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Wednesday 23<sup>rd</sup> February 2011

Dear Rachel

**Open letter consultation on the regulatory asset lives for electricity distribution assets**

Thank you for the opportunity to respond to your consultation letter on regulatory asset lives. This response expands upon Central Networks' response to the RIIO-T1 and GD1 submitted to Ofgem on 4<sup>th</sup> February 2011 which we hope you have had an opportunity to consider.

We welcome and support the majority of the RIIO proposals which continue to develop the current regulatory framework and we are pleased that Ofgem has stated that it is committed to providing a regulatory framework that is pro-investment and financeable. However, we do not believe that Ofgem's proposed changes to asset lives align with this commitment, or that such changes are in the best interests of both present and future customers.

It is widely acknowledged that extensive investment is required in UK energy networks in order to decarbonise the energy sector. Ofgem's own estimate is around £30bn of investment by 2020 and it is therefore essential that the regulatory framework is attractive to a broad range of investors, and that such investment can be financed in the most equitable way for customers. However, under Ofgem's proposals to increase asset lives, sustained equity injections and/or reductions in dividends would be required which would deter new investors. The need to attract a large amount of investment from a smaller pool of investors, coupled with the increased risk investors would attribute to the delayed profile of returns as a consequence of extending asset lives, would result in the need for a significantly higher cost of capital which customers would have to fund.

Ofgem's primary duty is to promote the interests of both future and present customers. However, delaying charges for customers further into the future would serve to increase the existing imbalance between current and future customers, particularly in this environment of increasing investment. We do not believe that making such a change



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would be acting in the best interests of current and future customers and hence not in line with Ofgem's primary statutory duty.

We do not believe that the balance of charges between current and future customers would be improved by extending asset lives, even with transitional arrangements in place. However, if Ofgem does insist that asset lives are extended, we believe this could only be financeable with transitional measures which have significantly greater impact than those Ofgem has proposed.

Given their impact upon financeability and investor perception, it is fundamental that Ofgem reassures investors that any transitional arrangements would adhere to some key principles. In order to preserve regulatory certainty, Ofgem must ensure that DNOs' financeability ratios meet investment grade criteria and that the 20 year recovery period for existing investment is maintained. It is also important that DNOs understand how any transitional arrangements would work in the context of the wider RII0-ED1 price control. Such transitional arrangements should be extensively discussed and tested by Ofgem and the DNOs working together and we would support the formulation of a joint working group to achieve this.

We would welcome the opportunity to take Ofgem through the modelling we have undertaken on this issue. If this is of interest or you would like to discuss any of the points raised in this consultation response or our response to RII0-T1 and GD1 then please do not hesitate to contact me.

Yours sincerely



Jonathan Ashcroft  
Head of Regulation and Strategy

### **Asset lives and depreciation**

We do not believe that Ofgem's desire to extend regulatory asset lives to reflect the expected economic lives for electricity distribution is in the best interests of customers, investors or the wider industry. Our main areas for concern are:

- We believe that under these proposals, current customers will see a price reduction in the short term offset by price increases for future customers in the long term. The transitional arrangements do not propose a way forward with regards to smoothing out these costs.
- Our modelling has shown that, under all of Ofgem's extended asset life scenarios, there is a prolonged need for equity injections/reductions in dividends, which could deter investors at a time when increased investment is required. Furthermore, the extension of the time period over which investment is repaid will increase risk for investors and make it difficult for companies to raise the capital they need.
- We are concerned that changes to asset lives would result in a breach of investment grade financial ratios, which would seriously impact financeability, the attractiveness of the industry to investors and the cost of capital, not to mention undermining regulatory certainty.

We have performed detailed modelling on the impact of changing asset lives, and we would welcome the opportunity to share this with Ofgem. Our modelling has shown that extending asset lives, even with transitional measures in place, is detrimental to the interests of customers and investors. We discuss this in more detail below.

### ***Background and principles***

We recognise that regulatory asset lives do not currently reflect the expected economic life of network assets. Neither, however, does the value of the RAV reflect the value of the network. The RAV, and depreciation thereupon, has always been a regulatory concept, designed to provide a return on DNOs' investments and to ensure DNOs can finance their activities. This concept was clearly illustrated in 1996 when Ofgem accelerated depreciation on the RAV to maintain returns to DNOs once vesting depreciation expired.

