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Dear Peter

**Regulatory Asset Lives for Electricity Distribution Assets**

Please find attached Electricity North West's response to your consultation regarding regulatory asset lives for electricity distribution assets.

RIIO price controls represent a significant evolution in the way that customers, companies and regulators will agree future network investment plans. We recognise the importance of the upcoming gas and transmission price controls as they represent the first translation of the RIIO principles, including asset lives, into price controls. The application of the RIIO principles will have a significant impact on prices for our customers from 2015 and we have, therefore, thoroughly reviewed and considered these proposals. This letter re-confirms our thoughts on your proposals for electricity distribution asset lives as well as outlining our view on whether it is sensible to make a public decision now on this issue.

As we explained in our response to your Strategy Consultations for the Gas Distribution and Transmission Price Control Reviews, we have a number of concerns with your proposed future approach to financeability issues under RIIO price controls. We are aware that the initial decisions on the implementation of the RIIO principles are being closely scrutinised by the global financial community. It is, therefore, essential that you translate the RIIO financeability principles into packages that encourage investors to provide sufficient finance (both debt and equity) to ensure that the £32bn of required network investment identified in Project Discovery is delivered at the lowest long-term cost for customers.

Many aspects of your financeability proposals, especially depreciation lives, cost of capital components and continued reliance on investors to fix financeability issues, are unattractive to investors. Availability of equity is important to deliver the innovative network investment which will be of a more discretionary nature and is less likely to be closely associated with primary outputs. If equity returns are insufficient, DNOs will focus on core investment, directly tied to primary outputs alone – none of the more discretionary investment which the other RIIO principles are intended to incentivise will be delivered. More work is needed to demonstrate how you will ensure that future price control packages will attract sufficient investment to deliver the sizeable investment programmes required of network companies. We do not believe that

replacing an NPV neutral financeability adjustment (accelerated depreciation) with an NPV positive mechanism (increased cost of equity) represents the best outcome for customers.

#### Developing an acceptable price control package

The ultimate test of the success of RIIO price controls will be whether they allow sufficient revenues to deliver investment for customers and returns to debt and equity investors whilst maintaining appropriate financeability metrics. We believe that this can be achieved if you consider your financing principles as starting positions from which transparent and mechanistic financeability adjustments can be overlaid in a consistent manner to achieve acceptable price control solutions. You must recognise that the financeability adjustments required to achieve acceptable solutions may be very material in the first RIIO price controls, given the need to transition from current assumptions, especially asset lives.

#### Electricity North West's view of asset lives proposal

We recognise that the technical asset lives for current electricity distribution assets are longer than the current regulatory electricity asset lives of 20 years. However, there are a number of uncertainties facing the industry that could significantly influence the average economic lives within the electricity distribution sector. Recognising the uncertainty about future energy markets, future energy technologies and future energy policies it is not sustainable for investors to be asked to wait 45-55 years to get a full return of their investment. Investors will require compensation for these extended cash flows, and the consequent increase in risk, via a long-term increase to the cost of equity.

We disagree with your statement that you have given adequate warning of changes to asset lives, particularly with regard to existing assets. The reaction of network companies in their responses to the proposal for changing asset lives contained within the RPI-X@20 paper "Embedding financeability in a new regulatory framework" illustrated its unexpected nature. This proposal had, up to this point in time, not been a major part of your published thinking, either as part of RPI-X@20 or otherwise.

We welcome your recognition of the importance of transitional arrangements in any move to a new approach to depreciation for electricity distribution assets. However, your view that the transitional arrangements should not exceed a single price control period (potentially eight years) is not one we agree with. Transitional arrangements need to be in place for as long as it takes to resolve the problem they were designed to fix. This may potentially be longer than one price control period and could extend to 20 years and beyond. If depreciation lives are to be extended, we would favour applying the revised asset lives to new assets, allowing existing assets to continue to depreciate on the current regulatory basis.

