



Assessing Financeability at RIIO-2

Western Power Distribution (WPD)

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Executive Summary

WPD commissioned NERA Economic Consulting (NERA) to review Ofgem's proposals in relation to ensuring financeability for RIIO-2 controls, as set out in its recent Framework Consultation.

Ofgem is consulting on three options to address financeability at RIIO-2

As Ofgem notes in its Framework Consultation, Ofgem has a statutory duty to have regard to companies' ability to finance their activities. Ofgem states that at previous reviews it has assessed whether companies can maintain an investment grade credit rating drawing on rating agencies' methodologies, and confirms that it intends to undertake a similar approach at RIIO-2.¹

However, it also notes that its proposed cost of equity and a declining cost of debt allowance is likely to lead to a lower overall baseline return at RIIO-2 which will make it more challenging to meet the standard financeability metrics which may deteriorate. Ofgem is consulting on three policy options for addressing financeability issues:²

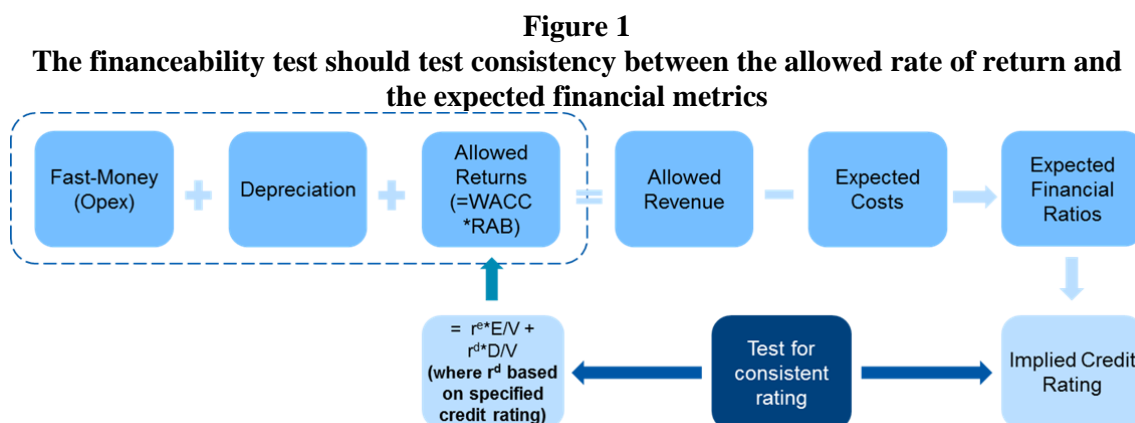
- Option A: Adopting a nominal return instead of a real return which will bring cash-flows forward
- Option B: Putting the onus on companies, e.g. to de-gear
- Option C: Introducing a licence backed revenue floor

The Onus should be on Ofgem to ensure consistency of its financial proposals

We have reviewed Ofgem's proposed approach and three options. The financeability test is a test of consistency between the rating underpinning the allowed rate of return and the rating implied by the forecast financial metrics. We conclude that if a lower cost of equity at RIIO-2 leads to a credit rating below an average of A and BBB (the rating that we expect to form the basis for the cost of debt allowance), then the onus is on Ofgem to reconsider its proposed cost of equity, and/ or the rating of the index underpinning the cost of debt mechanism.

¹ Ofgem (March 2018), op. cit., p.93.

² Ofgem (March 2018), op. cit., p.93.



Source: NERA illustration

The financeability test is generally performed on a notional basis. However, where Ofgem's approach to the cost of debt provides for an allowance that is lower than network companies' actual cost of debt, the financeability analysis should also be undertaken on the basis of actual debt costs.

Ofgem's short-term fixes (option B) do not resolve underlying problems, and may not be recognised by rating agencies

As Ofgem acknowledges short-term fixes, e.g. bringing forward cash-flows as under option B, do not resolve the underlying issue and will simply defer financeability issues to subsequent review periods. In addition, any arbitrary changes to regulatory levers (e.g. capitalisation rates) may not be recognised by rating agencies, and therefore may not result in improvements to financial metrics.

Ofgem's options A and C involve fundamental changes to the regime

One of Ofgem's other proposed fixes, moving to a nominal WACC (option A), represents a fundamental change to the existing regulatory framework and should be assessed in a wider policy context than purely considering financeability implications, including higher short-term bills and inter-generational equity.

In relation to option C, Ofgem proposes to provide minimum debt cover based on notional capital structure and notional cost of debt. There is no provision for companies' actual capital structure or actual debt costs, so the provisions may have little value to creditors. Ofgem also intends that any advanced revenues are recovered over future years: this approach simply defers financeability issues to subsequent years. The approach would also involve greater regulatory cost, in contrast to Ofgem's intention to simplify the regulatory framework.