We agree that charges to customers should be appropriate for the network assets they are using. CEPA's report for Ofgem "The Economic Lives of Energy Network Assets" (1) suggests that the replacement cost of the total electricity distribution network is £136Bn. Even accounting for the age of these network assets it is clear that current charges to customers are considerably lower than they would be if the RAV reflected the true value

of the network. If Ofgem's objective is to ensure customers pay appropriately for the assets they use and hence bring regulatory assets into line with economic assets, simply addressing one specific aspect of this problem, such as asset lives, is unlikely to achieve equity between current and future customers.

### ***Changing asset lives – customer impact***

We believe that under the current regulatory treatment current customers pay less than future customers for the use of the electricity distribution network. Deferring costs by lengthening asset lives would only compound the inequity between current and future customers.

#### *Balance of charges between current and future customers*

CEPA (1) states that bills will increase significantly over the 2010 to 2050 period owing to the network investments that are required.

Maintaining Central Network's investment at 2015 levels would see RAV double in real terms in just 12 years. Customers will therefore pay more in real terms in the future for the use of the network in its current state; evidence that the balance of charges between current and future customers is already weighted towards those in the future.

#### *Changing landscape for Electricity Distribution*

The UK Government has committed to reducing greenhouse gas emissions by 80% from 1990 levels by 2050. Achieving this target will necessitate major additional investment in the energy sector and network assets, the cost of which will also be borne by future customers.

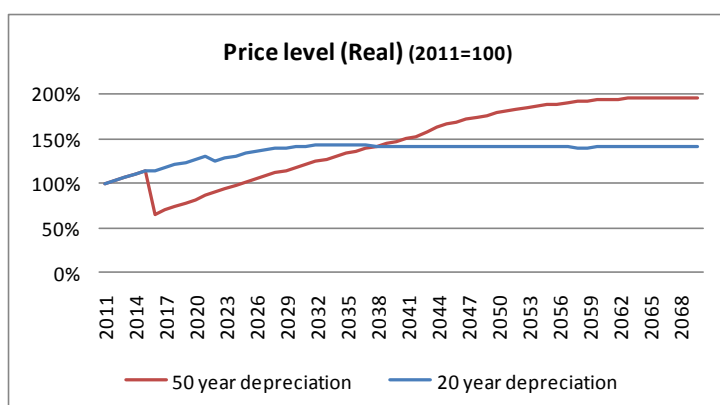
In his evidence on electricity market reform presented to the Energy and Climate Change Committee in January 2011, Alistair Buchanan acknowledged the investment challenge presented by RIIO, the need to attract investment in the energy sector and the importance of confidence, clarity and deliverability for investors.

Through the electricity market reform, the government is discussing ways to de-risk investment appropriately for investors to ensure the required level of investment can be raised. Whilst the mechanics are still unknown, this is the philosophy behind the reform proposals. Furthermore, Alistair Buchanan stated that the RIIO framework has taken uncertainty out of the capital markets. However, we do not believe that Ofgem's asset lives proposals align with this philosophy as they increase uncertainty for investors. Investors do not receive any commitment that future regulators will ensure that investment is repaid and extending the time period over which investment is returned to

investors therefore increases their exposure to regulatory change.

*Impact of asset life changes*

The chart below shows the difference in real price levels if asset lives are extended from 20 years to 50 years (note: this is from modelling performed for CNW):



The chart shows that any extension to asset lives would effectively delay a proportion of the amount customers pay for the network until further into the future. CEPA (1) states, and our modelling confirms, that extending asset lives would actually lead to price reductions in the short term, prior to a more rapid increase in prices.

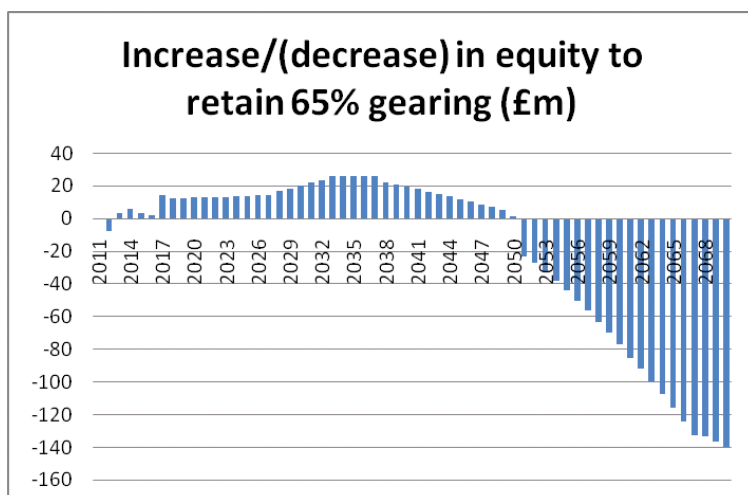
However, in the context of future customers already bearing higher charges than existing customers, and anticipated further price rises in the future to meet climate change targets as described above, transferring more costs from current to future customers by changing asset lives would not appear to align with Ofgem’s primary objective in that it is not in the best interests of both current and future customers to do so.