An excerpt from our response to the Gas and Transmission Strategy Consultation is appended to this letter. This outlines our more detailed views on your depreciation proposals.

#### Whether making a formal decision on DNO asset lives in March 2011 is sensible

I am very nervous that publishing a decision on one isolated component of our future price control package, presented in the absence of other price control components (especially transition arrangements and financeability tests), may give a skewed impression of future price controls. Given that any decision within your current proposed range of asset lives would suggest material reductions to future cash flows for DNOs, I am very concerned that this could lead to negative reactions from investors and credit rating agencies and hence unnecessarily increase DNOs' cost of capital. For this reason, I recommend that the Authority defer any formal decision on this matter until the RIIO-ED1 Strategy document is issued, presumably in late 2012, when this decision can be presented in the context of the rest of the RIIO-ED1 package.

In practice, if given formal notice of materially lower revenues in RIIO-ED1 (as would be the case if the Authority announce an extension of asset lives for RIIO-ED1), there would be significant pressure on DNOs to de-gear during the latter years of DPCR5 in anticipation of this change.

De-gearing should provide DNOs with some headroom to help mitigate the adverse impact on some financial ratios and the consequential credit rating reaction that extended depreciation lives would create. However it would also act as a brake on the capital expenditure programme for DPCR5 and it would also result in much lower returns to equity investors in the current period than Ofgem's allowed WACC and RORE methodology. This would undermine investor confidence in the sector before any price control discussions have commenced. The technical aspects of de-gearing may also be costly and inefficient if they involve early re-payment of existing long term debt rather than simply not raising new debt.

I urge you to proceed cautiously in how you present this extremely market sensitive information. In particular, it would be advisable to discuss the content of any announcement with the electricity companies in advance and it will be essential that any announcement is clearly presented in the context of a wider financeable package that will be announced at a later date.

We remain committed to working with your teams to develop the principles into a cohesive package which will meet the requirements of current and future customers.

If you have any questions regarding our response please do not hesitate to contact me or a member of my team.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'S Johnson', written in a cursive style.

Steve Johnson  
Chief Executive Officer

## Appendix

### Relevant excerpts from Electricity North West's Response to Gas and Transmission Strategy Consultations

#### 7.1 Principles

Electricity North West's key objective from any price control settlement is to secure sufficient revenues to deliver the level of service and outputs required by our customers at an efficient cost whilst meeting key financeability metrics and providing our investors with appropriate returns for their investment. Whilst the mechanics behind the revenue setting are important in terms of understanding how revenues have been calculated, the ultimate decision on the acceptability of a price control will be based on the sufficiency of revenues to deliver investments for customers and returns to debt and equity investors whilst maintaining appropriate financeability metrics.

We are concerned that a number of the financing principles outlined in Ofgem's consultation, if implemented on an economically "pure" basis, could jeopardise any potential to deliver an acceptable price control package. However, we believe that if Ofgem plans instead to consider its financing principles as starting positions from which transparent and mechanistic financeability adjustments can be overlaid in order to achieve acceptable price control solutions then an appropriate settlement could be agreed. Ofgem must recognise that the financeability adjustments required to achieve acceptable solutions may be very material in the first RIIO price controls, given the scale of the transition to be achieved to some of those starting positions (particularly depreciation lives). Ofgem must therefore consider whether the financeability payments that current customers will fund justify the changes that have in many cases been designed to reduce the costs borne by those same customers.

