



*ofgem*

**RIIO|T1**

**RIIO|GD1**

## **FINANCEABILITY ISSUES**

**City workshop  
1 February 2011**

## Agenda

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2.00pm

### **Presentation**

Stuart Cook, Senior Partner, Smarter Grids and Governance, Ofgem

2.30pm

### **Breakout discussions**

3.30pm

### **Closing remarks and Q&A**

Presentation

# **STUART COOK**

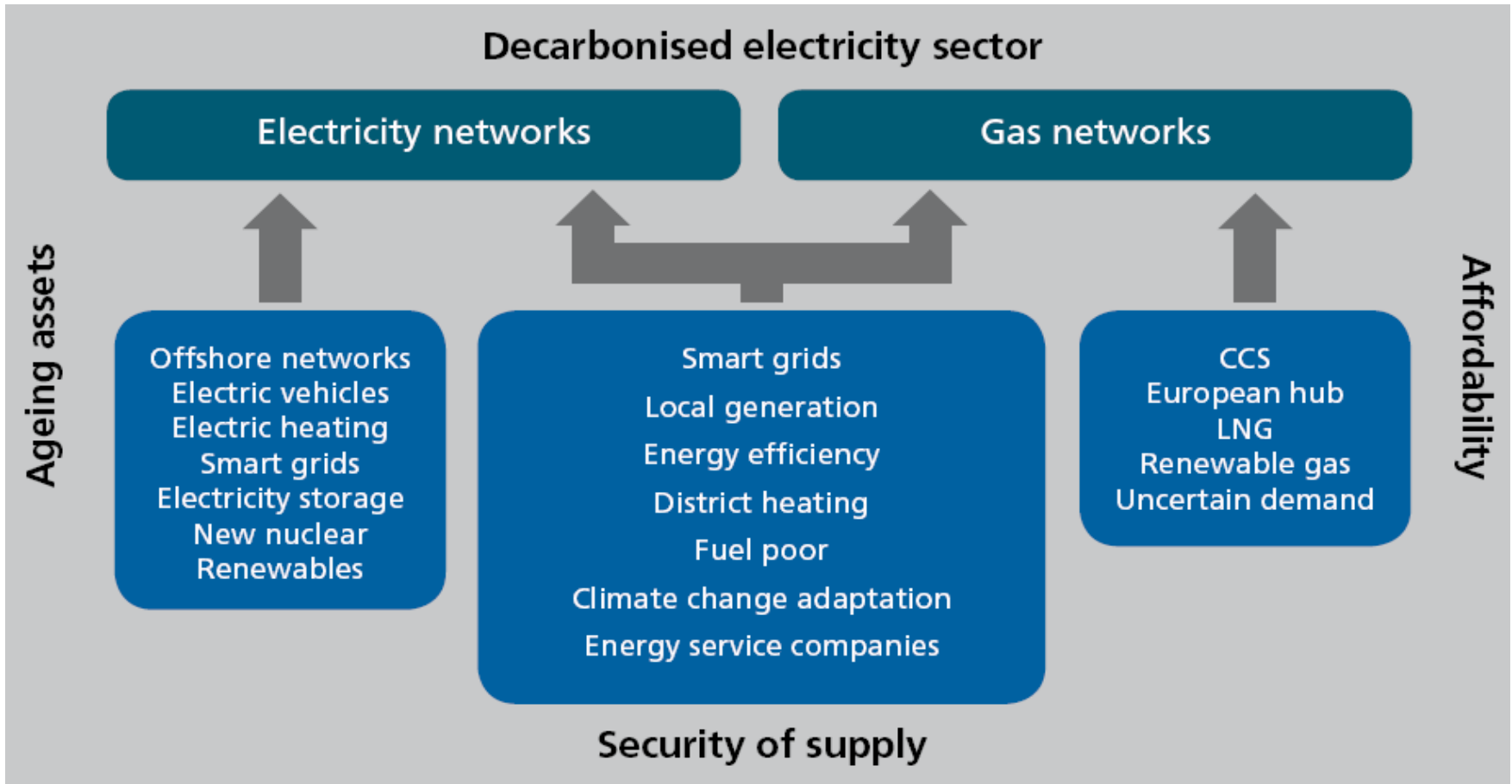
SENIOR PARTNER, SMARTER GRIDS AND GOVERNANCE