Overall, Ofgem's proposed options undermine regulatory predictability and certainty, and may increase financing costs

Ofgem's proposed options for addressing financeability depart from established regulatory practice and therefore undermine the predictability and certainty of the regulatory regime. This could have knock-on effects on credit metrics and cost of debt finance. For example,

Moody's ratings criteria include "*stability and predictability of regulatory regime*". Moody's elaborates on this measure as follows: "*We consider the characteristics of the regulatory environment in which a network operates. These include how developed and transparent the regulatory framework is; the regulator's track record for predictability and stability in terms of decision making [..].*"³

The implication is that a lower sub-rating on this metric could result in a lower overall credit rating for any given set of financial metrics, worsening companies' ability to finance their activities.

³ Moody's (2009), "Rating Methodology. Regulated Electric and Gas Networks", August, p.9. Link: https://www.eru.cz/documents/10540/462856/Priloha_c_4_RWE.pdf/a86f43c1-990c-4748-b383-1bc8abeccc59

1. Introduction

WPD commissioned NERA Economic Consulting (NERA) to review Ofgem's proposals in relation to ensuring financeability for RIIO-2 controls, as set out in its recent Framework Consultation.⁴

Ofgem is consulting on three policy options for addressing financeability issues:⁵

- Option A: Adopting a nominal return instead of a real return which will bring cash-flows forward
- Option B: Putting the onus on companies, e.g. to de-gear
- Option C: Introducing a licence backed revenue floor

In this section, we review Ofgem's proposed approach and three options, and respond to the three specific questions it raises in relation to these options.

This report is structured as follows:

- Section 2 explains the rationale for the financeability test, and the need for Ofgem to demonstrate the integrity of its revenue proposals, and therefore responds to Ofgem's Option B (putting the onus on companies). We also set out the relevant ratios and thresholds.
- Section 3 discusses how Ofgem's option A, setting the price control based on a nominal WACC, would lead to higher bills and financing costs.
- Section 4 explains that Ofgem's option C, revenue floor, ignores the fundamental issue and is impracticable.
- Section 5 explains why such unpredictable changes to the regulatory regime can worsen financeability.
- Section 6 draws conclusions.

⁴ Ofgem (March 2018), RIIO-2 Framework Consultation.

⁵ Ofgem (March 2018), op. cit., p.93.

2. Contrary to Ofgem's Option B, the onus should be on Ofgem to ensure the consistency of its financial proposals

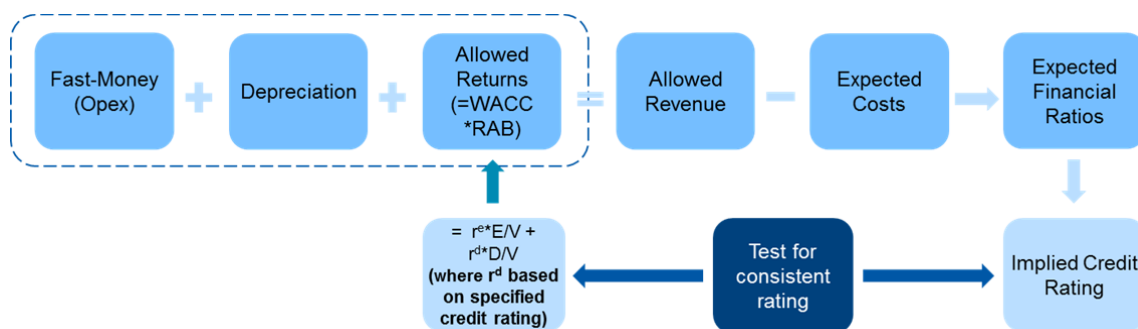
Under its option B, Ofgem suggests that the onus could be on companies to address notional or actual financeability constraints, for example, through an equity injection. It also raises the prospect of changes to regulatory parameters such as capitalisation rates to address credit metrics, although Ofgem acknowledges that such an approach may be discounted by rating agencies (RAs).⁶

We disagree that the onus should be on companies. In this section, we set out why the onus should be on Ofgem to ensure the consistency of its proposals.

2.1. A financeability test is a check on the consistency of the allowed return and the outturn financial metrics

A financeability test should assess whether a reasonably efficient licensee is able to finance its operations on reasonable terms and consistent with the terms assumed in the allowed return element of its allowed revenues.⁷ Specifically, the test should establish whether there is consistency between the credit rating underpinning the notional cost of debt in the allowed rate of return and the credit rating implied by the projected financial ratios under a notional financing structure, as shown in Figure 2.1.

Figure 2.1
In theory, the financeability test should test consistency between the allowed rate of return and the expected financial metrics



Source: NERA illustration

If the projected financial ratios imply that a reasonably efficient regulated business cannot raise debt finance on the terms (i.e. credit rating) as assumed in the allowed rate of return, the regulator has not set overall revenues that allow the company to have a reasonable prospect

⁶ Ofgem (March 2018). RIIO-2 Framework Consultation, p.97.