**Changing asset lives – impact for investors**

It is important to recognise that part of ‘protecting the interests of future and existing customers’ is to ensure that efficient companies are able to make the timely investment that future customers need. Ofgem has stated that it is committed to ensuring that efficient network companies are able to raise the finance that they require, both debt and equity, in a timely manner. We discuss below how we believe Ofgem’s asset lives proposals do not support this commitment.

*Need for equity injections or reductions in dividends*

The chart below shows the level of equity injections required/amount of dividend to be foregone by CNW equity investors when investment is held at 2015 levels and asset lives are changed to 50 years for new investment only:



The chart above shows that even when an asset life of 50 years is only applied to new investment, and when the level of capital investment is not increasing, there is still a need for sustained equity injections or reductions in dividends over a period of around 30 years. This effect will only be exacerbated by the need for increasing capital investment. We agree that investors may, and should, be willing to forego dividends in the short term in return for capital growth, but this is not sustainable over longer periods. Investors who are interested in investing in infrastructure businesses, such as pension funds, are looking for regular returns (2). Changing the profile of returns to shareholders in such a fundamental way would deter potential investors and make it extremely difficult to raise the investment needed.

*Increased risk for investors*

Increasing asset lives will, as discussed above, result in investment being remunerated over a longer period of time. Any retreat to the pure economic theory that equity investors are indifferent to the timing of cash flows is overly simplistic as, in reality, both equity and debt investors place importance on the timing of cash flows.

Moody's state that "the ability to recover prudently incurred costs in a timely manner is one of the most important credit considerations for regulated electric and gas networks, as the lack of timely recovery of such costs may cause financial stress" (3). This is a clear indication that credit ratings agencies are not indifferent to the duration of cash flows. Confirmation of the specific importance to investors of the 20 year asset life for electricity

distribution assets can be seen when, in relation to the RCF/Capex ratio, Moody's state: "Due to the large capital programmes required to upgrade ageing assets, we would expect to score this credit metric in the "Ba" category for most regulated networks with the exception of UK electricity distribution companies that benefit from accelerated depreciation" (3). The clear inference from this statement is that an extension to asset lives would have a negative impact upon credit ratings.

An additional factor for investors in regulated businesses is the length of time over which there is certainty of returns; in electricity distribution price controls to date the cost of capital has been agreed for 5 years; a relatively high proportion of the 20 years over which investment is recovered, thus providing a level of reassurance to investors. However, with a cost of capital fixed for a maximum of 8 years out of a potential 55 year return profile, this level of reassurance diminishes.

The ENA's response to Ofgem's RII0-T1/GD1 December 2010 consultation challenges Europe Economics' assertion that, as the betas for the owners of electricity distribution networks did not react to the shortening of regulatory asset lives in DPCR3, this is evidence that investors are indifferent to the timing of cashflows (4). Whilst we do not intend to replicate the ENA's points, we are wholly in agreement with the ENA's response.

