To: PNGL, FE and SGN

Introduction

On 9 March 2022 the Utility Regulator (UR) published its draft determinations for PNGL's, FE's and SGN's GD23 price controls.

We have subsequently identified an error in our calculations of the GDNs' interest cover during the years 2023 to 2028. The error is material and affects the conclusions that we reached about financeability in paragraphs 10.13 to 10.23 chapter 10 of the draft determination. The purpose of this letter is to provide corrected interest cover calculations and to give our revised assessment of each GDN's ability to finance its activities.

Corrected interest cover calculations

The error we identified relates to the computation of the GDNs' post-maintenance interest cover ratios (PMICR). Specifically, we have identified that the way in which we treated each GDN's Profile Adjustment is not consistent with the way in which the rating agencies have historically adjusted for this aspect of the price control calculation. If we adopt the rating agencies' established methodology, the projections of interest cover for the GD23 period are as set out in table 1 below.

These figures supersede the PMICR projections that we set out in tables 10.3 to 10.5 of the draft determination document.

Table 1: Revised modelling of PMICR

	2023	**2024**	**2025**	**2026**	**2027**	**2028**	**Average**
PNGL	1.3	1.3	1.2	1.1	0.9	1.0	1.1
FE	1.6	1.5	1.4	1.3	1.3	1.2	1.4
SGN	1.6	1.6	1.6	1.6	1.6	1.6	1.6

Financeability

In assessing whether our proposed price controls leave each GDN in a position where it will be able to finance their activities during the GD23 period, we consider the ability that the companies will have to utilise both debt and equity finance.

The profile of PMICR for SGN shown in table 1 is comfortably above the 1.4 times threshold that rating agencies have indicated a GDN will normally need to have in order to obtain and maintain a BBB credit rating. SGN's other debt-related ratios, reported out in table 10.5 of the draft determination document, are also consistent with a solid investment-grade credit rating. Accordingly, our assessment is that SGN ought to be capable of maintaining access to debt finance during the GD23 period.

As set out in paragraphs 10.2 to 10.10 of our draft determination document, we have aligned each GDN's GD23 return on equity to its estimated cost of capital. Accordingly, we are also satisfied that SGN will be able to secure equity finance on an ongoing basis.

The profiles shown in table 1 for PNGL and FE are somewhat different insofar as PNGL's projected PMICR falls short of the aforementioned 1.4 times threshold, while FE's projected PMICR becomes noticeably weaker during the GD23 period. Although the rating agencies' assessments of credit quality extend beyond the inspection of a single financial ratio, this weakness in PMICR could conceivably create challenges for PNGL and/or FE during the rating process.

Our observations on this matter are as follows.

First, we note that as part of their calculation of PMICR the rating agencies have previously 'looked through' the change in the balance of each GDN's accumulated Profile Adjustment. During the GD23 period, PNGL and FE will for the first time see the balance of the Profile Adjustment fall as customers start to pay back to the GDNs revenues that were deferred from earlier control periods. This means that the rating agencies' approach will result in material downward adjustments to the numerator in PNGL's and FE's PMICR.

In our view, the return of capital to investors and associated increases in the GDNs' GD23 cash flow acts, at least in part, as a source of additional cover for the interest payments that PNGL and FE will make to lenders. We would expect this additional interest cover to weigh in rating agencies' assessment of credit quality, either in a qualitative way or, potentially, via a change in the method of calculating PMICR. Accordingly, it is not clear to us how much weight we should place on the PMICR figures shown in table 1.

Second, we note that PNGL's DAV is projected to fall from £466.6m at the start of GD23 to £425.8m at the end of the GD23 period. In the longer term, PNGL's DAV is projected to fall further as new capital investment runs below the annual depreciation of the DAV. This additional return of capital to investors also acts, at least in part, as a source of additional interest cover and further reinforces our concerns about the weight that can be placed on the figures in table 1.

Third, we noted in our draft determination that the GDNs' credit worthiness is determined in part by the revenues that we provide via our price controls and in part by the amount of borrowing that the companies choose to take on. The PMICR profile in table 1 assumes that companies maintain a gearing ratio of 55%. If the rating agencies were to conclude, notwithstanding the points we make above, that cashflows during the GD23 period do not support a BBB credit rating at 55% gearing, it is open to PNGL and FE to adjust their mix of debt and equity financing.[1] We consider it is important in this regard that PNGL's and FE's existing borrowings mature in mid-2024 and mid-2025 respectively, affording the GDNs an opportunity to alter the scale of their borrowings and/or the way in which they borrow (e.g. the utilisation of index-linked debt).[2]

Taking all of the above factors into account, our view is that PNGL and FE should each be capable of obtaining a BBB credit rating for an appropriately constructed portfolio of debt and thus maintain access to debt finance during the GD23 period. Through the setting the allowed return on equity in line with the cost of capital, we are also satisfied that PNGL and FE will be able to secure equity finance where required on an ongoing basis.

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[1] The CMA considered this matter during firmus's appeal against the UR's GD17 price control. See paragraph 7.123 of the CMA's 2017 decision document.

[2] NB: lower gearing ratio would not have a material impact on the GDNs' weighted average cost of capital or on our assessment of required returns.

In reaching these conclusions, we have considered two alternative responses that we could make to strengthen the profiles of PMICR shown in table 1.

First, we have considered whether we should increase the GD23 rate of return. We have concluded, however, that there is no obvious error in our estimates of the GDNs' costs of capital that would warrant such an increase. In the case of debt, we have sought to align the revenues that the GDN's will collect from customers to the interest payments that we expect each GDN to make to lenders. We will update our interest cost forecasts for the latest market information when we make our final determination, and thereafter our proposed GD23 framework provides for a cost of debt adjustment mechanism. In the case of equity, we have positioned the allowed return on equity logically relative to the returns on offer from comparator companies, including the GB GDNs. We take comfort from the fact that the GB GDNs have been judged by Ofgem and the CMA to be able to finance their activities.

The second area we have looked at is tax. On examining our modelling, it is noticeable that a key contributing factor to weaker PMICR during the GD23 period is the projected increase in PNGL's and FE's corporation tax payments. We recognise that our approach to remunerating tax payments via a simple 'tax wedge' adjustment does not bring about a match between the year-to-year profile of costs and the annualised profile of revenues. However, we consider that it would be inappropriate for us now to adopt a different approach following a period of many years in which PNGL's and FE's tax allowances have exceeded tax payments. We instead take the view that it is for PNGL and FE to manage any timing differences.

Conclusion

Taking all the above considerations into account, we are of the opinion that all three GDNs are capable of financing their activities during the GD23 period via a prudent choice of capital structure. The correction of the error in our calculation of PMICR does not require us to make any change to our March 2022 draft determinations of the GDNs' GD23 price controls.