Assessment of Potential Financing Options for Utility Networks – A Discussion Paper

The Utility Regulator's Response

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Introduction

1. Last December the Utility Regulator published for discussion a paper prepared by First Economics (FE) on potential options for financing utility networks. Responses were sought from stakeholders to the ideas contained in the paper. The paper was also a contribution to a seminar on 12 January 2011 which was organised by the Utility Regulator to discuss financing of infrastructure.

2. The Utility Regulator received written comments to the FE from 13 organisations:

   - BGE (UK);
   - the Consumer Council for Northern Ireland;
   - EirGrid;
   - Endesa Ireland;
   - Firmus Energy;
   - Gaelectric Energy Storage;
   - Moyle Interconnector/Mutual Energy;
   - Mutual Energy;
   - NIE;
   - NIE Energy Power Procurement Business;
   - Phoenix Natural Gas;
   - Premier Transmission/Mutual Energy; and
   - SSE Renewables.

   These responses (apart from Gaelectric's which was marked confidential) have been published on our website along with this response paper.

Summary of FE Report and Respondents' views

(a) FE Report

3. The report started by characterising a regulated network as a combination of an operating business, a projects business and a capital recovery business and suggested that each of the three activities presented distinct and different risks to investors. It then questioned whether it was optimal to finance all three activities together before outlining two possible ways in which the financing of network businesses might develop. The first involved large capital projects being delivered by third parties rather than by the existing group of licensed networks. The second, more innovative proposition was that the stock of historical investments that network businesses have built up since privatisation could be financed and paid for separately from the day-to-day operation and further development of those networks. In both cases FE posed the question whether separation and consequent clarification of risk profiles might lead to lower financing costs or other benefits that could lead to lower customer bills.

(b) Responses

Three business concept

4. Respondents presented a range of views on whether it was appropriate and useful to see regulated utilities as a mix of three businesses. Some said they recognised the distinction as valid and saw logic for grouping activities according to their level of risk. EirGrid thought 'it was a useful lens for thinking about these issues' SSE Renewables found it an interesting framework but one that was over-simplified and too stylised. Some other respondents did not see the distinction between different component businesses as helpful. Phoenix and PPB both argued that in practice it was sometimes difficult to separate out these activities and ascribe risks separately. Some comments also focused on the split between opex and capex and were concerned that there could be a loss of coordination if these activities were split between businesses.

5. Several respondents went on to express the view that the model of the 'combined' business has been proven as successful over the last two decades, particularly in respect of delivering efficiencies. Some saw companies in many sectors as comprising a range of different activities with different degrees of risk and considered financial markets to be sufficiently experienced and sophisticated to understand and address these differences.

6. EirGrid articulated the view that repackaging of risk through ownership structure cannot eliminate risk just reallocate it between parties. They also noted (as did BGE(UK)) that allocating the majority of risk to consumers has the potential to reduce the power of incentives for efficiency.

Contention that current financing may be sub-optimal

7. Some respondents appeared to accept the premise that regulated utilities are currently financed sub-optimally. Others, particularly NIE and Phoenix Natural Gas, were clear that they saw no merit in the circumstantial evidence presented in the report, and felt there was no 'problem' to address through the discussion paper's proposals.

8. A common view among respondents was that apparent criticisms of current financing arrangements were not proven and that further analysis would be required to substantiate the contentions made in the paper. There was also a view from several quarters that efficient markets are large, sophisticated, liquid and mature and can be assumed to eliminate automatically any sub-optimality in financing decisions. Phoenix argued that in these circumstances there must be a strong burden of proof on any advocates of change bearing in mind the potential for increased financing costs from radical changes which are not well understood.

9. In terms of explaining the existence of a the significant risk premium that FE argued must currently be paid to lenders to regulated networks, NIE and Phoenix Natural Gas argued that this could be explained by an increase in the level of risk faced by regulated businesses over time. This might comprise an increase in cost risk (as a result of approaching the efficiency frontier) and financing risk (as a result of higher debt levels). Phoenix Natural Gas considered that revenue risk and regulatory risk also needed to be considered as factors.

