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ofgem

Summary of views from City Workshop – 1 February 2011

On 1 February we held an investor workshop hosted by JP Morgan. The event consisted of a presentation by Stuart Cook, a breakout session for group discussions (with each group chaired by an Ofgem representative), and a concluding Q&A session. Below we note investors' key messages in response to the six questions that were discussed in the breakout session.

1. **Evidence from economic analysis, analyst reports and Bank of England assessment suggests 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?**

   The bottom end of the December range was regarded as unrealistic with better returns on investment available elsewhere. However, the upper end of the range (around 7%) was generally regarded as representing a good return given the current environment and the risk profile of the companies. There was some support for higher returns although generally it was accepted that companies would need to be high performers to merit additional returns. Some attendees suggested that the higher returns were either nominal returns or leveraged equity returns.

   Several attendees suggested that we need to be careful when interpreting premium to RAV from transactions (for example sale of networks) as there would be many reasons for the premium from these sales and it could not be assumed to be entirely the result of cost of capital outperformance.

   Attendees also expressed caution about over-reliance on the experience of the Offshore Transmission Operator (OFTO) regime. In comparison with onshore transmission companies, OFTOs were seen to operate different business models in a different commercial and regulatory environment.

   Several people suggested that the size of the capex programme had increased the risk of the businesses, particularly for the transmission companies, as would the cash flow implications of longer asset lives and cost of debt indexation. All these factors would support a cost of capital at the top of the range.

   There were requests for more clarity on the need for equity injections and some acceptance that they would be needed given the size of the capex programme.

2. **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?**

   The focus of discussions was on rewarding investors rather than the balance with protecting consumers. Credit metrics were highlighted as being key with some comments that we should pay more attention to Funds From Operations (FFO) and cash flow metrics used by Standard & Poor as well as PMICR.

Networks are no longer viewed as low risk given likelihood that they will be cash flow-negative during the first RIIO price control period

There was some concern that if the returns were not attractive enough for public investors it might push companies into a private equity model
Concerns were also raised about the potential for the proposals to have a large immediate impact on revenues although most recognized that we had made it clear that there would be transition arrangements to smooth in any significant changes.

3. **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?**

   There was acceptance that, given the move to 8-year price controls, some form of an uncertainty mechanism is needed some agreement with the concept of indexation. However, there were a number of suggestions for improvement.

   Many considered that indexation could create perverse incentives in terms of when companies issue debt, at what maturities, and whether companies try to track the index in order to hedge against the risk of underperforming it. Other concerns included the choice of a 10 year trailing average which would not take account of older-dated debt, which is more expensive than that is captured by the index.

   Many attendees were concerned that a mechanistic approach was too simplistic and if followed too rigidly could result in companies being insufficiently rewarded. Attendees preferred to see the potential for regulatory judgment.

   There was concern about the use of Bloomberg as our source and some considered that the index needed to capture additional costs e.g. issuance costs and credit rating agency fees.

   A number of suggestions were made to improve the index including ratings to be included, maturity, length of trailing average and weighting but without any consensus on suggestions.

4. **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?**

   Discussions focused primarily on the transitional arrangements, with some regarding these as just another "regulatory fudge" rather than a glide-path to a more sustainable, stable and predictable set of regulatory policies.

   There was concern that we would limit transition to one eight-year price control period and a request for greater clarity over how we will assess the transitional arrangements proposed by the companies in their business plans.

Although many welcomed the potential to earn additional returns through incentives there was also concern that this could increase riskiness and overall industry costs and some highlighted that the calibration of incentives is key. An over-reliance on relative performance incentives could mean that some companies lose out even if they improve their performance.

Some respondents noted that it is important that Ofgem strikes the right balance between the strength of incentives and the level of risk.

5. 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?

There was limited discussion of this question with the general view that the risk levels and management quality was very similar across the UK regulated sector with some suggestion that the water sector was more attractive at present.

Some european networks were seen as having higher regulatory risk, less commercial management and the potential for higher returns.

Some respondents noted that any changes to the regulatory framework, regardless of their justification, could be seen to increase risk.

Some respondents also noted that investors might look negatively at a decision to reduce the allowed cost of equity below the level established for the last distribution price control review (DPCR5).

6. 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?

There was a strong desire expressed that investors needed to have better and more consistent information on the performance of the companies and that this requirement would increase as a companies' performance was more dependent on performance against outputs and incentive schemes.

Our introduction and use of the regulated return on equity (RoRE) received mixed views. Some see it as a valuable comparative tool and a piece of information that investors would not otherwise have, whilst others question its use particularly in the context of setting the base allowed revenues.