

29. If this pattern reflects the development of understanding by Ofgem (i.e. it is not a negotiating stance) this would suggest a problem of incentives in the introduction of the fast track review. For example, had there been a fast track route at DPCR5 a company offered the fast track option would have had to balance the benefit of an early settlement that might have allowed, say, the full recovery of its forecast network costs against, say, the disallowance of pension deficits that was being contemplated by Ofgem during the early stages of DPCR5.

30. Similarly, the fast track review would have to deal with matters that are part of the package at a price control review, but that are usually settled only at the end. These include matters such as the calibration of incentive mechanisms for quality of supply or losses. Ofgem's fast track process appears to be based on the supposition that all these important items can be settled a year earlier. An alternative approach might be for Ofgem to make 'no loser' commitments that would effectively ensure that a fast track company would not be disadvantaged by having qualified for, and accepted, the fast track route.

(iii) The role of third parties in delivery

31. We note that Ofgem wishes to retain the option (considered in previous RPI-X@20 consultations) of having third parties play a greater role in delivery and in the *Supporting paper* Ofgem gives further details of how this might work. We agree with Ofgem's assessment of the limits on the extent to which Ofgem can require network companies to transfer assets that they have invested in with a legitimate expectation that they would retain ownership of these assets in the foreseeable future.

32. It is clear that the criteria that Ofgem is setting for compulsory third party involvement in delivery (particularly those criteria relating to the size and separability of the projects) could more easily be met in the case of transmission licensees than in the case of distributors. In principle we are not opposed to third party delivery – indeed much of our investment plan is already delivered by third parties – but compulsory use of third parties gives rise to issues of regulatory oversight and, potentially, of stranded costs that would have to be resolved before it could be incorporated into the regulatory regime as part of the set of remedies available to a regulator where other incentives appeared not to be working effectively.

33. Ofgem distinguishes between an increased role for third parties in the delivery of investment or outputs for which the incumbent licensee remains responsible and the delivery of investments and outputs where the third party takes full responsibility. In the latter case Ofgem has said that the obligations and rights associated with the project would be taken outside the core price control. Ofgem recognises that under this scenario Ofgem would be responsible for designing and running the competitive tender process for evaluating the bids from the third parties, choosing the winner and regulating the delivery of the project.

34. We agree that once the compulsory route is chosen it is logical that responsibility must move from the incumbent network operator to the third party and that Ofgem would have to become very deeply involved in the specification and management of the tender and delivery processes. However, we wonder what has led Ofgem to conclude that a Government agency such as Ofgem will be better at procuring the efficient delivery of the investment and the desired outputs than the existing licensee.

CHAPTER 7 – ENSURING EFFICIENT DELIVERY IS FINANCEABLE

(i) The importance of financeability tests

35. We have argued in previous responses to RPI-X@20 consultation papers that Ofgem's proposals on financeability will significantly increase regulatory risk, increase the cost of capital and undermine important efficiency incentives that are present in the existing arrangements. Ofgem's proposals suggest a diminution in the importance that Ofgem will attach to financeability considerations in future price control reviews, which is at odds with the realities of the financial markets and with Ofgem's insistence that

network businesses are inherently low-risk. Ofgem seem to be arguing that long-term investors will not be troubled by the proposals and only those with a short-term horizon will find themselves dissatisfied with the outcome. We regard ourselves as being well-placed to comment on what a long-term investor might think about these proposals and, in that context, we can confirm that our shareholder regards the prospect of such a drastic reduction in cashflows in 2015 as a very negative impact and a significant regulatory risk.

36. We agree that efficient, well-managed network companies must be able to access finance on reasonable terms and that there should be no 'bail out' for inefficiency. However, we do not agree with Ofgem's proposition that the depreciation charge should reflect the average expected service life of network assets. The regulatory system does not reflect or derive its outputs from accounting concepts of operating costs and capital costs and, therefore, using concepts of depreciation to determine cash flows is misleading. It would be preferable for Ofgem to adopt the vocabulary of 'payment terms' rather than of 'depreciation periods' in this context.

37. The *Consultation paper* and the *Supporting paper* do not mention the fact that, in the past, items of cost that, in accounting terms, would be expressed as operating costs have been remunerated through RAV. We note that Ofgem is considering the use of a percentage that is consistent with the treatment in the statutory accounts of the licensee. However, we do not agree with the fundamental proposition that the repayment period should be aligned with, or derived from, accounting concepts or principles.