## Summary

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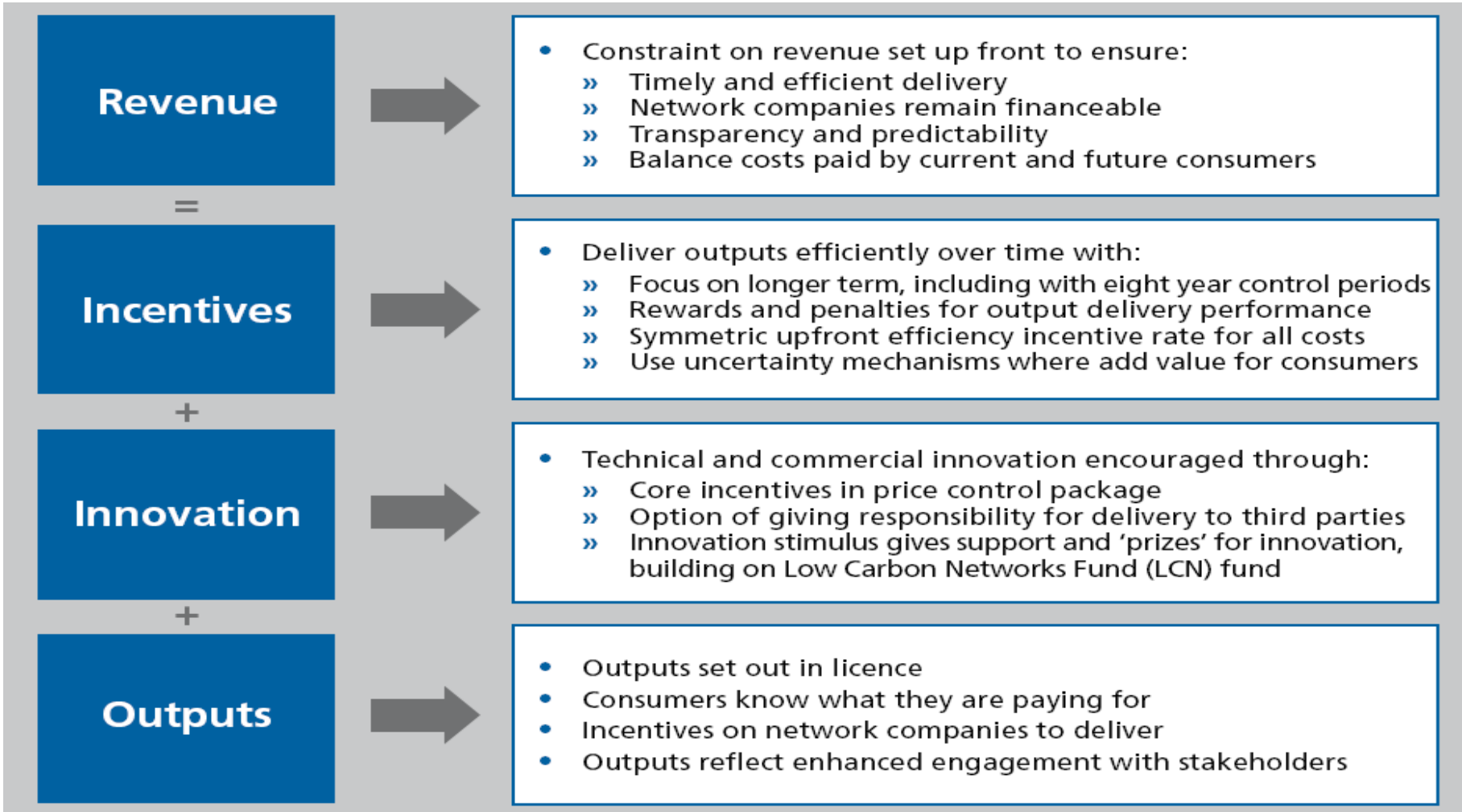
- We are committed to providing a regulatory framework that is pro-investment and financeable.
- Investors need to consider the overall package - we are at an early stage in the process.
- **RIIO puts the network companies in the “driving seat”** - they need to come forward with financeability proposals.
- We do not take investors for granted - investors have an important role to play.
- Companies that rise to the challenge have the opportunity to earn double digit shareholder returns. Those that do not will have nowhere to hide.
- We are open to compelling arguments.