⁷ Regulators generally apply the test to their view of efficient costs. At RIIO-1, Ofgem considered that WPD's costs were efficient, as demonstrated by its fast-track status. See: Ofgem (2014) Decision on fast-tracking, Link: https://www.ofgem.gov.uk/sites/default/files/docs/2014/02/fast-track_decision_letter.pdf

of recovering its costs. In these circumstances, the allowed rate of return cannot be considered reasonable.

Regulators conduct such tests to ensure that companies are able to finance their activities, a standard regulatory objective. For example, at ED1 Ofgem referenced its Principal Objective which is to protect consumers, and under which it must have regard to the need to secure that companies can finance their activities.⁸

In terms of solutions, if the projected ratios are weaker than the credit rating underpinning the cost of debt allowance at RIIO-2, then the direct resolution is for Ofgem to increase the cost of equity allowance to ensure the integrity of the revenue proposals. An alternative solution may be to set the cost of debt indexation mechanism based on an index which corresponds to the projected rating (e.g. BBB). In relation to the latter, Ofwat determined a BBB rated iBoxx index for the Thames Tideway Tunnel based on projected BBB credit metrics and rating for the infrastructure provider to ensure the integrity of the framework.^{9, 10}

2.2. Target ratio levels should be consistent with rating for allowed cost of debt index

Ofgem stated that it intends to use gearing (net debt to RAV), and the post-maintenance coverage interest ratio (PMICR) as the key credit metrics for its financeability assessment at RIIO-2, while it will also consider other metrics including funds from operations (FFO) interest cover, and retained cash-low (RCF) to net debt.¹¹

Moody's rating methodology provides a relatively mechanistic approach to rating determination, which Ofgem intends to draw on to conduct the financeability test at RIIO-2. The target financial ratios consistent with an A and BBB rating used by Moody's are set out in Table 2.1 below.

⁸ Ofgem stated: "3.1. Our principal objective is to protect the interests of existing and future consumers. In carrying out its functions in accordance with the principal objective, the Authority must also have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations on them. This means that, in setting price controls, we should have regard to the ability of network companies to secure financing in a timely way and at a reasonable cost in order to facilitate the delivery of their regulatory obligations. 3.3. We generally equate financeability with an ability to maintain an investment grade credit rating. The first stage of our financeability assessment is therefore to consider how our proposed price controls will affect credit ratings." (Source: Ofgem (July 2014), RIIO-ED1 Draft determination for the slow-track electricity distribution companies - Financial Issues, para 3.1, p.16.)

⁹ Thames Tideway Tunnel Project Licence, August 2015, p.72. Link: https://www.ofwat.gov.uk/wp-content/uploads/2015/10/lic_lic_baz.pdf

¹⁰ The Utility Regulator in Northern Ireland determined a BBB rated iBoxx index for PNG and firmus at the most recent reviews (GD17), as well as a NIE at RP7. These decisions were based on an assessment of credit risk, and an assumption that BBB represented the efficient notional rating. See for example, UR (November 2016) Price Control for NI GDNs, Chapter 10. Link: https://www.uregni.gov.uk/sites/uregni.gov.uk/files/media-files/2016-09-15_GD17_Final_Determination_-_final_0.pdf

¹¹ Ofgem (March, 2018), op. cit., p.94.

Table 2.1
Target Credit Rating Ratios Consistent with Moody's A and BBB Credit Score

Financial metric	A	Baa
Adjusted Interest Coverage Ratio:	2 - 3.5x	1.4 - 2x
OR	OR	OR
FFO Interest Coverage	4 - 5.5x	2.8 - 4x
Net Debt / RAB OR Net Debt / Fixed Assets	45 - 60%	60 - 75%
FFO / Net Debt	18 - 26%	11 - 18%
RCF / Net Debt	14 - 21%	7 - 14%

Source: Moody's (March 2017), Rating Methodology: Regulated Electric and Gas Networks, p.19

At ED1, although focusing closely on Moody's methodology, Ofgem considered a wider range of financial metrics than those used by Moody's. The list of financial metrics and thresholds for investment grade credit rating, as considered by Ofgem at ED1, are set out in Table 2.2 below.

Table 2.2
At ED1, Ofgem conducted its financeability test based on BBB ratio thresholds

Financial metric	Threshold
FFO interest cover ratio	2.5 min
Adjusted interest cover ratio, or PMICR	1.4 min
FFO / Net Debt	8% min
RCF / Net Debt	5% min
Net Debt / RAV	80% max
RCF / Capex	0.5 min
Regulated equity / EBITDA	5.5 max
Regulated equity / PAT	18 max
Dividend cover ratio	1.0 min

Source: Ofgem, RIIO-ED1 Draft determination for the slow-track electricity distribution companies, Table 3.1, p. 17.