10. Mutual Energy, however, saw the financing premium as coming from the current 'guarantee' of the RAB being implicit rather than explicit, the 'tainting' of the safe RAB with a riskier operating business and the application of a weighted average cost of capital in situations where marginal finance tended to comprise debt.

Third party investment proposal

11. The overall reaction to the proposal that capital projects could be delivered and financed by third parties varied between some respondents who saw an increased role for third parties as a welcome development and others who saw it as adding little if any value and potentially bringing with it additional cost. Most respondents recognised the constraints – particularly around project size and separability of assets – that determined for which investments the proposal might and might not be appropriate.

12. Some respondents, such as NIE PPB and NIE, considered that 'outsourcing' was already a feature of Northern Ireland's utility sectors and could not see how this proposal would add value beyond what was currently delivered by private contractors. NIE, for example, questioned whether better pricing or risk allocation could be achieved than under its existing contractor model. Phoenix

Natural Gas wondered why such a model would not have been adopted by companies already if it was beneficial. On the other hand, Moyle Indicator Ltd pointed to the experience of Ofgem's framework for off shore transmission connections and referred to the significant savings that were being realised from such a proposal in those circumstances. Scottish and Southern Energy suggested that the value of such arrangements could be informed by the experience of PFI.

13. Generally, respondents appeared to concur with the discussion paper that projects would need to be of sufficient scale and with relatively limited interfaces to justify separation. One party questioned how many schemes would be suitable for such an approach in Northern Ireland. Phoenix Natural Gas suggested that the threshold size might be significantly higher than the £50m indicated in the paper. NIE suggested that those projects of sufficient scale to warrant the associated transaction costs might be too integrated within other networks to allow ready separation.

14. Many respondents were concerned about the potential impact of separating new assets from existing networks. Views from parties included:

    - that key risks would need to stay with the network company, for example around planning and interfaces;
    - that trade-off decisions in network design would be harder to make if projects were separated from networks and from each other; and
    - that ongoing trade-off decisions in network operation would be harder to effect if expenditure decisions could not be coordinated between parties.

15. Respondents generally saw a greater opportunity for such models where there were the least interfaces. Parties generally recognised that projects relating to the 'reinforcement' of current assets would need to remain the responsibility of the assets' owners. Phoenix Natural Gas considered that because of the limitations of finding cases of geographical and functional separation, the proposal might only be considered as a 'backstop' in the gas sector, to be enforced if companies were not investing efficiently in the eyes of the regulator.

16. Parties generally agreed with the view in the FE report that the proposal might not offer lower financing costs per se. Eirgrid agreed that overall financing costs could not necessarily be expected to be reduced and did not see that the proposal would assist financeability. In its view, the risks around the construction costs would also need to be rewarded earlier, at transfer, in this model rather than over time through returns and this is something could

increase the financing burden. Scottish and Southern Energy identified this issue too and noted that it would increase the financing burden for the 'capital recovery' business. Firmus considered that the proposal could deter investment through reducing regulatory clarity and stability.

17. In terms of practicability, Scottish and Southern Energy considered there to be significant issues around asset transfer and ensuring that the investments delivered the required performance. They also raised the possible need for a design authority and arbiter. Mutual Energy was concerned that the choice between 'transfer' and 'maintain' models should be made on a case-by-case basis and in the light of the risk of creating a 'patchwork' network of varied ownership and operational responsibilities. The Consumer Council considered that consumers would also need to be protected against costs emerging from the third parties' activities post completion and transfer.

Alternative arrangements for financing historical investment

18. Views on the FE suggestion that a portion of the RAB could be separated out, made subject to a more explicit guarantee from customers, and then be financed and paid for separately from ongoing network operation and development were sharply divided. The division was between long-term incumbents, who strongly rejected the idea and others, principally Mutual Energy, who saw merit in exploring the proposition more fully.