38. Ofgem notes that equalised incentives for opex and capex require that any benchmarking should be carried out on a total cost basis. We urge Ofgem to start work on this aspect of its proposals soon as we believe that the difficulties associated with total cost benchmarking will require considerable thought.

(ii) The benefits of shorter payback periods in terms of price signals

39. We have argued previously that there is merit in the payment terms being concentrated over a shorter period than the service life of the asset because this will send a sharper signal about the investment consequence of incremental demand, thereby focusing the attention of customers, regulators and licensees on the price consequences of investment. We made this point at the last electricity distribution price control review

(DPCR4) and in all of the relevant responses we have made to the RPI-X@20 consultations. The point has not been addressed in any Ofgem publications but we believe that it has merit and should be considered seriously.

(iii) The price consequences of extended depreciation lives

40. Our own analysis of Ofgem's financeability proposals indicates that an extension of asset lives to 40 years from the 20 years assumed at DPCR5 will result in a smaller price increase for CE customers in the DPCR6 period (3% in nominal terms). However, prices at DPCR7 would need to increase by about 40%. In real terms, there would be a reduction in prices in the DPCR6 period of 12% but this would be followed by real price increases of 16% in the DPCR7 period and 14% in the DPCR8 period. Retaining the current 20 year asset life results in a real increase of 9% in the DPCR6 period followed by a 5% real increase in the DPCR7 period; prices would then remain relatively flat in real terms in the periods covered by DPCR8, DPCR9 and DPCR10. Ofgem's proposals will visit on future generations the price consequences of the investment decisions that we are being urged to make today and in the immediate future.

41. The Ofgem proposal to extend asset lives would increase the future RAV of CE. The value of the RAV in 2007/08 prices would increase in 40 years time from £2.4bn to £4.7bn (in real terms). Across the DNOs we estimate that this will increase total RAV values from around £19bn to £38bn. Ofgem also suggests that electricity transmission asset lives could increase beyond the current 20 year assumption. If the transmission asset life were also increased to 40 years, electricity network RAVs would increase by over £30bn. Assuming 65% of this funded by debt this would mean that we would be saddling future generations with around £20bn of extra debt. The parallel with the deficit in public finances is striking.

42. Of course when customers eventually pay for the assets being invested in over the near term they will pay much more in cash terms because inflation and return must be added to the sums that must be recovered. It is surely the case that the customers' discount rate is lower than the companies' discount rate. The various generations of customers are not therefore NPV-neutral to the extension of the repayment period.

43. The question of intergenerational fairness has to look both ways. Ofgem is concerned that today's customers may pay too much if they have to bear too big a share of the costs of assets from which later generations will also benefit. However, today's customers are paying too little of the costs of the assets that serve them today. This arises because the privatisation discount was followed by the acceleration of the depreciation of the pre-vesting assets so that many of the assets that are used to service customers today have been fully depreciated and therefore do not appear in RAV. Ofgem's treatment of the issues emphasises the intergenerational 'unfairness' that it supposes would arise from the continuation of the 20 year life without taking account of the distortion that is already locked into today's prices by the treatment of this subject since privatisation.

(iv) Phasing-in of Ofgem's financeability proposals

44. We note that Ofgem has stated that it will consider phasing in the financeability aspects of the RPI-X@20 recommendations if this is necessary. In this connection we note that Ofgem has also published a paper from CEPA that considers the phased implementation of any changes. This could be signalled several years before implementation occurs. The benefits CEPA envisage from phasing include:

- limiting uncertainty and consequently not increasing costs unnecessarily;
- providing time for the impact of previous regulatory determinations to be unwound; and/or
- providing time for existing investors to change their ownership without causing unnecessary windfall losses through fire sales.

45. CEPA also recognise that a sudden change in the approach to financeability could:

- increase the cost of accessing finance in the short-term as the markets learn about the new regime and test how it is being implemented;
- face a cash-flow precipice owing to the impact of accelerated depreciation and expensed investments; and

- lead to existing ‘income’ investors wishing to reduce their ownership and ‘growth’ investors taking up stronger positions.