By comparison with Table 2.1, the thresholds for ratios applied by Ofgem at ED1 appear to be closer to BBB rating rather than average A and BBB, and therefore appear inconsistent with its notional cost of debt assumption (based on an average of A and BBB rated iBoxx bond indices). At RIIO-2, Ofgem should ensure that the projected ratios, alongside the qualitative factors considered by Moody's in determining the overall credit rating for energy networks, are consistent with an average of A and BBB, assuming that this is the basis for the cost of debt indexation mechanism.

Ofgem should also consider financeability based on actual debt costs and capital structure, as well as notional.

In principle, the assumed initial gearing should be consistent with the gearing assumed by the regulator in determining the WACC. At ED1, Ofgem's central assumption was to test financeability based on the notional debt position of DNOs, on grounds that it is up to DNO owners to resolve issues that may arise if their actual position significantly differs from notional. Similarly, Ofgem's baseline scenario assumed debt costs consistent with the cost of debt allowance.¹²

However, Ofgem should also consider financeability using actual gearing and actual cost of debt. For example, at ED1, Ofgem considered financial ratio sensitivities based on actual gearing levels and actual debt costs,¹³ and similarly the CMA in the cases of Bristol Water and NIE considered actual gearing and actual debt costs.¹⁴

In particular, where a company's actual cost of debt differs from the regulators' allowance (e.g. where the regulator has allowed an industry wide embedded debt cost rather than a company specific cost of debt), this provides a rationale for using companies' actual debt costs in the test. This may be an important issue for licensees at RIIO-2, depending on Ofgem's approach to setting the cost of debt allowance.

2.2.1. Financeability testing should be undertaken against plausible downside scenarios

At ED1, Ofgem's central assumption was to test financeability based on the notional debt position of DNOs, as well as extending the analysis to take account of the DNO's actual embedded debt positions (as noted above)¹⁵. Ofgem also considered financeability under a range of interest rate scenarios, modelling both changes to company interest costs and allowances, in order to assess resilience to possible downside scenarios.¹⁶

Likewise, the financeability assessment at RIIO-2 should also include testing based a range of different interest rate scenarios including plausible downside scenarios.¹⁷ As well as interest costs, the stress testing should encompass plausible downside scenarios for totex, where downside scenarios should take into account any difference between Ofgem's view of efficient costs and companies' business plan submission.

¹² Ofgem (July 2014), RIIO-ED1 Draft determination for the slow-track electricity distribution companies - Financial Issues, para 3.9, p.17.

¹³ Ofgem (July 2014), RIIO-ED1 Draft determination for the slow-track electricity distribution companies - Financial Issues, para 3.10 – 3.11 and Table 3.2, p.17. Also see Ofgem (July 2014), RIIO-ED1 Draft determination for the slow-track electricity distribution companies - Overview, para 5.25, p.42.

¹⁴ See for example, CMA (2015) Bristol Water plc. Link: https://assets.publishing.service.gov.uk/media/56279924ed915d194b000001/Bristol_Water_plc_final_determination.pdf

¹⁵ Ofgem, Draft Determination for RIIO-ED1 – Financial Issues, para 3.9.

¹⁶ Ofgem (2014) Final Determination for RIIO-ED1, Para 5.24 Link: https://www.ofgem.gov.uk/sites/default/files/docs/2014/11/riio-ed1_final_determination_overview_-_updated_front_cover_0.pdf and para 3.9-3.10 of Draft Decision.

¹⁷ Ofgem, RIIO-ED1 Draft determination for the slow-track electricity distribution companies.

2.3. Assumed dividend pay-out and variation in capital structure

Both Ofgem (RIIO ED1 for slow track DNOs) and CMA (NIE 2014) have modelled dividend pay-out ratios at 5 per cent of the equity portion of the RAV. The CMA's rationale for this assumption is that an efficient licence holder would implement a dividend pay-out policy consistent with the post-tax cost of equity reflected in the WACC determination, i.e. around 5 per cent.¹⁸

The revenue allowance at RIIO-2 should also provide for equity issuance costs to achieve the notional gearing at the start of RIIO-2 where this is changed relative to previous reviews. That is, Ofgem should provide for issuance costs to allow companies to de-gear to the lower notional gearing. Ofgem should also continue to provide for equity issuance costs to maintain the notional rating during review, e.g. where companies' investment programme would otherwise increase gearing above the notional level. As at previous reviews, Ofgem should allow for the cost of such (notional) equity injections, e.g. at RIIO-1, Ofgem allowed for an equity issuance cost of 5 per cent.¹⁹

2.4. Ofgem correctly recognises that short-term fixes may not be supported by Rating Agencies

Under its proposed option B, Ofgem notes that Ofwat has considered changes to depreciation and capitalisation rates in order to ensure financeability at PR19, but acknowledges that in early discussions the rating agencies have said that they will “discount such approaches”.²⁰

We agree: there may be constraints from rating agencies on regulators' ability to use such short-term fixes to address financeability constraints, where the fix simply postpones problems to future price controls.

