



Draft Determination Supporting Document NGET CORE Q32a Limitations of CPM

As a part of the NGET Draft Determination Response

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Limitations of CPM

1. “The locking in of debt and equity rates that reflect current market rates, which remain low historically”

Interest rates: The efficient nature of financial markets means current interest rates available for the lock in period already reflect expectations of future interest rates, i.e. value could only be “locked in” if the financial markets were inaccurately optimistic about future interest rates.

A borrower can therefore expect to be no better or worse off from locking in debt over a longer period compared to a series of shorter-term loans over the same amount of time. For the proposition to hold you would have to believe the market for debt is inefficient and that longer duration securities are mispriced compared to shorter term securities. This belief is contrary to rational and evidence based regulatory practice. Indeed, ‘locking in’ a rate transfers the risk to the lender and therefore this will have an additional cost associated with it compared to a series of short loans where the borrower carries the risk.

Asymmetric application: CPM cannot be expected to deliver value for consumers either with the consistent application of CPM to all eligible projects, or with an opportunistic application only. If CPM is consistently applied to all projects, over time the cost of debt will, on average, approximate to the RIIO cost of debt allowance meaning there is no consumer value to be derived on the cost of debt, i.e. you cannot expect to beat an average cost of debt, on average, with a consistent application of CPM.

Ofgem appears to favour an opportunistic – or asymmetric – application of CPM, i.e. only using CPM when interest rates are below the cost of debt index. An asymmetric approach would result in the network being underfunded (i.e. receiving an allowance below the WACC) as the RIIO portfolio would tend to accumulate a disproportionately high proportion of assets for which the cost of finance is higher than the RIIO trailing average. This would give rise to financeability concerns as illustrated in the figures below.

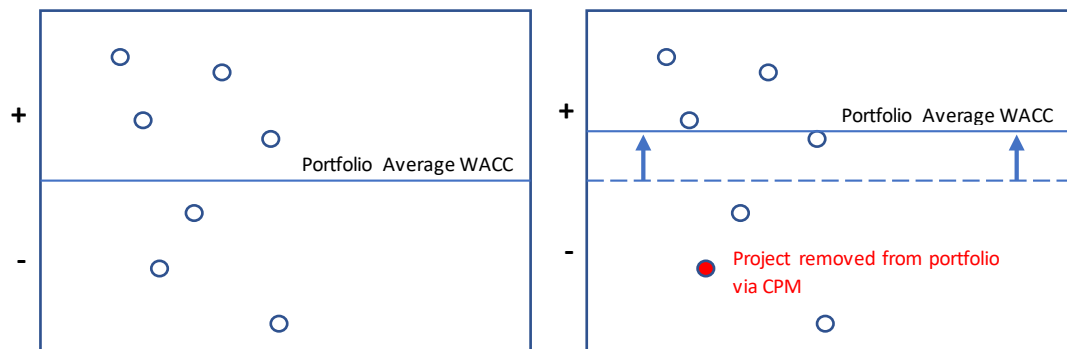


Figure 1: Pre-CPM Portfolio WACC

Figure 2: Post-CPM Portfolio WACC

Figure 1, the TO receives an allowance that reflects the average cost of debt across the portfolio (average WACC). Figure 2, however, highlights when a project is removed from the portfolio for delivery via CPM, the cost of debt pertaining to that project should also be removed to adjust the portfolio WACC. This adjustment results in a higher portfolio WACC, which is not currently taken into consideration by Ofgem. Should CPM be applied to several projects, it will result in the consistent underfunding of the network. In addition, Ofgem’s policy from the RIIO ‘Handbook for implementing the RIIO model’. It states that the cost of debt index will be subject to ‘a check that the index still provides a reasonable estimate of the cost of debt’, if the adjustment is made to the portfolio WACC, any perceived benefits from the application of CPM is lost.

This also marks a significant departure from the logic and consensus underpinning RIIO, which is that a TO might be underfunded for some projects but can expect to balance those losses against instances where the average allowed return on the portfolio is above the cost of financing other projects within the portfolio. The introduction of opportunistic treatment of financing costs will not deliver value for consumers because it would be unsustainable.

The fact that a network will be at risk of under recovering its cost of debt increases regulatory risk in the sector and reduces investor confidence. Regulatory discretion of this nature would lead to investors targeting higher returns in order to compensate for such losses. This will create pressure to increase the overall WACC – for debt and equity funders – which consumers would pay for in future projects. This point is also supported in our **[Finance Annex response – INCLUDE REF]**, which illustrates should CPM be applied across our projects, by the end of RIIO-2 our network will no longer be classified as investable.

We take note of Ofgem’s proposal to consider network financeability as part of the decision process and welcome further dialogue on this matter.

2. *“Making use of market revealed project-specific benchmarks where appropriate (such as using the observed OFTO rates for the operational period)”*

Risks: Carving out single projects under CPM, rather than delivery as part of a portfolio of corporate-financed regulatory projects under LOTI, does not generate value. The lower WACC associated with project-specific financing is achieved through additional protections and considerable risk transfers from the project company to contract partners and/or consumers, both of which carry significant costs. Ofgem does not include these costs in CPM (and specifically states that it will only fund project finance costs where a network company indicates its intention to pursue a project finance approach (p.162-163 of the Core Document)) despite it being a project-specific model – meaning that CPM is not a proxy of competitive delivery in a project-specific financing context. Returns should reflect risk, and with the underlying activities of constructing and operating a project being fundamentally the same whether LOTI or CPM is applied there is no reason to expect a different WACC unless there is a difference in risk.