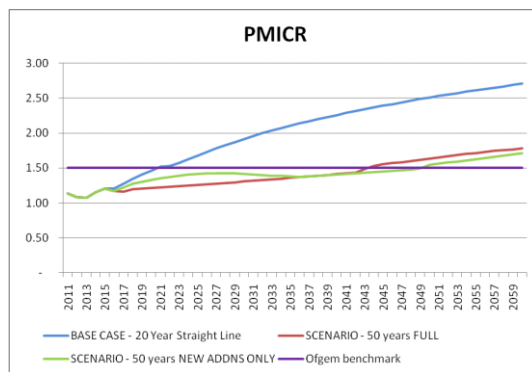
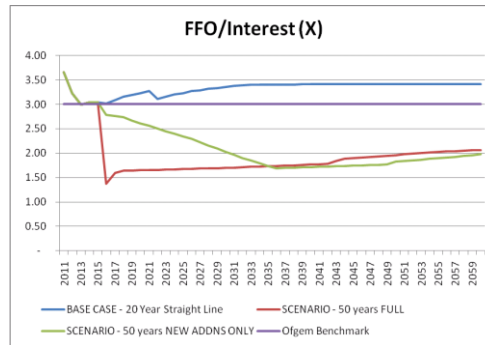
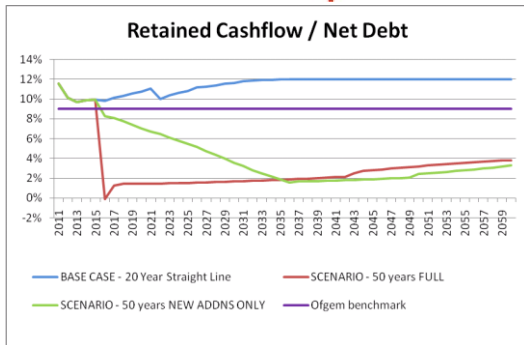
### ***Changing asset lives - impact upon financeability***

Ofgem has a duty to ensure that licensees can finance their activities. However, under the asset lives proposals put forward in Ofgem's RII0 proposals, financeability ratios are pushed far beyond the acceptable range for an investment grade credit rating, something which would have a major impact upon regulatory certainty, with significant implications for the cost of capital.

The charts below set out what Ofgem's key financial ratios would be for CNW under notional gearing for the base case (asset lives of 20 years) and what our modelling shows these to be where:

- i) all asset lives are extended to 50 years, and
- ii) where asset lives are extended to 50 years for new assets only,

assuming investment is held constant at 2015 levels for both scenarios (note: this is based purely on price control income with no outperformance on incentives or other areas):



From the charts above, it is clear that DNOs would not be able to maintain investment grade ratios at gearing levels of 65% if asset lives were extended in the manner Ofgem proposes.

Ofgem has stated that its financeability analysis will focus on the medium to long term. However, evidence shows that credit ratings agencies only look at projected ratios in the short term. Moody's (3) state that "Given that the regulated networks generally have good visibility a few years into the future, financial projections often provide a reliable and useful tool to enhance credit analysis in cases where we believe that there is a high probability that a company's credit metrics will improve (e.g. an agreement with the regulator) or deteriorate (e.g. a large capital programme), we map using the prospective ratios". Our modelling shows that financeability ratios do not return to investment grade levels when asset lives are extended. Even if some allowance for outperformance were included, any upturn in ratios would be far beyond the "few years" view used by credit rating agencies. It is also unlikely that any ratings agency would look beyond the end of the current price control as, beyond this point, there is no "agreement with the regulator" referred to by Moody's above.

If Ofgem were to allow a network operator to breach its investment grade ratios in the short term, thereby failing to meet one of its stated duties, this would significantly undermine regulatory certainty and the low cost of capital investors are willing to accept based upon this.

### ***Changing asset lives – impact upon the Cost of Capital***

Ofgem's proposals on increasing asset lives have major consequences for investors and the cost of capital, including:

- The lengthening in profile of regulatory returns, which would reduce the pool of investors willing to invest;
- The additional risk for investors associated with delaying cash flows into the future;
- The requirement for regular and sustained equity injections (and/or reduction in dividends) and the issuance costs associated with this;
- The breach of financial ratios over the short and medium term; and
- The erosion of regulatory certainty.

The impact of these consequences is that investors in electricity distribution would require a significantly higher cost of capital than the Ofgem rate of 4.69% included in the DPCR5 final proposals or the range proposed by Ofgem in the RIIO consultation documents.

Any increase in the cost of capital due to the lengthening of asset lives would mean that customers pay more for the same amount of investment. This increase arises because customers must compensate investors for the additional risk associated with financing that investment over a longer period of time. We do not believe that making a decision that costs the customer more in the long term would be acting in their best interest or that such a decision would be welcomed by customers.

### ***Changing asset lives - transitional arrangements***

#### *Transitional arrangements – important principles*

By introducing the asset lives issue Ofgem has created significant uncertainty in capital markets and we believe Ofgem must act to limit this by reassuring investors that, if asset lives are extended, any transitional arrangements would be based on the following principles:

- Financial ratios will be maintained at levels which are in line with investment grade credit ratings both in the long and short term;
- The commitment to a 20 year recovery period for existing investment will be

honoured (“grandfathering”);

- Any transitional period will be appropriate for customers and investors and may be longer than a single price control, and
- Any increase in risk for investors as a consequence of increasing asset lives will be reflected in the cost of capital for RIIO-ED1.