Specifically, in the context of its proposed switch to CPI indexation, Ofwat has stated that companies may consider adjustments to pay-as you go (PAYG, or that element of expenditure recovered within year) to off-set any negative bills impacts. However, PAYG adjustments – which move away from the “natural” expense/ capitalisation rate – may not be recognised by Rating Agencies. For example, Moody's has stated that that “*use of regulatory levers to offset bill increases could erode confidence in the regulatory framework. [...] if revenue deferrals are imposed on companies such that the “allowed” return can never be realised, our current view of the regulatory framework could be weakened.*”²¹

Moody's has also questioned the potential use of short-term financial levers in the case of Phoenix Natural Gas, which has substantive revenue deferral as a consequence of the need to smooth prices in the early years of the project, and consequently weak credit ratios. In this

¹⁸ CMA (2014) NIE plc, para 17.39. Link: https://assets.publishing.service.gov.uk/media/535a5768ed915d0fdb000003/NIE_Final_determination.pdf

¹⁹ See for example, Ofgem price financial model (PCFM), https://www.ofgem.gov.uk/system/files/docs/2017/11/et1_pcfm_november_2017.xlsm

²⁰ Ofgem (2018) op. cit., p. 96

²¹ Moody's (January 2016), Transition to CPI creates risks for water and energy networks, p.1.

case, Moody's states that: "[...] *although the AICR is likely to rise if financial levers are used [...] we would not regard credit quality as having been improved.*"²²

2.5. Conclusions on Ofgem's Option B

In conclusion, under option B, Ofgem asks whether the onus should be on companies to address financeability issues, e.g. through an equity injection and associated de-gearing to achieve investment grade credit metrics. As we explain in this section, such an approach would not be appropriate. The onus should be on Ofgem to ensure the consistency of its financial proposals at least on a notional basis, and potentially also on an actual basis where the notional cost of debt allowance is lower than companies' actual debt costs. It is up to companies to ensure that they maintain an investment grade credit rating based on their *actual capital structure*, and consistent with licence requirements, but only once Ofgem has demonstrated the integrity of the price control proposals on a *notional* basis.

²² Moody's (January 2016), Transition to CPI creates risks for water and energy networks, p.6.

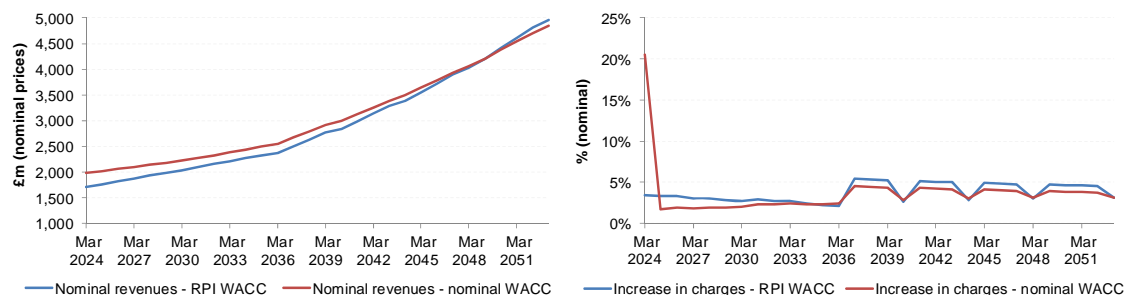
3. A nominal based WACC may improve financeability, but would lead to higher bills and financing costs

A switch to a nominal based WACC regime would bring cash-flows forward which could potentially improve credit metrics, but introducing such a substantial change to the existing regulatory framework should be considered in a wider policy context, as opposed to being adopted as a “fix” to any existing financeability concerns. A switch to nominal WACC would lead to higher network charges in the short run, while reducing them in the long-run compared to the existing RPI-indexation approach, raising concerns of inter-generational equity. It could also lead to potential increases in debt financing costs due to the removal of the RPI ILD hedge.

We have modelled the illustrative impact on network charges for WPD of a switch to a nominal WACC regime from the existing RPI-indexed approach at the start of RIIO-ED2.

First, we consider the impact of the change in isolation, i.e. we assume that all regulatory parameters (e.g. totex, capitalisation rate, depreciation, WACC) remain fixed as per ED1.²³ Based on these assumptions, we estimate that a switch from RPI-indexed to a nominal WACC would lead to a one-off increase in WPD’s DNOs’ network charges of around **20 per cent** relative to the existing RPI-indexed approach (offset by lower charges in the long-run), as shown in Figure 3.1 below. In absolute terms, the increase in charges would be around 21 per cent under a nominal WACC approach at the start of ED2 (as shown in Figure 3.1).