19. As noted above, the long-term incumbent networks started from the position that existing financing arrangements are efficient and that there is therefore no problem to solve. NIE and Phoenix Natural Gas noted that FE's ideas bear similarities to ideas that have been put forward by Professor Dieter Helm which have been widely rejected by the regulatory community.

20. Several of the incumbents did not believe it was feasible or desirable for customers to give more explicit underwriting to companies' RABs. They were particularly critical of any suggestion that the government could be expected to participate in the giving of any sort of guarantee given the current pressures on public finances, and historical reluctance to get involved in private-sector financing decisions.

21. They went on to note that absent a de-risking of the separated RAB any reduction in financing costs in one place would be offset by an increase in financing costs elsewhere, giving no net benefit to customers. Indeed, there was a view that customers could be worse off if financial re-engineering depleted the network operator's ability to manage and accommodate risk, if the creation of multiple companies created a lack of clarity about roles and responsibilities, or if the refinancing of existing debt resulted in transaction costs and a loss of efficiency incentives. Two respondents suggested that there was

an additional danger that a departure from standard international practice would raise the cost of capital in Northern Ireland.

22. Other respondents were less pessimistic. Mutual Energy and its subsidiary companies questioned whether markets fully appreciated the implicit guarantee that RABs currently carry. They noted that their experience showed that the transfer of risk away from lenders and on to customers can generate significant reductions in prices without obvious detriment to consumers' interests.

23. There was, though, recognition that a number of practical challenges would need to be overcome before any restructuring of industry finances could take place. These challenges included the need to convince lenders and rating agencies that risks had been reduced, the importance of avoiding any addition to public-sector borrowing requirements, and the challenge of managing industry fragmentation and new interfaces. Mutual Energy thought that none of these things would be insurmountable obstacles.

Utility Regulator's Position

24. We accept that after more than 20 year's experience that investors in the utility market have a good perception of the risks. That said, we would also take the view that financial markets do not always work perfectly and there remains the potential for investors to have misperceptions of risk and hence for the cost of capital to be unjustifiably high.

25. In the first instance therefore it is incumbent on the Utility Regulator to understand and provide adequate clarity on risks and how they are being shared between customers and companies. In this way we can help to ensure that the costs of capital adequately reflect those risks.

26. This reflects the stance we have proposed in chapter 7 (Risk and Uncertainty) in our recently published consultation, 'Network Price Controls: Proposals for a Cross-Utility Approach'. In this we propose that we would be informed by GB precedents when setting price controls. However in making assessments of the cost of capital and allowed revenues we would ensure that only where the risks facing our companies were similar to those in GB would we making similar cost of capital assessments to those in GB. If we considered greater risk mitigation appropriate in Northern Ireland (with consumers bearing more of the risk) this would be reflected in lower costs of capital and/or allowed revenues. We were firmly of the view that we would not allow companies to seek GB rates of return while allowing more generous levels of risk mitigation than those facing equivalent GB companies.

27. We therefore do not rule out consideration and implementation of more radical approaches for financing which, in our assessment, improve the risk reward trade-off between customers and companies. We note that mutualisation in the past has brought benefits to customers. We note however that it was done with very simple assets and at a time when there was a judgment by the Regulator that decisions on the cost of capital was over-generous.

28. We accept that the hurdle for change however should be a high one and fully recognize the threat to the cost of capital of inappropriate or poorly explained changes to standard practice.

29. We will therefore take a pragmatic approach and do a cost-benefit analysis of any mutualisation (or other alternative financing proposals) should they arise. We consider that the current flight to secure assets may have improved the potential for such initiatives where assets can been seen to be secured by regulatory and customer guarantees. We do not however under-estimate the potential dilution of incentives and hence risks to efficiency of initiatives with little or no private equity. We will also be wary of any initiatives which involve a significant premium to the RAB.

30. We do not think the specific proposals by FE should be pursued further at this time. This is largely on the grounds that we judge the potential benefits do not justify the potential risks. That said, we do not rule out consideration of further alternative financing proposals which improve the risk trade-off between customers and companies.