

Ofgem's RII0-ED1 'Slow Track' Final Determinations

On Friday 28 November, Ofgem published Final Determinations (FDs) for the remaining 10 electricity distribution network operators (DNOs), having already agreed a 'fast track' determination for the four Western Power Distribution (WPD) DNOs in February.¹ These FDs set out Ofgem's proposed price controls for the 2015-23 period, including the outputs and targets the DNOs need to deliver, their expenditure allowances and the allowed cost of capital.

Some of the key features of the FDs include:

- expenditure allowances of £17.5bn, £1.3bn (or 7.1%) less than the amounts requested by companies. Ofgem's reductions to company proposals broadly related to different views on efficiency, the savings that could be achieved from smart grids and the expected differences between input cost pressures and RPI inflation (to which DNOs' revenues are indexed);
- a real, post-tax cost of equity of 6.0% (compared to the approximately 6.4% requested by most DNOs), and a cost of debt based on a trailing average of benchmark bond indices, the same as proposed for the Draft Determinations (DDs). Slow-track DNOs will face one of the lowest WACCs (3.8% real, vanilla) ever set by an economic regulator in the UK;
- a package of rewards, penalties and incentives that Ofgem considers will enable each DNO to earn a return on equity in a range of roughly 2 – 10.5% (at 65% gearing), somewhat less advantageous than the 3 – 12% range available to the fast-tracked WPD DNOs; and
- the FDs will entail significant reductions in DNOs' customer charges in 2015/16 (up to £35 in 2012/13 prices for SPMW), followed by more gradual reductions over the remainder of the period.

As Table 1 below illustrates, the FDs are broadly similar to the DDs published in July (discussed in a previous [Briefing Note](#)). While both total expenditure ("totex") and revenue allowances have been increased slightly in aggregate, the FDs continue to represent a tough challenge for the DNOs, albeit some DNOs have fared better than others.

Table 1: Totex and FDs – comparison of FDs and DDs (£m)

	Totex			Base revenue		
	DDs	FDs	Diff (%)	DDs	FDs	Diff (%)
ENWL	1,794	1,825	1.7%	2,797	2,892	3.4%
NPG	2,928	2,959	1.1%	4,582	4,599	0.4%
UKPN	5,995	6,029	0.6%	9,964	10,027	0.6%
SPEN	3,206	3,186	-0.6%	5,144	5,156	0.2%
SSEPD	3,398	3,456	1.7%	5,761	5,864	1.8%
Total	17,321	17,455	0.8%	28,248	28,538	1.0%

The DNOs have until March 2015 to decide to appeal Ofgem's FDs to the Competition and Markets Authority (CMA). Looking further ahead, Ofgem has flagged a number of aspects of its methodology (such as the approach to real price effects and indexation of the cost of equity) which it may wish to revisit for RII0-ED2 (applying from 2023), if not for RII0-T2 and RII0-GD2 (applying from 2021).