Figure 3.1
A switch to nominal WACC would increase DNOs' network charges by around 17 per cent at the start of ED2 relative to RPI WACC approach, assuming WACC as per ED1 (2018/19 value)



Source: NERA modelling

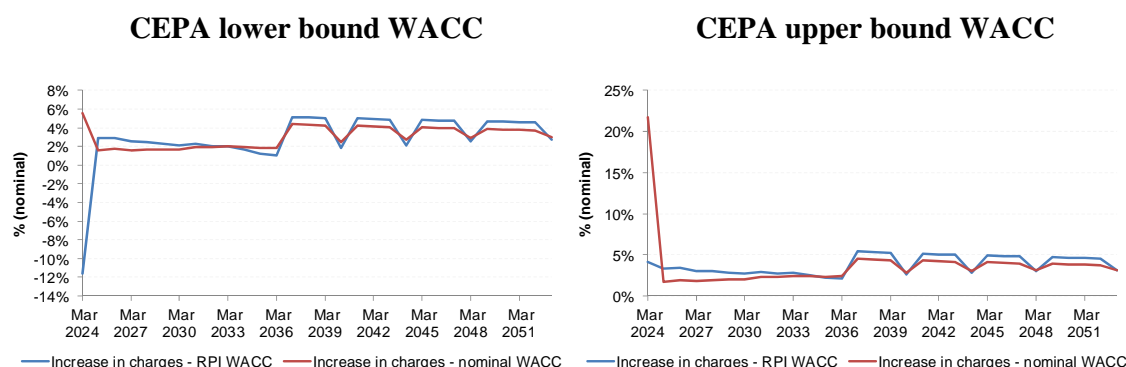
Note, the profile of charge increases observed for the period post-2036 is driven by the depreciation profile and the assets depreciated as per RIIO-ED1 transitional arrangements falling out from the allowance.

Second, we consider the impact of the change to a nominal WACC approach, but also taking into account potential changes in the allowed rate of return for ED2, using CEPA’s estimated

²³ Specifically, we assume all regulatory inputs from ED2 onwards are equal to the forecast for year ending March 2023, the last year of ED1. For the WACC, we assume a value equal to the latest update for year ending March 2019.

vanilla WACC for RIIO-2 of 1.27 to 3.62 per cent (real, RPI-deflated).²⁴ As shown in Figure 3.2, the *relative increase* in charges due to change from RPI-indexed WACC to a nominal WACC is similar to Figure 3.1 above (around 17-18 per cent), while the *absolute increase* in charges at the start of ED2 is between 6 and 22 per cent, taking into account the change in the WACC for RIIO-2 as estimated by CEPA.

Figure 3.2
Taking into account CEPA's WACC for RIIO-2 shows charges would increase between 6 and 22 per cent in absolute terms at the start of ED2



Source: NERA modelling

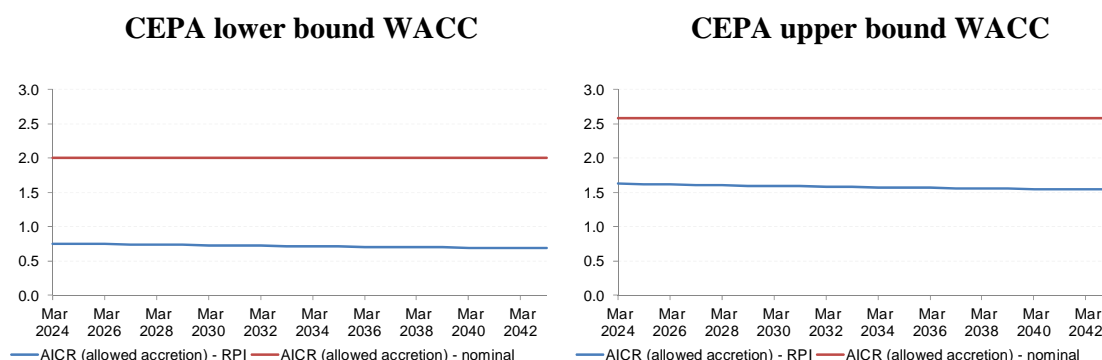
Figure 3.3 below shows that bringing forward cash through a change to nominal WACC at ED2 could lead to adjusted interest cover ratios (AICR) which are above Ofgem's threshold of 1.4²⁵, if WACC is set within the CEPA proposed range (assuming notional financial structure). However, the below results crucially depend on the reasonableness of the allowed cost of debt estimates included in CEPA's WACC, which appear questionable notably in CEPA's lower bound, which assumes a real cost of 0.3 per cent (real, RPI-deflated) for RIIO-2.²⁶

²⁴ CEPA (February 2018), Review of cost of capital ranges for Ofgem's RIIO-2 for onshore networks, Table 7.1, p.71.

