ofgem Making a positive difference for energy consumers

Financeability Assessment for RIIO-2:

Further Information

S&N Regulatory Finance Team

26 March 2019

Important Note

- This document provides further guidance to Transmission and Gas Distribution companies with regards to how they should assess financeability, as mentioned in the December 2018 Sector Specific Consultation ("SSC").
- Stakeholders were asked the following relevant questions as part of the December Consultation:
  - FQ22: What is your view on our proposed approach to assessing financeability? How should Ofgem approach quantitative and qualitative aspects of the financeability assessment? In your view, what are the relevant quantitative and qualitative aspects?
  - FQ23: Do you agree with the possible measures companies could take for addressing financeability? Are there any additional measures we should consider?
- Whilst the Sector Specific Decision is due to be published in May 2019, this guidance is being provided alongside the business plan model to aid companies' business plan submissions, but will be updated as necessary.

Proposed Approach to Assessing Financeability

ofgem Making a positive difference for energy consumers

Background to Ofgem's Statutory Objective & Duties

- Section 3A of the Electricity Act 1989 and section 4AA of the Gas Act 1986 set out Ofgem's principal objective and general duties. The relevant wording in relation to the principal objective and financeability appears across these two Acts and states the following:

  - "(1) The principal objective of the Secretary of State and the Gas and Electricity Markets Authority (in this Act referred to as "the Authority") in carrying out their respective functions under this Part is to protect the interests of existing and future consumers……."
  - "(2) In performing the duties………….the Authority shall have regard to……
    (b) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed…… "

ofgem Making a positive difference for energy consumers

Proposed Approach to Assessing Financeability

- We propose the following approach to assessing financeability
  - Consider a notional efficient operator in the relevant sector
  - Consider financeability at the individual licensee level on a notional basis
  - Consider a suite of financial ratios, including the average over the 5 year control and any trend
  - Consider these alongside qualitative factors pertaining to each sector
  - Set the notional gearing level at the start of the price control with modelled gearing allowed to fluctuate in accordance with price control cashflows
  - Carry out sensitivity testing to assess the resilience of financial ratios under different scenarios
  - Although the focus of the financeability assessment as a check to the price control financial package will focus on the notional company we will provide companies with the ability to input actual company structures into business plan data templates and the business plan model
  - Expect licensees to provide board assurance that the licensee is financeable on both a notional and actual basis

Licensees will remain responsible for their financing decisions and choice of actual capital structure with the risks associated with these decisions remaining with shareholders, not consumers. Licenses will continue to include a requirement to maintain an investment grade credit rating

ofgem Making a positive difference for energy consumers

Financial Ratios

- We propose to continue to use a suite of financial ratios to assess financeability alongside qualitative factors.
- We would not expect to focus on any individual financial metric or to provide threshold levels but will look at the average of metrics over the price control period and the overall trend.

Ratio	Calculation
Gearing	$\dfrac{\text{Net Debt}}{\text{RAV}}$
FFO Interest Cover (including accretions)	$\dfrac{\text{FFO (pre cash net interest}^1\text{)}}{\text{Cash net interest}^1 + \text{principal inflation accretion}}$
FFO Interest Cover (cash interest)	$\dfrac{\text{FFO (pre cash net interest}^1\text{)}}{\text{Cash net interest}^1}$
Adjusted Interest Cover Ratio (AICR) or PMICR[2]	$\dfrac{\text{FFO (pre cash net interest}^1\text{) - RAV depreciation}}{\text{Cash net interest}^1}$
Nominal PMICR[2]	$\dfrac{\text{FFO (pre cash net interest}^1\text{) - RAV depreciation + YoY RAV inflation}}{\text{Cash net interest}^1 + \text{principal inflation accretion}}$
FFO/Net Debt	$\dfrac{\text{FFO (post cash interest)- principal inflation accretion}}{\text{Net Debt}}$
RCF/Net Debt	$\dfrac{\text{FFO (post cash interest) – dividends – principal inflation accretion}}{\text{Net Debt}}$

[1] Cash net interest excludes principal inflation accretion on inflation linked debt. [2] Alternative ratio can be calculated that adjusts numerator for excess fast money (ratio calculated with reference to actual controllable opex rather than fast pot expenditure)

ofgem Making a positive difference for energy consumers

Financial Ratios (continued)

Ratio	Calculation
EBITDA/RAV	$\frac{\text{EBITDA}}{\text{RAV}}$
RoRE	$\frac{\text{EBIT} - \text{tax} - (\text{cost of debt} * \text{debt RAV})^{1}}{\text{Equity RAV}^{1}}$
Dividend Cover	$\frac{\text{Profit after tax}}{\text{Dividends declared}^{2}}$
Dividend/RegEquity	$\frac{\text{Dividends declared}^{2}}{\text{Equity RAV}^{1}}$