# The energy sector faces considerable challenges



**MORE THAN £30BN OF INVESTMENT OVER 10 YEARS**

# The RIIO Framework is designed to be pro-investment



## We are committed to providing a financeable framework

Our financeability  
duty

- Ofgem's principal objective is to protect the interests of existing and future consumers
- But we also have a 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"*

- RIIO will define **clear outputs and associated revenues**
- RIIO is **evolutionary, we will not introduce sudden change** – transitional arrangements to avoid sudden impact on earnings and cash flows
- The RIIO framework provides **greater transparency and predictability**
- We will put **financeability on a sustainable footing** – we want to avoid storing up problems for the future
- We will provide you with the **information you need to be able to monitor** companies effectively.

## We have not backed away from October's commitments

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*"(We) will enable efficient network companies to raise their equity and debt as they need to finance their regulatory obligations."*

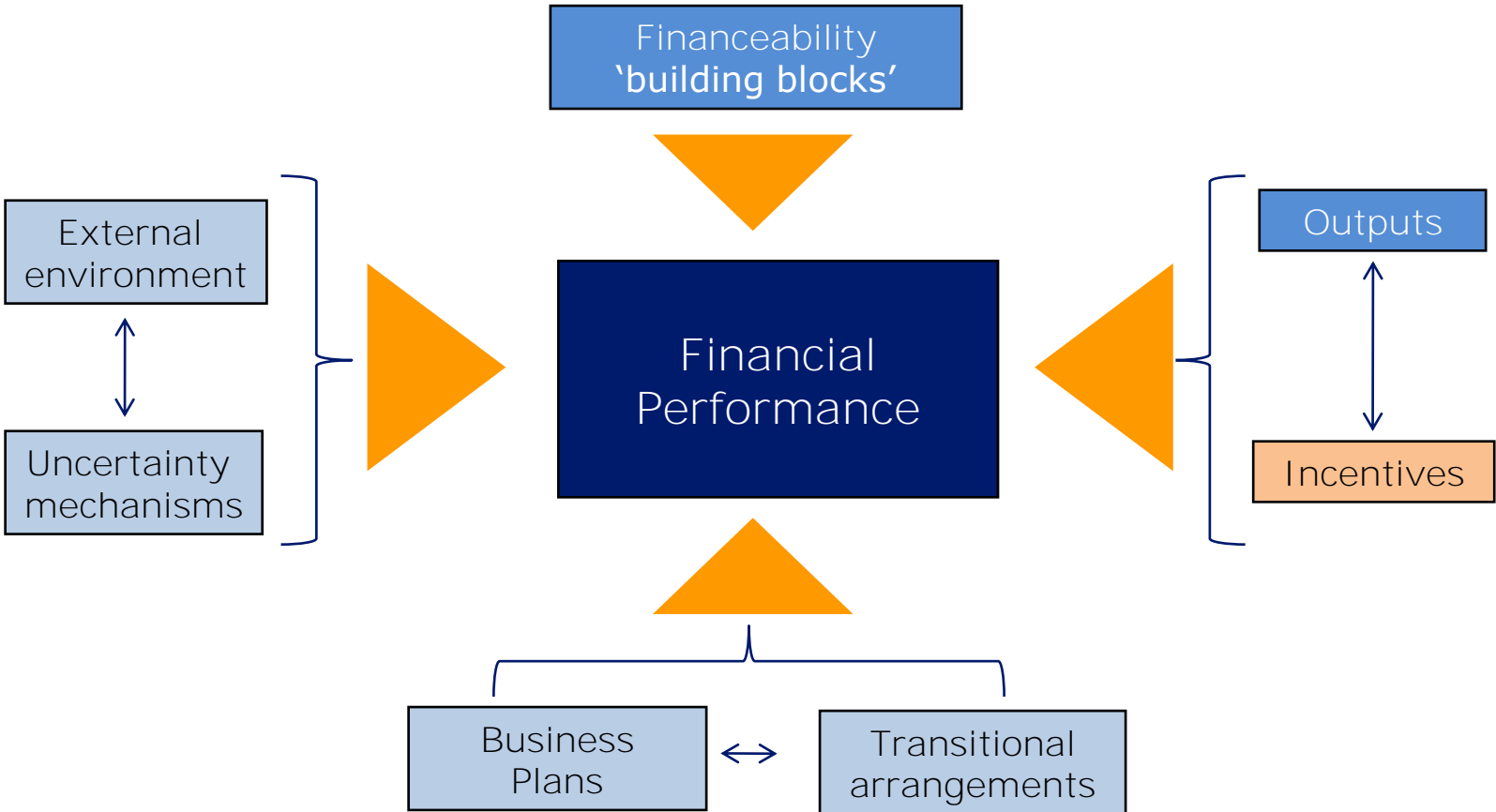
*"In terms of equity metrics, we will take into consideration the impact of our price determination proposals on such ratios as the notional RAV/ EBITDA and Regulatory Equity/Earnings for the regulated company."*