²⁵ See Table 2.2

²⁶ See: CEPA (2018) op. cit., p.37. CEPA's 0.30 per cent cost of debt estimate is based on a number of assumptions that are likely to understate the efficient debt costs of WPD over RIIO-2. First, CEPA assumes a 10 year trailing average of the average of A and BBB rated iBoxx over RIIO-2. The conceptually correct approach is to match the trailing average to the average tenor of issuance of the constituent bonds in the index of around 20 years, which will provide for a higher forecast. Second, CEPA makes a downward adjustment of 25 bps for the so-called regulatory halo effect, although its conclusions contradict other studies. For example, the CMA undertook its own analysis of the existence of the halo effect at BGT 2015 appeal of Ofgem's RIIO-ED1 decision. The CMA noted that there was no evidence of a halo effect since 2009, and that any historical halo effect had diminished over time. See: *CMA (2015) British Gas Trading Limited v The Gas and Electricity Markets Authority*, Figure 15, p.150. Third, CEPA derives the real cost of debt based on a 20-year breakeven inflation which is likely to over-state inflation because of illiquidity issues, and is currently ca. 30 bps higher than the HMT's long-term inflation forecast. For example, CMA discussed illiquidity issued in long-dated IL gilts. See *CMA (then CC) (March 2014), Northern Ireland Electricity Limited price determination*, p.13-21.

Figure 3.3
Nominal WACC approach could lead to AICR above Ofgem threshold of 1.4



Source: NERA modelling

Even though the adoption of a nominal WACC approach may bring forward cash which can help address financeability concerns for ED2, this represents a fundamental change to the existing regulatory approach which should be considered from a wider perspective than just financeability. Such wider considerations should include, as a minimum, the following factors:

- **Impact on network charges (short-run):** As shown above, the introduction of nominal WACC would lead to a one-off increase in network charges between 6 and 22 per cent at the start of ED2. Such a substantive increase is unlikely to be justified from the customers' perspective. This increase could be in theory offset by adjusting other regulatory parameters (e.g. capitalisation rates). However, any such adjustments would remove the benefit of cash being brought forward in the first place and hence lead to no improvement in financeability and may also be viewed negatively by rating agencies as undermining the confidence in the regulatory framework (as set out in section 2.4).
- **Inter-generational equity (long-run impact on network charges):** A switch to nominal WACC also raises concerns regarding inter-generational equity. A nominal WACC approach implies that in a steady state, the value of the asset base is written down in real terms over time, which in turn implies that current customers would pay a higher price than future customers for receiving the same service. This may not be considered fair from an inter-generational equity perspective.
- **Impact on risk from removing RPI-hedge for ILD:** A switch to nominal WACC would remove the RPI-inflation hedge offered by the current regulatory regime, which companies have used to issue RPI-linked debt. This in turn could increase companies' financing costs (e.g. through companies having to hedge their existing RPI exposure using RPI-nominal swaps).

4. A licence backed revenue floor ignores the fundamental issue with poor metrics, and is impracticable (Option C)

4.1. Ofgem identifies two variants for a revenue floor

Under option C, Ofgem proposes to limit the downside of the price control package to give greater assurance that debt costs will be met. It states that this would involve “*introducing a licence condition that sets a floor below which company revenue would not be allowed to fall*”, and that the floor could be set at a level that “*would allow a notionally geared company to more easily service interest payments equal to the cost of debt allowance.*”²⁷

Ofgem considers that the revenue floor could secure higher value for consumers, as “*a positive impact on credit ratings could reduce the rate of interest lenders would require. Similarly, reducing default risk could provide further downward pressure on rates.*”²⁸ It identifies two variants:

- Variant 1: *Maximum penalties*: Places a limit on the value of underperformance, e.g. by determining that the return on regulated equity (RoRE) would not fall below a pre-defined level, say, 1 per cent;
- Variant 2: *Minimum coverage ratios*: E.g., Ofgem would provide a minimum revenue to ensure a particular level for a financial ratio such as the AICR

In either case, Ofgem notes that the additional revenue required to meet debt payments would need to be returned to consumers at a future date, e.g. through a reduction in the value of RAV or reduced revenues.

4.2. The approaches ignore the fundamental problem that financeability identifies

Our main concern with Ofgem’s proposed revenue floor is that it avoids the fundamental problem: where expected credit metrics correspond to a rating which is below the rating assumed in the allowed return, the allowed return should be reconsidered. That is, Ofgem’s proposals ignore the inconsistency problem and the reason for the financeability test.