(v) The impact on financial ratios

46. If Ofgem is to implement its financeability proposals, the judgement about whether to have a phased introduction must take into account an assessment of what would happen to key financial ratios for companies if the existing ‘correction’ for financeability were to be unwound. CEPA’s initial conclusion, at the aggregate level, is that it is possible that the ratios may indicate that phasing could be required.

47. We have modelled the effects on CE’s ratios of the various depreciation scenarios that are shown in the chart that appears on slide 59 of the *Presentation pack*, namely:

- a 20 year life (i.e. current regulatory depreciation policy);
- a 40 year life (i.e. full implementation of the Ofgem’s financeability principles without any transitional phasing);
- a gradual movement from a 20 year to a 40 year life over the length of one price control (2.5 years p.a.);
- retention of the 20 year life for investment currently in RAV, with a 40 year life assumed for new additions only; and
- a 40 year life for all investment, using a ‘sum-of-years-digits’ form of depreciation for existing RAV (front loading) and ‘straight-line’ depreciation for new additions.

48. Based on a 40 year asset life (i.e. full implementation of the Ofgem’s financeability principles without any transitional phasing on extending asset) and in line with Ofgem thinking, the level of Senior Net Debt/RAV has been held constant by assuming additional equity injections. The following points arise from this analysis:

- The decrease in regulatory depreciation, leading to a higher RAV, has a very slight benefit to our adjusted interest cover ratio, increasing it by [*]x as the capex needed to maintain our RAV is lower.

- Ofgem in its updated straw man indicated that the gearing ratio and the adjusted interest rate cover ratio (or the similar PMICR) are the ratios that Ofgem will consider for financeability tests. We note that Ofgem has emphasised the importance of the ratios that are not adversely affected by the change in depreciation life.

- However, when we examine the ratios used by the ratings agencies (on whom the providers of capital rely) to test our plans, we notice that all the other liquidity ratios suffer greatly under the extended depreciation life due to the reduction in the amount of cash received from customers. Retained Cash Flow/Capex (RCF/Capex) falls to such an extent that we would generate [*]% of our capex needs from our operations, compared to an expectation of [*]% in our plan. With no dividends being paid in these years we could expect the ratio to remain in the [*]% to [*]% range.

- Both the Funds From Operations/Net Debt (FFO/Net Debt) and RCF/Capex ratios would be severely reduced by the change in regulatory asset lives. FFO/Net Debt would fall by around [*]bps and RCF/Capex would fall by around [*]bps.

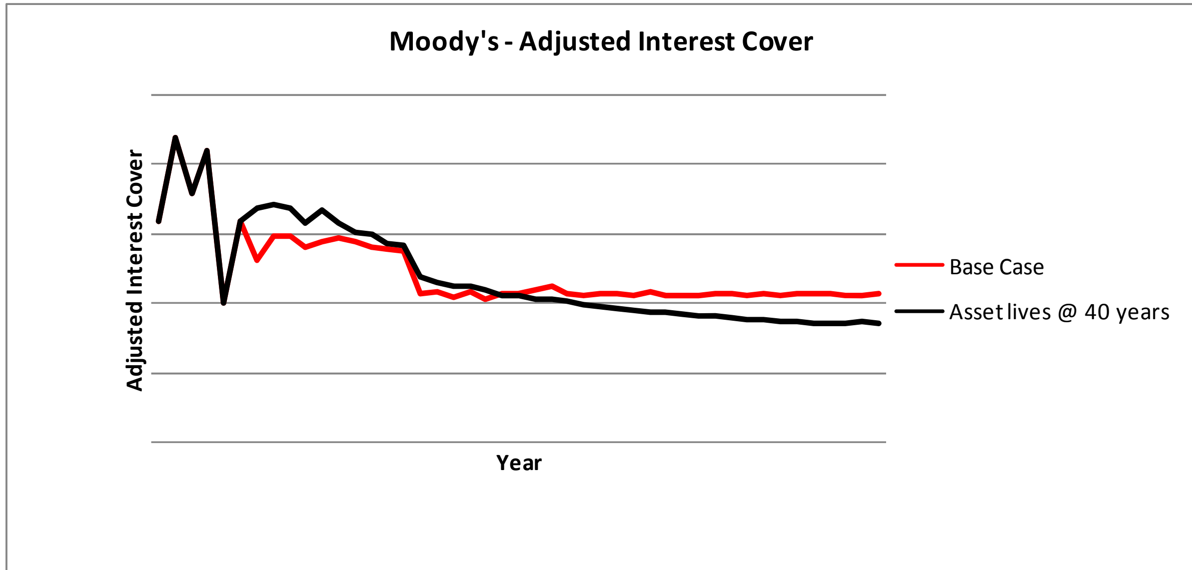
- From a debt covenant point of view our interest cover (defined in the covenants as EBIT/Interest) would be severely reduced (by as much as [*]x at a group level). We would have about [*]x headroom against our existing covenants.

