

Peter Trafford  
OFGEM  
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25<sup>th</sup> February 2011

Dear Peter

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

UK Power Networks welcomes the opportunity to respond to Ofgem's open letter on the regulatory asset lives for electricity distribution assets. I can confirm that this letter can be published on the Ofgem website; however, we would ask that the annex remains confidential.

We agree with the analysis presented that shows an economic asset life of 45-55 years for electricity distribution assets and the general principle of equalising regulatory asset lives to economic lives. We also acknowledge that there is a strong case for the reform of Networks financing, given the context of an imminent requirement for sustained high levels of capital investment, to facilitate the decarbonisation of the energy sector.

In advancing these proposals, Ofgem has sought to address the ultimate funding of this investment and specifically how to achieve an appropriate sharing of the burden between current and future customers. However, it is our belief that there is still further work required to arrive at suitable arrangements which will enable the Networks companies to finance their operations and ensure that the investment community has the confidence to provide the significant amounts of capital required.

The financing framework is one of the fundamental discussions within any price control. By its very nature, a range of factors need to be weighed up in achieving a settlement which is affordable for customers, acceptable to the companies and attractive to investors. Policy on regulatory depreciation is a key element within this, and hence we must question Ofgem's preference to bring forward the decision on this issue, and in effect remove it from that broader financing discussion. We believe that this will constrain those discussions and may in fact result in Ofgem needing to contemplate difficult decisions, such as an increase in the cost of capital, simply to fulfil its duty to ensure that companies are financeable.

We have modelled a range of scenarios in our financing model, further details of which can be found in the annex attached. It is clear that, without mitigating actions, Ofgem's current proposal for a 50-year depreciation period, introduced over an 8-year price control period, will lead to cash flow credit metrics that are sharply deteriorating even when capex profiles are broadly flat and gearing levels vs RAV are constant. To avoid downgrades in credit ratings, organisations would need to issue equity and maintain lower gearing levels going forward. This is not the basis on

which investors thought they were backing capital investments already made, nor is it consistent with Ofgem's assumptions regarding target capital structure.

Keeping all other parameters constant, we foresee a requirement for significant equity investment over an 8 year price control period. By flexing the ratio of fast and slow money to the statutory proportions of around 30/70, from the current 15/85, there would still be a need for a smaller but sizeable equity injection. This has all been modelled with an assumption of constant CAPEX investment.

Ofgem has had considerable success in establishing the credibility of the sector with investors, and the stability of the regulatory framework has been key to this. Modifying rules for future investment, so dramatically, will have a negative impact on investor perceptions of the attractiveness of our industry. Furthermore, changing the regulatory framework on investments already made will do lasting damage to investor confidence which will inevitably feed through into a requirement for higher returns to mitigate regulatory risk.

We are very strongly of the view that any change to regulatory depreciation should only apply to new assets (i.e. those constructed after 1 April 2015). This will have the dual benefit of providing a more tolerable transitional arrangement, whilst sending a clear signal to the investment community of Ofgem's long-term commitment to fair and transparent regulation of the sector. We regard this position as absolutely paramount.

Turning to the longer term, it does appear that there is the potential for contention between the shareholders reasonable expectations and Ofgem's broader role of balancing the needs of consumers, society more generally and the industry players. The change in depreciation period, when combined with an eventual flattening or downturn in capital investment, will result in future increases in cash flow relative to required expenditure. These increased cash flows will be the means through which shareholders will ultimately receive their returns on the enhanced investment delivered in the next 10-15 years.

We are concerned that Ofgem will inevitably come under pressure to moderate the returns to shareholders irrespective of their legitimacy. Of course Ofgem have the option of explicitly factoring this increased regulatory risk into the WACC. However, we recognise such an additional cost within the new framework will be difficult for Ofgem. Therefore, without fettering future regulator's discretion, we believe that all of the principles of any change to the depreciation policy and adjustment mechanism should be hard coded into the regulatory framework. We would point at the good work that has been done in the area of pensions as an example where this has worked well in previous price control settlements.

In summary, UK Power Networks proposes the following package which we believe would satisfy the interests of customers and both existing and future investors:

- Equalisation of regulatory asset lives with economic lives
- This change should only apply to new assets constructed after 1 April 2015
- A minor change to the ratio of fast and slow money, to bring it closer to the statutory proportions, to apply from 1 April 2015

We trust that this letter will inform Ofgem in arriving at proposals that will be acceptable to UK Power Networks. We restate our commitment to working with Ofgem to develop a sustainable approach to Networks financing, and are happy to share more detail of the results of our modelling.

If you have any queries, please do not hesitate to contact me on 0207 397 7715.

Yours sincerely

Keith Hutton  
Head of Regulation, Risk and Compliance  
UK Power Networks