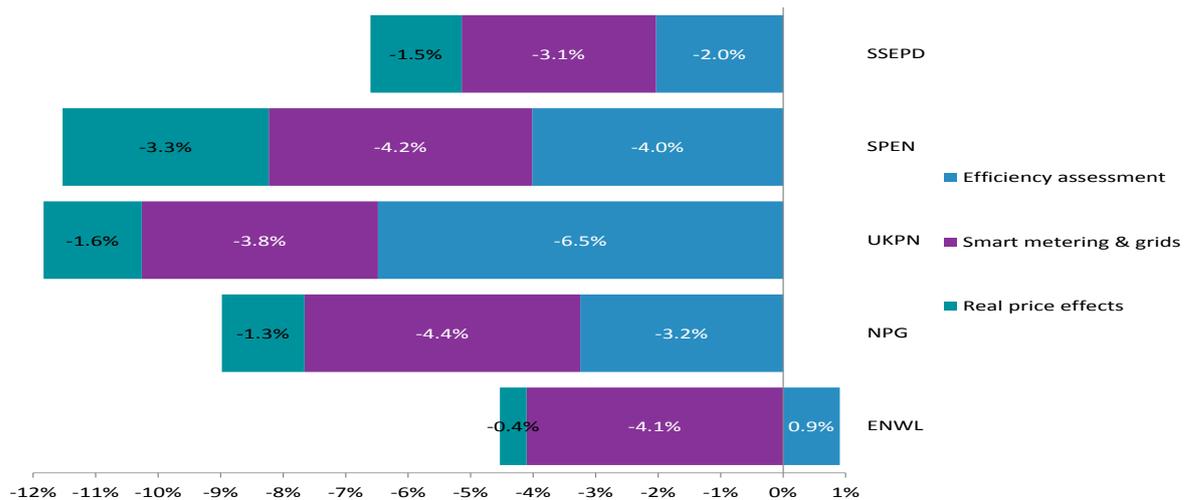
¹ There are 14 DNOs in Great Britain, part of six ownership groups: (i) Electricity North West Limited (ENWL), a stand-alone DNO; (ii) Northern Powergrid (NPG), which owns Northeast (NPGN) and Yorkshire (NPGY) DNOs; (iii) Western Power Distribution (WPD), which owns West Midlands (WMID), East Midlands (EMID), South Wales (SWALES) and South West (SWEST) DNOs; (iv) UK Power Networks (UKPN), which owns London Power Networks (LPN), South East Power Networks (SPN) and Eastern Power Networks (EPN) DNOs; (v) Scottish Power Energy Networks (SPEN), which owns Scottish Power Distribution (SPD) and Scottish Power Manweb (SPMW) DNOs; and (vi) Scottish and Southern Energy Power Distribution (SSEPD), which owns Scottish Hydro Electric Power Distribution (SSEH) and Southern Electric Power Distribution (SSES) DNOs. DNOs which submitted business plans which Ofgem considered were sufficiently robust were awarded 'fast track' status. As a result, those DNOs' business plans were subject to less scrutiny and revision by Ofgem and their determinations were announced earlier than for other DNOs.

Totex

Key features of the FDs include:	Main changes since the DDs:
<ul style="list-style-type: none"> According to Ofgem, DNOs (excluding WPD) should have included £728m of savings associated with becoming 'smart grids' over the ED1 period, compared to £476m included in their business plans – a 53% increase;² DNOs' (excluding WPD) business plans argued that their cost allowances needed to be £771m higher because of real price effects (RPEs), but Ofgem concluded that cost allowances should only be £43m (a reduction of £728m);³ and Ofgem decided to retain its traditional approach of setting an allowance for RPEs in advance, as part of the general price control, rather than introducing indexation or other ex-post adjustments. 	<ul style="list-style-type: none"> Ofgem updated the inputs and made some minor revisions to its top-down totex econometric models and bottom-up activity-by-activity cost assessments, creating some winners and losers; Ofgem has revisited its approach to estimating savings from smart metering and grids, increasing the estimated savings achievable by slow-track DNOs from £691m in DDs to £728m in FDs; Ofgem updated the input data to its assessment of RPEs, reducing the challenge on RPEs slightly; and Ofgem updated its assessment of pension deficit funding allowances, reflecting the latest triennial valuations (which become available since DDs).

Ofgem assessed that expenditure allowances of £17.0bn, £1.8bn (or 9.5%) less than the amounts requested by the 10 DNOs, are appropriate.⁴ Figure 2 below summarises the impact of Ofgem's deductions from DNO business plans, split into three main categories: efficiency modelling, real price effects and smart metering & grids. The cuts varied from 3.6% for ENWL to 11.8% for UKPN, suggesting that even the strongest performing DNOs (in Ofgem's view) will need to improve efficiency materially over the ED1 period.