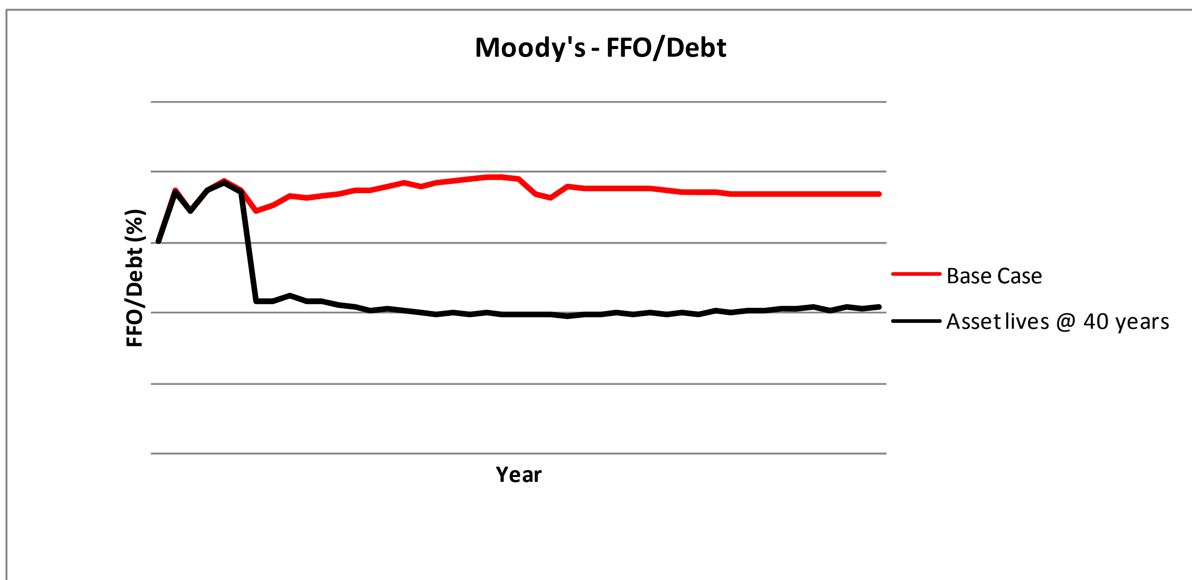
49. Overall, moving the regulatory asset life assumption from 20 years to 40 years with effect from 2015/16 has a clear and significant negative impact on our key financial ratios.