We also consider the approaches are impracticable:

- Ofgem proposes to provide minimum debt cover based on notional capital structure and notional cost of debt. There is no provision for companies’ actual capital structure or actual debt costs, so the provisions may have little value to creditors (and therefore to customers). In particular, companies’ actual cost of debt is likely to exceed notional in many cases given Ofgem’s proposals on setting the cost of debt allowance.
- Ofgem intends that any advanced revenues are recovered over future years: the approach simply defers financeability issues to subsequent years. It also suggests that the revenue

²⁷ Ofgem (2018) op. cit., p. 96

²⁸ Ofgem (2018) op. cit., p. 96

floor would provide little value to creditors, as in theory companies could rebalance cash-flows, e.g. itself borrow against future cash-flows as opposed to effectively borrowing from customers.

- The revenue floor may provide some insurance in the event of adverse cost or incentive performance. However, cost performance is observed with a lag, and accounted for in the price control financial model (PCFM) with a lag of at least two-years. These timelines may be too long to provide adequate protection for creditors.
- Ofgem has an objective to simplify the framework, but a revenue floor provides for further complexity and intrusion.

5. Ofgem's options undermine consistency and predictability of the regime

Ofgem's proposed options for addressing financeability depart from established regulatory practice and therefore undermine the consistency and predictability of the regulatory regime.

Predictability or consistency is an established principle of good economic regulation. For example, the UK Government has published core principles for the development of the UK economic regulators which identify predictability as a key principle:²⁹

- *“the framework for economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence*
- *the framework of economic regulation should not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return, subject to the normal risks inherent in markets”*

The OECD identified predictability in order “to curb opportunistic behavior” as a core principle for economic regulators. The OECD elaborates on the principles of consistency and predictability as follows:³⁰

- *“Consistency, reducing the risk that returns on sunk investments might be expropriated through lower than optimal charges for their use by third parties;*
- *Stability and predictability, reducing the risk that plans for infrastructure maintenance and development or for transport services will be changed to reflect short term political pressures (rather than staying with long term political objectives), raising costs or confiscating value;”*

Moreover, regulatory stability and predictability are highly valued by credit rating agencies in their scoring methodologies. In particular, the methodology rests on four key factors, one of which is ‘Regulatory Environment and Asset Ownership’, accounting for 40 per cent of the final score. One of the criteria this factor is measured against is ‘stability and predictability of regulatory regime’. Moody's elaborates this measure as follows:

“We consider the characteristics of the regulatory environment in which a network operates. These include how developed and transparent the regulatory framework is; the regulator's track record for predictability and stability in terms of decision making; and its independence vis-à-vis politicians.

²⁹ UK Department for Business and Skills (April 2011) Principles for Economic Regulation, p.5
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31623/11-795-principles-for-economic-regulation.pdf

³⁰ OECD (2011) Better Economic Regulation: The role of the regulator, p. 12
<http://www.internationaltransportforum.org/jtrc/DiscussionPapers/DP201103.pdf>

A network operating in a stable, reliable and highly predictable regulatory environment will be scored high; those networks operating in a less developed regulatory framework [...] will receive the lowest scores on this factor.”³¹

Specifically, in order to justify the highest rating of Aaa, “*Regulation is independent, well established (>15 years of being predictable and stable) and transparent (published methodologies clearly define risk allocation between companies and customers and are consistently applied, with public or shared financial model)*”.³²

The implication is that a lower sub-rating on this metric could result in a lower overall credit rating for any given set of financial metrics, worsening companies’ ability to finance their activities.

³¹ Moody’s (2009), “Rating Methodology. Regulated Electric and Gas Networks”, August, p.9. Link: https://www.eru.cz/documents/10540/462856/Priloha_c_4_RWE.pdf/a86f43c1-990c-4748-b383-1bc8abeccc59

³² Moody’s (2009), “Rating Methodology. Regulated Electric and Gas Networks”, August, p.11. Link: https://www.eru.cz/documents/10540/462856/Priloha_c_4_RWE.pdf/a86f43c1-990c-4748-b383-1bc8abeccc59

6. Conclusions

The financeability test is a test of consistency between the rating underpinning the allowed rate of return and the rating implied by the forecast financial metrics. If the financial metrics provide a credit rating below an average of A and BBB, then this provides a clear rationale for Ofgem to reconsider either the cost of equity, or the rating of the index underpinning the cost of debt mechanism.

The test is generally performed on a notional basis. However, where Ofgem's approach to the cost of debt provides for an allowance that is lower than network companies' actual cost of debt, this provides a reason for conducting a financeability test on the basis of actual debt costs.

As Ofgem acknowledges short-term fixes, e.g. bringing forward cash-flows, do not resolve the underlying long-term issue and any arbitrary changes to regulatory levels (e.g. capitalisation rates) may not be recognised by RAs. Ofgem's other proposed fixes – nominal returns – represent fundamental changes to the existing regulatory framework and should be assessed in a wider policy context than purely considering financeability implications (including higher short-term bills and inter-generational equity considerations).

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