*"Where a company does demonstrate that application of the financeability principles in a single step would cause an efficient company financing difficulties, we will implement transition arrangements."*

**ALL QUOTES FROM RIIO DECISION DOCUMENT (OCT 10)**



# Investors need to consider the overall package



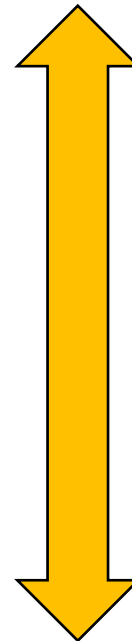
**TO DATE, OUR FOCUS HAS ONLY BEEN ON 'BUILDING BLOCKS' AND ON OUTPUTS**

# Incentives for the companies to deliver key outputs

## SIX OUTPUT CATEGORIES



## A RANGE OF INCENTIVES



**Symmetric Financial Incentives**

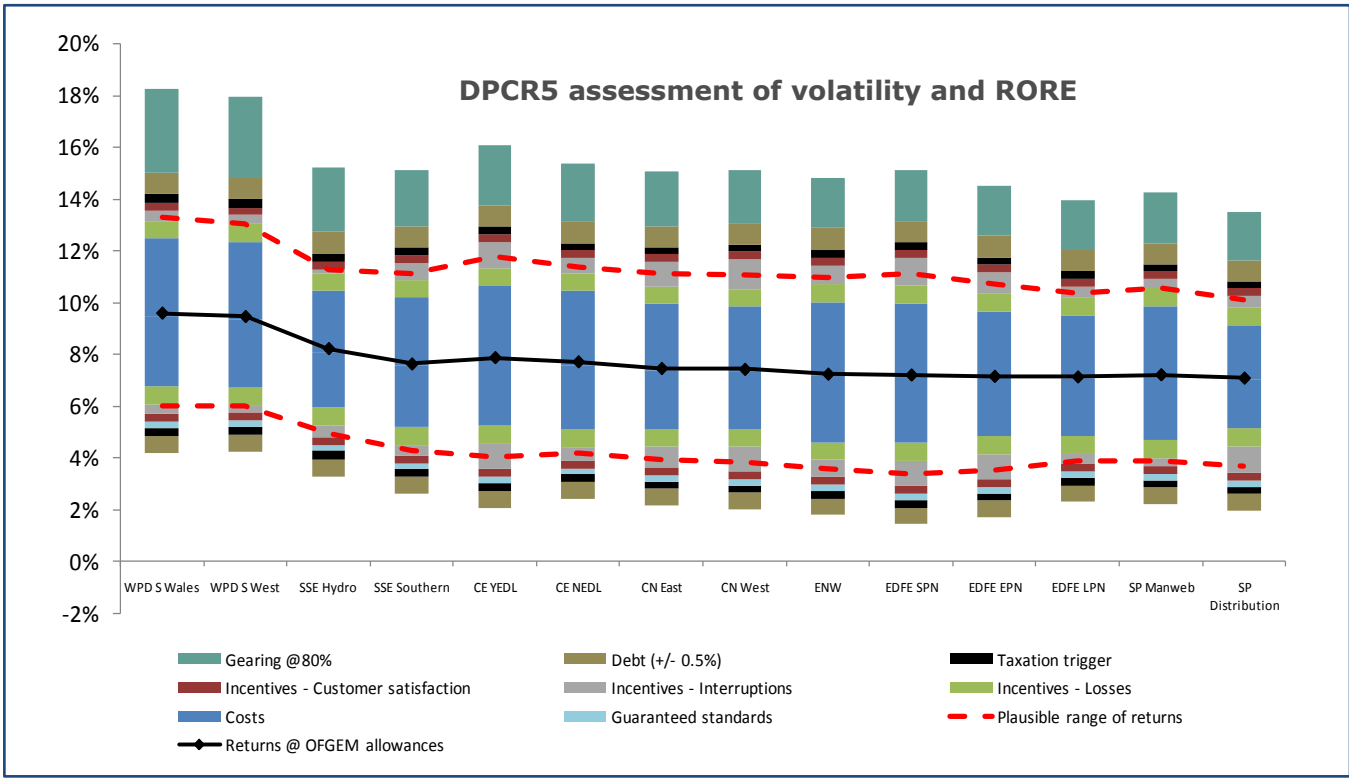
**Asymmetric incentives (reward only / penalty only)**