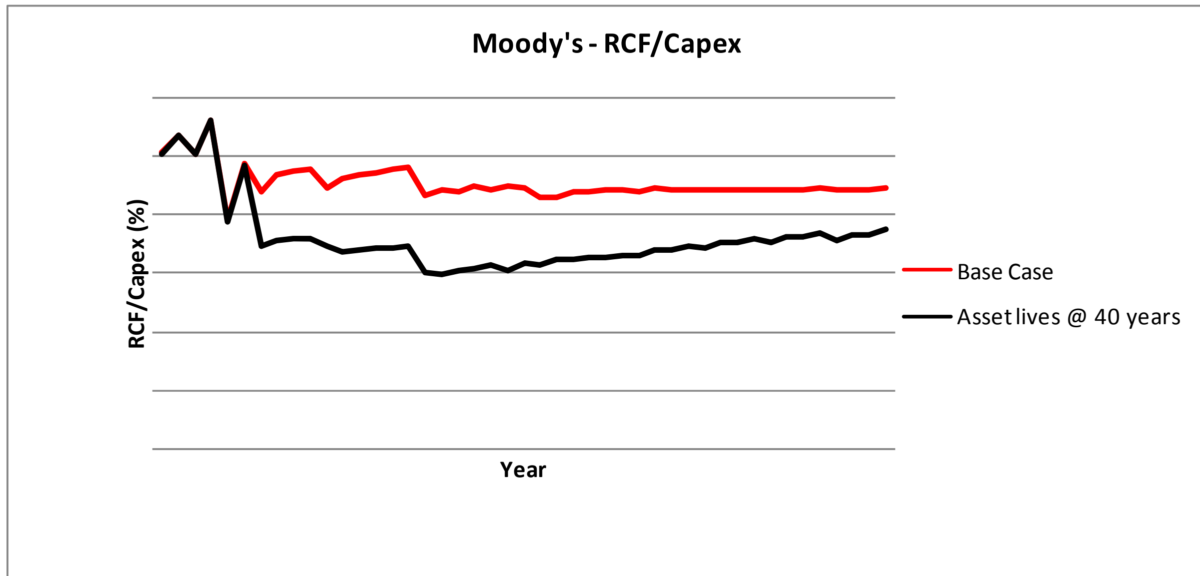
50. From this we conclude that, to ensure that we could continue to finance the business in the DPCR6 period, some transitional arrangements would indeed be necessary if Ofgem were to implement the financeability components of the RPI-X@20 conclusions.

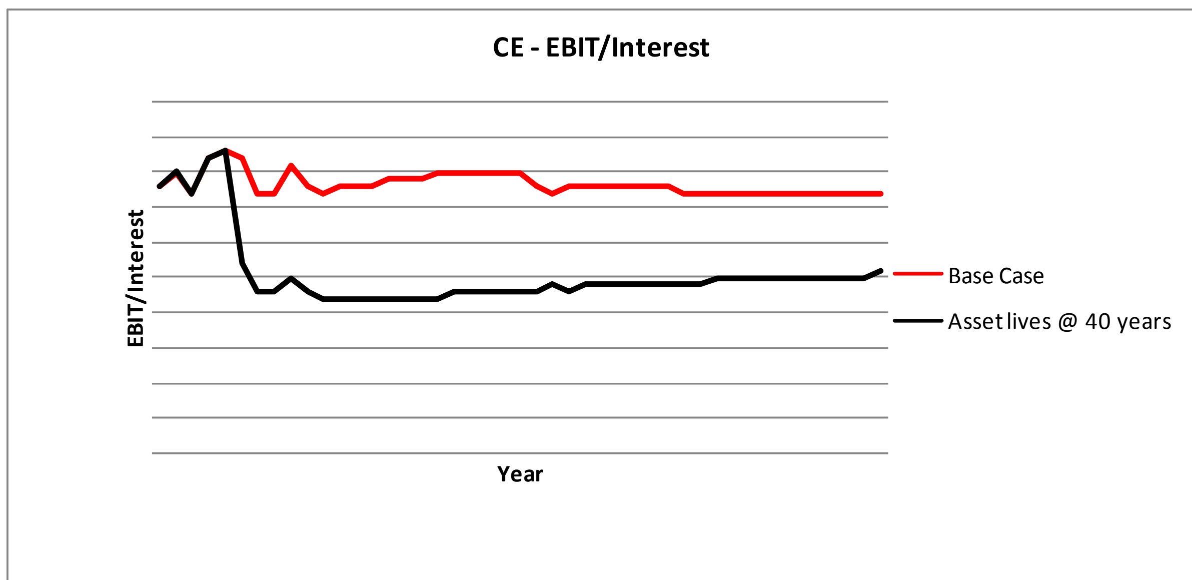
51. However, we also have fundamental concern about the longer terms aspect of the proposals.

52. We have modelled forward the impact on CE's key ratios assuming the same speed of money as in the DPCR5 *Final proposals* and we present the impact on the key ratios below:









53. In this modelling we have held the gearing at current levels. Ofgem may be assuming that the impact of extending asset lives on ratios is short term and that over the longer term ratios return to levels currently being experienced with depreciation based on 20 years. The above graphs show that any gradual return is very long term and indeed on most of the measures the ratios do not recover to current levels at all.