Figure 2: Ofgem's RIIO-ED1 cost assessment relative to DNOs' proposals



While the overall reductions assessed by Ofgem were lower for FDs than DDs, some DNOs benefited more than others: the percentage reduction in UKPN's costs is essentially unchanged, while the cuts applied to ENWL and SSEPD are around 2 percentage points lower than previously. The impact of each of Ofgem's cost challenges has also been revised:

- while ENWL and SSEPD's efficiency challenge (the blue bars in the chart above) are little changed from FDs, the other DNO groups received increased challenges as a result of Ofgem revising its assessment to incorporate updated and revised input data from the DNOs and narrowing the types of costs excluded from the top-down econometric models;^{5,6} and

² The £728m figure is stated in Table 2.5 of Ofgem (2014) "RIIO-ED1: Final determinations for the slow track electricity distribution companies – Business plan expenditure assessment", November. This amount is not, however, consistent with the disaggregated information shown in Table 11.1 of the same document (which implies savings of £798m).

³ RPEs refer to input cost inflation exceeding (or falling short of) general price inflation (which is measured using the Retail Price Index (RPI) for the DNOs).

⁴ Ofgem has included allowances of £17.5bn for the 10 DNOs over the ED1 period, equal to 75% of Ofgem's assessment (£17.0bn) and 25% of DNOs' proposals (£18.8bn).

⁵ Each of the DNOs made minor revisions to its cost submissions since the DDs: ENWL and SPEN reduced their proposed costs by £0.8m and £3.4m respectively, while NPG and UKPN increased their proposed costs by £0.7m and £32.6m. SSEPD did not revise its costs.

- the effects of Ofgem's smart grid and RPE adjustments are more diverse than at DDs. For example, while the RPE adjustment reduced costs for each DNO by 4 – 5% at DDs, ENWL receives a much smaller cut than the other DNOs at FDs.

Ofgem's assessment of RPEs in the FDs is marginally more generous than in the DDs (as Table 2 below illustrates): instead of assuming RPEs would actually reduce DNOs' costs by £78m over the ED1 period in the DDs, Ofgem now considers that RPEs will push costs up by £43m over the period. Incorporating updated data which had become available since the DDs was the primary driver of the revisions to Ofgem's assessment. Nevertheless, Ofgem's position remains substantially below what the DNOs had requested, suggesting DNOs are likely to be very disappointed with Ofgem's conclusion in this area. Most of the DNOs may, however, be marginally more pleased that Ofgem has decided not to – in line with most DNOs' responses to the DDs – move away from setting an ex-ante allowance for RPEs (something which Ofgem had consulted on after the DDs). While Ofgem has signalled it intends to review its approach to RPEs again for future price controls, it conceded that it would be too difficult (and the risk of unintended consequences too high) to make this change at such a late stage of the RIIO-ED1 process.

However, while Ofgem pared back its reductions for RPEs from the DDs, it has increased its assessment of the savings the 10 slow track DNOs are able to achieve as a result of smart grids (see Table 2 below). Although Ofgem re-assessed upwards the amount of savings DNOs had embedded in their business plans, it continued to consider that substantially more savings could be achieved. Overall, Ofgem now considers £728m of savings over the ED1 period can be achieved by the DNOs, even higher than the £691m Ofgem included in DDs.⁷ Ofgem has not clearly explained why it has arrived at a higher assessment of potential savings, but the slow track DNOs are unlikely to be pleased that Ofgem has ultimately concluded on an even higher level of savings (and one which entails an additional £396m reduction in spending compared to company submissions, higher than the £322m of extra savings assumed in DDs) despite (a) Ofgem having increased its assessment of the amount of savings DNOs had embedded in their plans; and (b) DNOs having advanced a range of arguments for why Ofgem had overstated the amount savings which could have been achieved as a result of smart meters & grids in DDs.