**Discretionary awards**

**Reputational Incentives**

**WE WILL REFINE AND CALIBRATE INCENTIVES IN MARCH**

# Incentives and outcomes: assessment similar to DPCR5



**UNDER RIIO, RORE RANGE MAY GO TOWARDS ZERO FOR POOR PERFORMERS  
WE EXPECT GOOD PERFORMERS TO HAVE COMPARABLE UPSIDE POTENTIAL**

## A range of uncertainty mechanisms to minimise risk

<b>GAS DISTRIBUTORS</b>	<b>COMMON TO BOTH SECTORS</b>	<b>TRANSMISSION COMPANIES</b>
Repex programme	Mid-term review of outputs	Incremental entry and exit capacity
Connections?	RPI indexation	Electricity transmission investment
	Cost of debt index	Connections?
	Triennial update of pension deficit funding	Inter-TSO costs
	Tax changes	
	Traffic Management Act	
	Security costs	
	Ofgem fees & business rates	
	Disapplication of price control	

**COMPANIES TO SET OUT UNCERTAINTY MECHANISMS IN THEIR BUSINESS PLANS**

## We are at an early stage in the process

- We will set out further details on incentives in March
- We expect the companies to propose uncertainty mechanisms and transitional arrangements in their business plans.
- We are open to compelling arguments on the need for financeability parameters outside our proposed range.

FAST-TRACKED	TIMING	NON FAST-TRACKED
Initial Strategy	Dec 2010	Initial Strategy
Strategy Decision	Mar 2011	Strategy Decision
Business Plans	July 2011	Business Plans
Fast track Consultation	Dec 2011	-
Fast track Decision	Feb 2012	-
-	July 2012	Initial Proposals
-	Dec 2012	Final Proposals

**THE COMPANIES ARE IN THE "DRIVING SEAT"**

## Investors have an important role

### We rely on investors to:

- Keep pressure on management teams
- To support management teams who want to appeal Ofgem's decisions if they believe them wrong.

### You will have:

- Enough regular information to make these judgements
- Confidence that all companies could outperform

But, investors must be alert:

- Lazy or poor management will be found out under RIIO.
- GB Network Regulation was never intended to be risk free.

**IN THIS AREA, CONSUMERS & INVESTORS HAVE COMMON INTERESTS**

## Recap

- We are committed to providing a regulatory framework that is pro-investment and financeable
- Investors need to consider the overall package
- **RIIO puts the network companies in the “driving seat”**
- We do not take investors for granted.
- Investors have an important role to encourage companies to step up and deliver for consumers.

### **Will now turn to:**

- Asset Lives and depreciation
- Transitional Arrangements
- Components of cost of capital - cost of debt, cost of equity & notional gearing

## Proposals for asset lives and depreciation

- Asset lives will reflect useful economic lives
- Intergeneration equity
- Gas asset lives proposed to be maintained at 45 years. Front loading of depreciation on new investment?
- Electricity asset lives proposed to increase from 20 years to 45-55 years
- Proposed change in gas distribution RAV capitalisation rate

Network		Proposed Economic Asset Life	Proposed Depreciation Profile
Electricity	Transmission	45 – 55	Straight Line
	Distribution	45 – 55	Straight Line
Gas	Transmission	45	Straight Line
	Distribution	45	Front-loaded