#### *Transitional arrangements – adequacy*

Ofgem has stated that it is committed to ensuring that efficient network companies are able to raise the finance that they require in a timely manner and that, where a new approach to depreciation would raise concerns about financeability, transitional arrangements would be adopted. However, our modelling has shown that the transitional approaches proposed by Ofgem are not sufficient to counter the effect lengthening asset lives would have on financeability and therefore the cost of capital. Neither do they have sufficient effect to maintain the current balance between present and future customers. If Ofgem does insist that asset lives are extended, we believe this could only be financeable with transitional measures which have significantly greater impact than those Ofgem has proposed.

#### *Transitional arrangements – financeability*

Part of protecting the interests of customers is to ensure that efficient companies are able to attract the investment that future customers need. It is essential that financeability is maintained if DNOs are to be able to attract such investment, especially with the anticipated increases in required investment. We expect that any transitional arrangements should ensure that DNOs would be able to maintain financial ratios at levels which are in line with investment grade credit ratings both in the long and short term.

#### *Transitional arrangements – grandfathering*

The importance of honouring existing commitments in order to maintain investor confidence is recognised by the Department of Energy and Climate Change in its Electricity Market Reform consultation document (5). The principle of “grandfathering” is an essential regulatory safeguard underpinning regulatory certainty and is growing in emphasis in the energy sector as the government focuses on the need to secure increasing investment in our industry. Any departure from this by Ofgem applying new asset lives to existing assets would undoubtedly undermine regulatory certainty and may have a far reaching impact.

### *Transitional arrangements – duration*

We do not believe there is any need or justification for any transition to new asset lives to be managed in just one price control. Ofgem has stated that a period of eight years would be enough for companies to adapt financing approaches. However, it is not simply a matter of the time taken to adapt financing but the impact upon financeability, and upon present and future customers, of such a short transitional period which must be considered. Although Ofgem has stated that it gave appropriate signalling regarding changes to asset lives, it is reasonable for DNOs and investors to assume that Ofgem would ensure that financeability was maintained in the short and long term, as is its duty, and as it did in the past when DNOs were faced with the “cliff face” as vesting depreciation expired.

### *Transitional approaches – wider context*

Transitional approaches could include financeability adjustments, a rebalancing of the fast and slow pots, a much longer transitional period over which any changes are introduced, or some combination of these approaches. Given the importance of the asset lives issue and its impact upon financeability and investor perception, it is fundamental that any such arrangements should be rigorously discussed and tested by Ofgem and the DNOs before any decisions are made. We agree that it is beneficial to have clarity on such issues as early as possible but not at the expense of having a workable solution which serves the interests of both customers and investors.

It is also important that DNOs understand how any transitional arrangements would work in the context of the wider RII0-ED1 price control. It would be impossible to make any assessment of whether transitional arrangements are acceptable without information on the cost of capital, the balance of fast and slow money, and other relevant factors in the price control framework. Although we would welcome the establishment of key principles by Ofgem as outlined above, it is unclear how any “decision” on an isolated element of the price control could be made without understanding how it would be applied in practice.

We would welcome clarification from Ofgem on what it hopes to achieve through extending asset lives so we can work together to achieve an outcome that is equitable for both customers and investors. Central Networks would support the formulation of a joint Ofgem-DNO working group on asset lives, with wider industry participation where appropriate, which could then work together to accomplish this objective.

References:

- (1) The Economic Lives of the Energy Network Assets – A Report for Ofgem. Cambridge Economic Policy Associates (CEPA), Sinclair Knights Merz (SKM) and GL Noble Denton. December 2010.  
<http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/CEPA%20Econ%20Lives.pdf>
- (2) May 2010. Inderst, G. (2009), "Pension Fund Investment in Infrastructure", OECD Working Papers on Insurance and Private Pensions, No. 32, OECD publishing, © OECD. doi:10.1787/227416754242. This paper lists stable and predictable cash flows as one of the favourable investment characteristics of infrastructure assets the investment industry deduces from the economic characteristics of infrastructure assets (p.7)
- (3) "Regulated Electric and Gas Networks", Moody's August 2009.
- (4) [http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/Energy\\_Networks\\_Association.pdf](http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/Energy_Networks_Association.pdf)
- (5) "Electricity Market Reform", Department of Energy and Climate Change, December 2010.