Phased WACC: The division of a project into construction and operations phases to determine the WACC for each cannot of itself generate a lower WACC. Whilst splitting the WACC allows for better benchmark data, Ofgem has not adopted appropriate benchmarks for either phases, resulting in an inappropriate basis for drawing conclusions over the life of projects. To claim consumer value from splitting the construction and operational phases, it is incumbent upon Ofgem to identify appropriate benchmarks for both phases. Which Ofgem has not done but acknowledges this in seeking to understand the comparison, and that it is difficult to monetise the value of undertaking this comparison.

OFTO benchmark: There are material differences between the OFTO regime and CPM and, as a result, a false comparison has been drawn between the two. Unlike typical project-financed assets, such as OFTOs, CPM does not benefit from key contractual protections that provide certainty on the allocation of risk. It also lacks specificity, leaving considerable scope for regulatory discretion that could be perceived as increasing regulatory risk. It is wrong to contend that locking in the WACC for the 25-year operational period reduces regulatory risk sufficiently to make risks equivalent to the OFTO benchmark. Where there are no construction risks borne by the OFTO (which is priced post-construction for a 25-year revenue period), and therefore, has a lower risk profile than under RIIO.

Further, investors can take little assurance that regulatory risk has reduced given the lack of a separate licence, Ofgem’s inability to commit not to reopen CPM (i.e. fetter its discretion), and the very fact that Ofgem initially proposed to re-open a price control to introduce CPM. A more balanced view of risks suggests CPM is no less risky than RIIO over the lifetime of the asset (when taking note of the construction benchmarking for CPM) and so a lower WACC cannot be expected. Not only are risks different to the OFTO regime but as reported in previous consultation responses and engagement, the OFTO returns used by Ofgem appear to be understated and flawed.

3. *“Enabling a higher gearing during the operational period, through a project-specific risk allocation, resulting in lower overall financing costs”*

CPM cannot drive savings on the basis that higher levels of gearing can be achieved for single-asset infrastructure projects than would be appropriate for diversified portfolios under RIIO. Ofgem relies heavily on evidence from the OFTO regime, interconnectors and PFI/PPP projects to support this assertion. Ofgem has observed a higher gearing and a lower WACC for those projects but has wrongly assumed a causal link and is wrong to draw the conclusion that these projects benefit from a lower WACC because of the higher gearing.

The higher gearing capacity and lower WACC observed in OFTOs and similar regimes are the result of measures taken to significantly reduce risk, typically at high cost. In the “Consultation on proposed changes to our electricity interconnector cap and floor regime to enable project finance solutions” paper Ofgem acknowledge that risks must be transferred elsewhere (e.g. to consumers) to achieve project finance solutions. Absent of such extensive and costly de-risking, high levels of gearing cannot typically be achieved. No evidence has been produced to show that the estimated reduction in the WACC is adequate to offset the increased costs associated with achieving this reduction in risk.

Also, Ofgem’s claim contradicts the Modigliani-Miller theorem, which is a basic corporate finance principle underpinning the Capital Asset Pricing Model (CAPM) commonly used by regulators in infrastructure industries, which is also used to set the WACC for the construction period under CPM. This stipulates that firms cannot lower their WACC by simply increasing leverage. If a firm increases its leverage, then the required return on equity increases as equity risk becomes more concentrated. It may be true that this outcome can be affected by certain frictions, such as the tax shield which is applicable to debt, however this tax friction will not apply under the CPM regime because the regulatory framework gives licensees a tax allowance and sets the vanilla allowed return using the post-tax cost of equity and pre-tax cost of debt.

4. Additional points:

Additional consumer costs

- a. The need to ensure (consistent with a proxy for a competitive outcome) that a project is financeable on a stand-alone basis, as opposed to being part of a financeable portfolio, drives increased costs for consumers. Ofgem will also need to carefully consider the impact on NGET’s financeability of carving out the project from NGET’s remaining portfolio and any knock-on impact for its credit rating.
- b. Consumer detriment is caused by the recovery of the investment over 25 years under CPM rather than 45 years under RIIO. The Social Time Preference Rate indicates that society would prefer to pay later rather than sooner. As such, CPM introduces a dis-benefit to consumers by using a 25-year operations period rather than a 45-year period.
- c. Ofgem have directed TOs to various CPM updates and appropriate impact assessments that were undertaken by Ofgem since the CPM was first consulted upon in January 2018. To date, these impact assessments have not supported the application of CPM. This again leads us to believe that CPM is not a satisfactory model for competition for either consumers or network operators. We also question the appropriateness and relevance of these assessments now. The parameters that underpin the analysis will now be considerably out of date – however, Ofgem seems prepared to adopt a very similar methodology to that developed for the purposes of the January 2018 Hinkley Seabank delivery model consultation. Given that market conditions and the RIIO parameters have undergone some readjustment in the intervening time-period, and we have more up-to-date information and enhanced understanding of the models, a new impact assessment should be undertaken to confirm whether CPM is still in the best interest of consumers, which takes note of these changes. Based on the recent decisions on Hinkley and Shetland, this would be welcome by TOs to ensure the most recent updates from RIIO-2 are reflected in the analysis.
- d. Ofgem has also indicated its intention to adopt the Amberside model, originally developed in the context of the HSB project in RIIO-T1, as the default means of determining a project revenue from the relevant financing arrangements and project capital and operational costs. We cannot rule out that the effect of this model may be to drive additional costs for consumers if not appropriately calibrated for RIIO-T2. We ask that Ofgem publish this model for consultation and detailed consideration.