**TRANSITIONAL ARRANGEMENTS WHERE THERE ARE FINANCEABILITY ISSUES**



## We will establish transitional arrangements

### Benefits of transitional arrangements:

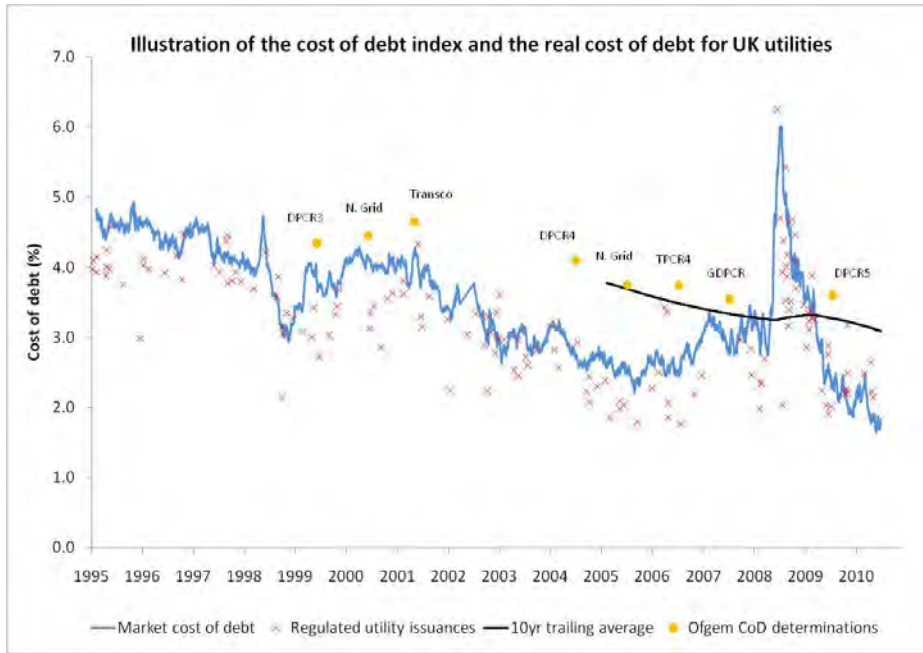
- Avoid increased perception of regulatory risk (from sudden deferral of cash flows)
- Provide time for businesses to re-organise their financing
- Allow firms to increase equity through retained earnings
- Reduce likelihood of rights issues when market conditions may not be ideal
- Avoid increased short term tax liabilities from reduced debt finance

***ONUS ON COMPANIES TO DEMONSTRATE WHY TRANSITIONAL ARRANGEMENTS ARE NECESSARY AND TO PROPOSE A SUITABLE APPROACH***

# Proposals for cost of debt

- **Traditional approach** - fixed rate based on blend of embedded debt costs and cushion for debt cost increases
- **Under RIIO** - cost of debt indexation. Index, a blend of A & BBB rated sterling issuers

- An uncertainty mechanism to provide protection to consumers and investors
- Allowance will be reasonable but not excessive
- Companies should be able to continue to outperform the index



**WE WELCOME VIEWS ON THE DEFINITION OF THE INDEX**

# Proposals for cost of equity: 4.0 – 7.2%

- Range based on a number of sources, including determinations and market transactions
- Need to balance protection of consumers with need to attract investment funds
- Low risk of businesses. And need to consider the overall package including transitional arrangement, uncertainty mechanisms and incentives.