54. At DPCR5 we supported Ofgem's move to introduce more equal incentives for operating and capital expenditures. We note that the *Consultation paper* and the associated papers contemplate the deeming of a ratio between 'fast' and 'slow' money that is more closely aligned to spend in the opex and capex categories than it was at

DPCR5. We do not share Ofgem's assumption that the repayment period for investments made by network companies should be determined by reference to the accounting concept of depreciation. Moreover, if Ofgem were minded to fix the ratio of 'fast' to 'slow' money in this way, the consequences in terms of financeability would have to be considered. We believe that if this approach were to be adopted together with an extension of the asset lives from 20 years to, say, 40 years, the consequences for the ratios that determine our credit rating would be seriously adverse.

55. We note that in the water industry investment in underground assets is treated as fast money and suggest that the adoption of this kind of treatment may result from similar difficulties in ensuring that the companies are financeable and are able to retain investment grade ratings.

56. As far as the assets that are represented by the existing RAV are concerned, companies made those investments under a regulatory regime that was based on the current assumptions about depreciation and financeability. We do not believe that Ofgem can now significantly change the basis on which *these* assets are remunerated. Such a retrospective action would amount to a breach of the regulatory contract. This point has implications for the design of any transitional arrangements.

57. We note with concern that Ofgem appears to be considering a depreciation method that would defer the cash flows even further on the grounds that utilisation of the asset may increase over a long period and the recovery of the costs should be tilted in recognition of this. This expedient would make the problems that we have described even worse.

58. Ofgem's proposal to consider back-end loading the depreciation profile to take account of the fact that load will grow over time fails to recognise the salient point that network costs are driven by the costs of meeting peak demand. The advent of electric vehicles and other parts of the environmental agenda will not give rise to costs that will rise with the take up of the service, but it will generate investment needs in the short term. The idea that the depreciation profile should be back-end loaded flies in the face of conventional economic pricing principles.

(iv) The implausibility of the commitment to allow recovery in future and the impact on the allowed cost of capital

59. In general terms Ofgem's financeability proposals may be summarised as placing less emphasis on short-tem levels of credit rating metrics and giving equity a greater role in maintaining credit rating metrics. On behalf of Ofgem, CEPA has argued that lengthening depreciation periods has no impact on the cost of capital because the yield curve is relatively flat between 20 and 40 years.

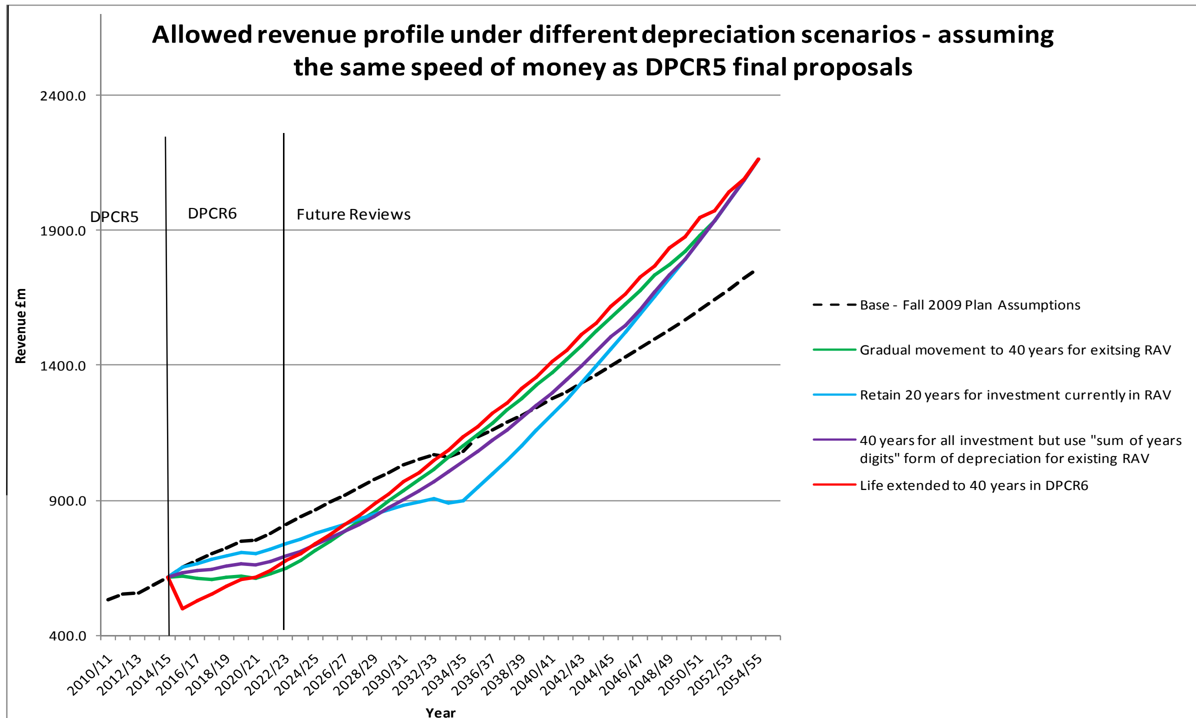
60. We do not agree with CEPA's assessment. In particular, the timing of the cash flows is relevant to both equity investors and lenders to whom what matters is (a) cash flows in the regulatory period and (b) cash-flows over the lifetime of the regulated assets. Looked at from both these perspectives, the Ofgem proposals significantly extend the repayment period and this introduces additional risk that would increase the cost of capital.