[1] Debt RAV and equity RAV are calculated by reference to the notional structure
[2] Dividends should reflect circumstances of each company and should include payments made under subordinated shareholder loans

What Companies Should Provide

ofgem Making a positive difference for energy consumers

Proposed Information to be Provided to Ofgem

- We expect company Boards to provide assurance that they are satisfied that the licensee is financeable on a notional and actual basis.
- Licensees will also be expected to show that they expect to be able to comply with the licence requirement to maintain an investment grade credit rating based on their actual structure.
- Companies will be expected to submit the set of financial metrics detailed on slides 6&7 and provide in the business plan financial model both the notional and actual financial structures.
- Companies will be expected to use the working assumptions from the December 2018 SSC and interest rate and inflation assumptions provided in business plan data templates for their initial business plan submission to the Challenge Group, these working assumptions may be updated by Ofgem for future business plan submissions.
- To provide explanations and evidence to support the capitalisation and regulatory depreciation rates they propose for each year.
- To provide explanations and evidence to support any deviation from the 60% working assumption for notional gearing.

Capitalisation & Regulatory Depreciation Rates

- Licensees will need to determine appropriate capitalisation rates and regulatory depreciation rates.
- Capitalisation rates and regulatory depreciation rates impact the level of revenue that is collected by licensees in each year and how much is deferred to subsequent years.
- We would expect depreciation rates to broadly approximate to the useful economic life of the network assets and for different generations of consumers network charges to be broadly in proportion to the value of network services they receive.
- The starting assumption will be that depreciation rates will be set at RIIO-1 levels with any deviation from this evidenced and justified.
- We would expect capitalisation rates to be justified with reference to
  - Expected levels of opex and capex (starting point of actual controllable opex to actual totex)
  - Balance of affordability and financeability
  - Impact on consumers, demonstrating customer support for proposed bill profile, including affordability for both current and future customers.
  - Smoothing switch to CPIH or bill smoothing generally
  - Interaction between capitalisation and depreciation rates

Potential Solutions to financeability challenges

- Companies should submit business plans that demonstrate financeability.
- If credit metrics indicate a potential concern there are a number of company actions that could be taken. Examples are below[1].

Company Action	Comments
Restriction of dividends	Restriction of dividends will improve cash reserves and improve some metrics (e.g. gearing, FFO/Net debt). However, we recognise that in itself this measure may not improve interest cover metrics.
Equity injection	Either where companies have significant investment programmes or unsustainable cost or debt positions equity injection could be used to maintain gearing at a level close to notional gearing and take pressure off financial metrics.
Refinancing of expensive debt (using equity injection or dividend restriction)	Dividend restriction and/or equity injection could be used to refinance expensive debt which could then be refinanced with lower current coupon debt, taking pressure off interest cover metrics.
Adjust capitalisation or depreciation rates, if appropriate	We would maintain the position that depreciation rates should broadly match the useful economic lives of assets but if evidence would support a change to depreciation rates from RIIO-1 and this aids financeability then Ofgem is willing to consider this. Companies should provide justification for any deviation from expected capitalisation rates evidencing customer support and balance of affordability.
Adjust notional gearing	Adjusting the notional capital structure can improve financeability but should be based on evidenced risk profile and realistic assumptions around actual company gearing levels.

[1] Consistent with paragraphs 4.16 and 7.20-7.21 of the finance annex to the SSC

Questions for Stakeholders

Questions for Stakeholders

- Do you have any comments on the proposed approach to assessing financeability?
- Do you have any suggestions for the appropriate scenarios to be run for stress testing?
- Do you have any comments on the proposed financial metrics to be calculated or formulation of these?
- Do you have any comments on the proposed information to be provided by companies?

Comments to be provided by 15th April 2019 in writing to RIIO2@ofgem.gov.uk with the email subject title “Financeability Further Information Comments”.

ofgem Making a positive difference for energy consumers

Our core purpose is to ensure that all consumers can get good value and service from the energy market. In support of this we favour market solutions where pratical, incentive regulation for monopolies and an approach that seeks to enable innovation and beneficial change whilst protecting consumers.

We will ensure that Ofgem will operate as an efficient organisation, driven by skilled and empowered staff, that will act quickly, predictably and effectively in the consumer interest, based on independent and transparent insight into consumers' experiences and the operation of energy systems and markets.

www.ofgem.gov.uk