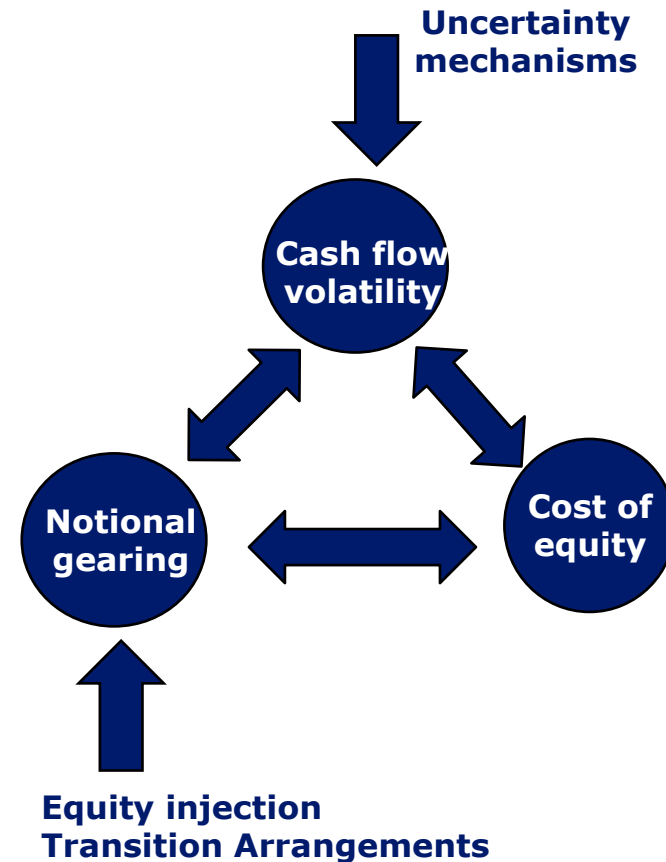
## Recent Determinations

DETERMINATION	COST OF EQUITY (%)
DPCR5	6.73
GDPCR1	7.25
TPCR4	7.00
CC Bristol Water	6.60
Ofwat PR09	7.08
CC/CAA Stansted	5.00-8.20
ORR CP4	6.50-7.00
Austrian Electricity T	7.42
Belgium Gas Transmission	5.86
German Electricity & Gas T&D	6.37
France Electricity T	5.17
Ireland Gas T&D	5.80-6.75

**WE ARE OPEN TO COMPELLING ARGUMENTS**

## Steps to setting notional gearing

1. Assess cash flow volatility
2. Assess size of notional equity wedge consistent with volatility
3. Sense check result – iterate as required
4. Check credit and equity metrics
5. Iterate as required



**WE WELCOME VIEWS ON CREDIT AND EQUITY METRICS**

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Breakout sessions

# **QUESTIONS FOR DISCUSSION**

## Questions for discussion - One

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Evidence from economic analysis, analyst reports and Bank of England assessment suggest a real cost of equity of 4.0-7.2%.

Transaction evidence seems to support this view, eg EDFE network sales.

Yet we are told that equity investors in utilities require returns of 10-15%.



**How can these two apparently conflicting sources of information be reconciled?**

## Questions for discussion - Two

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Our primary statutory duty is to protect current and future consumers. One aspect of this is price. A further aspect is to ensure appropriate investment is made and therefore that we provide sufficient rewards to attract investment from providers of debt and equity finance.



**Do our proposals provide an appropriate balance between protecting consumers and rewarding investors?**



## Questions for discussion - Three

The cost of debt is traditionally set based on a balance between the cost of embedded debt and the forward cost of debt, with allowance to protect against rises in debt costs over the price control period.

A longer price control increases the reliance on forward costs and makes protection against rising debt costs through a fixed rate more difficult and more risky for companies.



**Does cost of debt indexation provide reasonable protection for investors against a fixed cost of debt for a longer period?**

**Does it allow companies to benefit from a longer period in which to outperform the regulatory settlement?**

## Questions for discussion - Four

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In RIIO we set out to provide long-term financeability through providing clarity and predictability to the key financial drivers, based on long term sustainable positions for the asset base, allowed return, capitalisation and depreciation.



**Do our proposals provide sufficient clarity to attract long-term capital into the sector recognising that there will need to be a period of transition?**

## Questions for discussion - Five

In the following areas:

- Operational risk
- Regulatory risk
- Political risk / public perception
- Management quality
- Ability to access the market
- Overall attractiveness to investors



**In your opinion, how do regulated GB energy networks compare to:**

- **other GB/UK regulated companies?**
- **European regulated networks?**

## Questions for discussion - Six

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We believe there is an important role for investors in ensuring that management deliver returns.



**Do you agree?**  
**What do you see as reasonable upside/downside returns on regulated equity for good/poor performance?**

# **CLOSING REMARKS AND Q&A**

# NOTES

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## NOTES

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The background of the slide is a composite image. On the left, there are rows of solar panels under a bright sun. On the right, a hand is shown holding a white sheet of paper. At the bottom, a blue water tap is visible. The overall theme is clean energy and customer service.

*ofgem*

Promoting choice and value  
for all gas and electricity customers