61. These theoretical discussions should continue and will no doubt assist the Authority in reaching its decision on the recommendations proposed by Ofgem.

62. However, we would urge that a degree of common sense in brought to bear on the question. It is surely obvious that the inability of a regulator to make binding commitments about cost recovery in the future must increase perceptions of risk if the cash flows are deferred to a period in which the licensee will not need the cash to continue to operate.

63. Ofgem's proposals would defer the recovery of investment made in the next decade far into the future. This leads to stress on financial ratios as shown in the foregoing paragraphs. In addition, under all the scenarios we have considered, at some point in the future (between 2034 and 2044) the income lines cross and we would start to recover more cash from customers under Ofgem's proposed 40 year life than we would if the current policy were to be maintained.

64. The graph below shows the allowed revenue of CE under different depreciation scenarios, assuming the same speed of money as in the DPCR5 *Final proposals*.



65. Our problem with all of the profiles illustrated in the graphs above is that the recovery of our investment will be secured only if we can sustain the position of a widening gap that opens up in the later years. No regulator can bind its successors and it is not fanciful to imagine an Authority, comprising different individuals, within a different political climate, perhaps with different duties given to it by Parliament, or even possessed of a different view of the existing duties. The credibility problem is that under all these scenarios the licensee would have shown that it could finance its continuation in business on tighter ratios than would be present in these later years. The improvement in ratios at that time would be justified only by the, admittedly powerful, argument that the licensee was entitled to recover the investments that it had made in the past to meet its statutory duties. But a regulator might be tempted to argue that these represent sunk costs and that the duty on the regulator to ensure that the licensee can continue to finance its activities can be met without such a cash-positive position. We do not know how politicians, society or, indeed, regulators will look upon the investments made in the next decade in pursuit of a low carbon economy in, say 2054. The notion that, over such a long period of time, the regulatory assumption underpinning the current PRI-X@20 conclusions will be sustained is, in our view, hubristic.

66. For these reasons we believe that Ofgem should reconsider its financeability proposals having more regard to the inescapable truth that it cannot bind its successors. Where analysis of plausible scenarios indicates that recovery of sunk costs will only be achieved decades into the future, at which time companies must be expected to be highly cash-positive, Ofgem should think again about the credibility of its position. Confidence that costs will be recovered is essential to the maintenance of a low cost of capital for network companies. For any changes implemented as a result of the RPI-X@20 project to be considered sustainable there should be a broad equivalence between the cash coming into the business and the cash leaving the business. The RPI-X@20 conclusions with respect to financeability do not meet that test.

(vi) Conclusions with respect to the extension of depreciation lives

67. In summary, Ofgem's financeability proposals would deny a licensee 'top line' revenue at precisely the time that it needs it to invest in the business, on the strength of a promise that it will be able to recover these amounts when it will not need the cash. The policy is misconceived because it fails to recognise the realities of the markets in which licensees have to finance their activities and it fails to take account of the range of factors to which the ratings agencies pay attention. Moreover, the promise of repayment in future years lacks credibility and there is nothing that Ofgem can do to overcome this.

68. We do not see the merits of a situation where Ofgem would *deny* a company access to cash at a time when it needs it only to promise to give it *more* cash (i.e. the same net present value) in the future. The result would be that the customers would have been saddled with a financing charge that could have been avoided. It seems difficult to argue that this is an appropriate way to look after customers' interests.