The price control packages must attract and retain investors. Our experience of ownership by infrastructure investors illustrates the importance of achieving appropriate returns to deliver the full extent of the £32bn of network investment identified in Project Discovery. Our equity funding is invested via infrastructure investment funds by institutional investors, pension funds and other companies seeking long term, stable returns. In making any decision to inject further equity into Electricity North West, potential investors will consider alternative equivalent-risk investments that are available to them. We compete with other infrastructure assets and infrastructure companies for investment; if the regulatory settlement offers lower risk adjusted returns than equivalent investments overseas or in other infrastructure sectors, or if investors believe that the risk/reward balance is inappropriate for the asset class or if cash yields (dividends) are less frequent or predictable than in alternative investment opportunities the required investment will not be forthcoming. Clearly a lack of financial investment would in the short term limit the amount of network investment for our customers. It is unlikely that the effects will be clearly observable in the first few years (a point which was recognised in our debates regarding network health). Faced with a scarcity of equity, companies will modify their investment priorities to focus solely on the core investment required to achieve primary outputs alone. Any discretionary investment, such as the investment the RIIO framework explicitly sets out to incentivise, is far less likely to be delivered. In the longer term a shift in allowed returns would be required in order to attract investors back into the sector. The UK has a long history of attracting investment founded on regulatory frameworks that are stable and transparent. It is therefore important that Ofgem ensures the introduction of the RIIO financing principles does not introduce an increasing level of regulatory risk or the perception of an increasing risk.

In the following sections we highlight a number of our concerns with the theoretical economic proposals contained within the Strategy paper.

## 7.2 Asset lives and depreciation

### Asset Lives

We agree that the low carbon transition will centre on the electricity sector and that peak electricity demand will grow significantly over the period to 2050. In addition, we also recognise that the technical asset lives for current electricity distribution assets are longer than the current regulatory electricity asset lives of 20 years. However, as recognised in the paper produced by CEPA, there are a number of uncertainties facing the industry that could significantly influence the average economic lives within the electricity distribution sector.

The move towards smart grid technology and the increased use of short life technology assets will have a material impact on average technical lives and should not be underestimated. The desire to use commercial agreements (eg demand side management) as a mechanism to minimise investment is also likely to reduce the “solution asset” life. We therefore do not believe that the proposed asset life range is reflective of the future network asset life or the uncertainty associated with developing and utilising innovative operating practices.

In addition, as is made very clear in DECC’s Electricity Market Reform Consultation Document, December 2010, competition between energy sources will not be decided just by the market but, to a large extent, by government policy. Recent history suggests that views on climate change and the policies that deal with it change frequently. This could lead to changing requirements of networks and potentially technical obsolescence. Recognising the uncertainty about future energy markets, future energy technologies and future energy policies it is not sustainable for investors to be asked to wait 45-55 years to get a return on their investment. We suggest that such a proposal would only be acceptable to investors if a substantial cost of equity premium were made available to compensate for the longer duration of cashflows and increased risk.

One of Ofgem’s goals for the RIIO price controls is to deliver the investment required to support the move to a low carbon energy sector. Ofgem must recognise the availability of equity is important to deliver the innovative networks investments which will be of a more discretionary nature and are less likely to be closely associated with primary outputs. Therefore, investment conditions must be favourable to ensure such investment is seen as a priority for companies and their financial backers. As with low carbon generation assets, investors in networks have already provided some finance to customers (via companies) on specific terms, namely a return on and return of capital over a predetermined time period (20 years for electricity distribution). Any significant change to the regulatory contract materially increases investors’ perception of regulatory risk and could damage investor confidence (recognised by DECC in its discussions of Grandfathering arrangements for low carbon generators). We have already seen evidence of energy network equity investors reacting negatively to Ofgem’s proposals in this area.

The claim that Ofgem has given adequate warning of changes to asset lives, particularly with regard to existing assets, is incorrect. The reaction of network companies in their responses to the proposal for changing asset lives contained within the RPI-X@20 paper “Embedding financeability in a new regulatory framework” illustrated its unexpected nature. This proposal had, up to this point in time, not been a major part of Ofgem’s published thinking, either as part of RPI-X@20 or otherwise.

### Depreciation Profiles

We note the comments made by both CEPA and Ofgem on depreciation profiles with regard to electricity distribution. We agree with CEPA that a back-end loaded depreciation profile would be inappropriate for electricity distribution or transmission given the expectation that network utilisation is expected to be relatively balanced across the generations of customers. Using a straight line depreciation profile has the added attraction of relative price stability compared with any other profile. We therefore support Ofgem’s suggested approach that a straight line depreciation profile should be used.

## Transitional Arrangements

We welcome Ofgem's recognition of the importance of transitional arrangements in any move to a new approach to depreciation for electricity distribution assets. However, the view that the transitional arrangements should not exceed a single price control period (potentially eight years) is not one we agree with and we do not support. Transitional arrangements need to be in place for as long as it takes to resolve the problem they were designed to fix. This may potentially be longer than one price control period and likely to extend to 20 years. We note the two proposals for transition arrangements contained within the consultant's report: applying revised asset lives to new assets or stepped depreciation lives. Both of these mechanisms may require longer than one price control to fully unwind; the effectiveness of the mechanism in mitigating financeability issues must take precedence over any desire to constrain the mechanism to an artificially limited fixed time period. Applying the revised asset lives to new assets and allowing existing assets to continue to depreciate on the previous basis will help to maintain investor confidence in the regulatory system and be consistent with the process of "grandfathering" regulatory arrangements under an existing regime.

### **7.4 Assessing Financeability**

#### Financeability Ratios

It is essential that Ofgem utilises the most appropriate financeability tools to ensure that the overall price control package is financeable. If the package is not attractive to investors, companies will be unable to fund critical investment. Financeability tests and the thresholds must be consistent with Credit Rating Agencies' views.

Rating agencies and other regulators use a broad range of financial ratios to assess the financeability of utility companies. We are encouraged that the post maintenance interest cover ratio (PMICR) has been highlighted as a key credit rating metric. However, the definition of the PMICR needs to be aligned to the work on transitional arrangements to ensure that transition arrangements are not rendered impotent by the definition of PMICR. Any changes to the definition of PMICR must be agreed with the Credit Rating Agencies.

Equity metrics must also consider the importance of the stability of returns. Equity investors in listed utility companies see the investments as proxy bonds with comparatively high expected yields to compensate for low growth prospects. Similarly, long term infrastructure investment funds require steady returns throughout a price control period and across multiple periods to discharge their responsibilities and continue to attract investors to this asset class.

Whilst Ofgem's principles acknowledge that predictability and transparency of returns are important to long term investors, its two proposed equity metrics of Notional RAV / EBITDA and Regulated Equity / Regulated Earnings do not deal with this issue as they do not assess cash distributions to equity. Therefore, the long-term consistency of returns, the profile of returns across the period as well as the total returns should be recognised in Ofgem's financeability tests.

We acknowledge that the standard equity ratios of earnings per share, price:earnings ratio are not easily used for regulated companies; where many are privately owned. We accept, therefore, that the RAV figure is the appropriate basis to measure returns against. We suggest that Ofgem additionally sets target ratios regarding the level of cash distributions as part of the overall return on equity; as indeed it did in DPCR4. We propose an assumption of a range for cash yield with a minimum 50% of cash distributions of annual equity returns on the equity portion of the RAV; with the balance held as retained earnings. This additional financeability test would therefore measure a company's ability to make such annual cash distributions. Equity investors would not take the same view as looking at an average ratio over say 3 years, as the credit rating agencies will do for debt ratios. Missing 1 or 2 years of dividends or being unable to offer stable returns would cause network equity investors to completely review the attractiveness of their investments.

## Financeability Adjustments

A number of tools are available to address financeability issues that are exposed via assessment against financeability ratios. We strongly believe that, wherever possible, financeability adjustments should be Net Present Value (NPV) neutral in order that customers do not pay more than they need to. Ofgem should only use NPV positive adjustments once the neutral mechanisms are exhausted. Depreciation transition and capitalisation should therefore be first choice. Equity injections are not the most efficient way of addressing financeability issues

Ofgem must recognise that the financeability adjustments required to achieve acceptable packages may be very material in the first RIIO price controls, given the very significant changes to some of Ofgem's economically pure financing starting positions (particularly depreciation lives).