69. Furthermore, we are concerned that Ofgem has not properly thought through the implications for the sector of encouraging a change in ownership to a species of investor that is supposed by Ofgem to be prepared to wait for a very long time for their money. We have seen no evidence that such investors exist but, even supposing that they do, these investors would surely place more emphasis on ensuring that long-term investments can be justified so as to lock-in the future value of RAV (as opposed to having a more balanced approach to the total costs of the asset base). Perhaps Ofgem has decided that its own cost reporting and benchmarking techniques will be enough to

drive efficiencies and prevent the build up of an excessive RAV but we would argue that too much focus on long-term RAV values will not encourage the most efficient outcome for customers.

(vii) The use of a mechanistic ten year trailing average for the cost of debt

70. The debate about the appropriate cost of debt that takes place at price control reviews has suffered from a lack of consistency on the part of Ofgem about what it is trying to achieve when it reaches a judgement on the appropriate cost of debt. For example, at DPCR3 Ofgem made an explicit allowance for the higher cost of embedded debt. At DPCR4 the contribution towards embedded debt costs was handled by using a long run trailing average. At both these reviews, albeit in different ways, Ofgem was explicitly or implicitly recognising that companies would need to finance and re-finance their businesses from time to time and that the cost of debt of an efficiently financed company would reflect the market conditions that prevailed at the time that the instrument was negotiated. Ofgem did not present the issue as a purely forward looking exercise.

71. At DPCR5, however, Ofgem presented the difference between the cost of debt assumed at DPCR4 and the rates that prevailed in the markets during the DPCR4 period as out-performance in the return on regulatory equity (RORE) analysis. Similarly, some commentators argued that using an index to adjust the cost of debt over the price control period would solve the 'problem' of 'aiming high' to cover the risk that debt rates might increase over the next price control period. This presentation of the issue gave the impression that the regulator's proper concern was solely to allow for the market rate of debt in the forthcoming period, rather than to reach a pragmatic decision that both looked ahead, because of the need to finance or re-finance in the next period, and also looked back, because a company's actual debt costs would reflect the debt costs in the financial instruments to which it was already committed.

72. We have argued in the past, and we continue to believe, that the regulator should allow companies to recover their actual cost of debt if the debt was incurred efficiently at the time it was taken on, even if subsequent market movements make that debt look expensive with the benefit of hindsight.

73. Ofgem's proposals whereby the cost of debt would be embedded in the allowed return, based on a long-term trailing average of forward interest rates, adjusted annually, has the merit that it will capture, to some extent both the cost of debt in the forthcoming period and the cost of debt in the previous ten years. However, it is not clear that such an approach is consistent with the statutory duties of the Authority with respect to securing that the licensee can finance its business. It is easy to imagine circumstances where a licensee would need to take on a significant amount of debt in the next period and that debt would be available only at rates that were in excess of the long-term trailing average in the price control formula. In that case Ofgem's approach would be inconsistent with its financing duty. It is equally possible to conjecture a scenario where the converse is true.

74. For those reasons the CC rejected the use of a long-run index in the Bristol Water case, describing this as inconsistent with the duties of the CC in the reference. It appears that the CC considers that a regulator cannot escape from making a reasonable estimate of the likely cost of capital in the relevant price control period and that such an assessment should take into account the real circumstances of the licensee, including its actual debt commitments. We appreciate that this brings with it the need to make judgements about whether a company has made efficient financing decisions, but we believe that it is not possible for the Authority to circumvent its duty in this respect. The CC recommended a weighting of three quarters for existing debt and one quarter for new debt costs in the recent Bristol Water case. We suggest that the Authority might have regard to this precedent as it considers the recommendation in the *Consultation paper.*

CHAPTER 8 – INNOVATION STIMULUS PACKAGE

75. We agree with Ofgem about the benefit to be derived from an innovation stimulus package. This is necessary because, as Ofgem acknowledges the benefits of innovation will often come through in more than one price control period and will accrue to parties other than network companies. The innovation stimulus package helps to overcome these disincentives to investment in innovation.

CHAPTER 9 – SUMMARY

76. We have no comments to make on Chapter 9.