Ofgem also revised its assessment of pension deficit funding allowances, based on updated triennial valuations of the size of those pension deficits which had become available since DDs. Overall, as Table 2 below shows, Ofgem allowed an additional £109.5m across the 10 slow-track DNOs, but as with some of Ofgem's other changes, there were some winners and losers: UKPN and SPEN both received material increases in allowances, while NPG had its funding reduced by around £38m.⁸

Table 2: Selected cost allowances – comparison of FDs and DDs (£m)

	RPE allowances			Total smart grid savings			Pension deficit funding		
	DDs	FDs	Diff	DDs	FDs	Diff	DDs	FDs	Diff
ENWL	-8	5	13	-72	-73	-1	132	127	-5
NPG	-14	7	21	-117	-134	-17	208	170	-38
UKPN	-27	14	41	-237	-282	-45	649	713	63
SPEN	-15	8	23	-129	-160	-31	354	446	92
SSEPD	-13	9	22	-138	-150	-12	363	360	-3
Total	-76	43	119	-693	-799	-106	1706	1816	110

⁶ Ofgem uses a "tool kit" approach to assessing efficient expenditure, combining (i) a top-down econometric totex model; with (ii) a bottom-up econometric totex model; and (iii) a bottom-up disaggregated activity based model. Ofgem excluded around £1.8bn of costs from its two totex econometric models at DDs (with these costs assessed separately), but reduced this to £512m in the FDs. Costs related to flood mitigation, BT21C, losses and environmental, operational and non-op capex IT&T, ETR 132 tree cutting activity, wayleaves and third party connections were excluded at DDs, but included for FDs.

⁷ The £691m is FTI analysis of Table 11.2 of Ofgem (2014) "RIIO-ED1: Final determinations for the slow track electricity distribution companies – Business plan expenditure assessment", November. The £728m is stated in Table 2.5 of the same document, but is inconsistent with Table 11.1 of that document which suggests £798m of savings have been included.

⁸ See Ofgem (2014) "RIIO-ED1: Final determinations for the slow track electricity distribution companies – Business plan expenditure assessment", Table 5.2, November.

Financial Issues

Key features of the FDs:

- a cost of equity of 6.0% in real, post-tax terms;
- a cost of debt based on a trailing average of A and BBB benchmark bond indices, equal to 2.6% real, pre-tax in 2015-16;⁹
- a notional gearing assumption of 65%, which when combined with the costs of debt and equity above implies a real vanilla WACC of 3.8% for 2015-16;⁹
- existing assets will continue to be depreciated over a 20 year period, but additions to the RAV will be depreciated over a 45 year period on a straight line basis;¹⁰
- the expenditure profiles, combined with the capitalisation rates and asset life assumptions, imply RAV growth of around 1% p.a. (in real terms) for each of the DNOs;¹¹ and
- based on comparisons to the financial metrics commonly employed by rating agencies, the FDs will enable the 10 DNOs to maintain an investment grade credit rating (in Ofgem's view).

Main changes since the DDs:

- capitalisation rates (i.e. the proportion of totex added to RAV) were revised lower for ENWL and SSEH. The reduction for ENWL was targeted at resolving a financeability issue identified in the DDs, while the change for SSEH was in response to reclassification of some expenditures (relating to Shetland island) from outside the totex regime to inside it.¹² Capitalisation rates for the DNOs are now in a range of 62 – 80% (compared to 68 – 80% at DDs); and
- Ofgem have made a clearer commitment to using a 20 year trailing average cost of debt index at RIIO-ED2 than it did in the DDs.

Ofgem's proposals in relation to the cost of equity are in line with its earlier guidance in February¹³ and in the DDs, notwithstanding that the DNOs all reiterated their requests for higher allowances in response to the DDs. Likewise, the asset lives set out in the FDs are consistent with the DDs and the methodology Ofgem set out in 2013.¹⁴

Ofgem's approach to the cost of debt is also unchanged from DDs i.e. the cost of debt in each year of the ED1 period will adjust automatically for changes in a trailing average of benchmark bond indices (converted into real terms). The period over which the trailing average is calculated will extend from 10 years in 2015/16, to 11 years in 2016/17 and so on. Under this approach a 20 year trailing average would be used from early in the ED2 period and Ofgem has signaled an intention to continue to use a 20 year trailing average over the remainder of the ED2 period "if DNOs maintain their general practice of issuing debt that matures after about 20 years".¹⁵ Ofgem maintained its approach to the cost of debt despite arguments from the DNOs that it failed to compensate DNOs for their expected cost of debt or for the costs of issuing debt i.e. transaction costs. With respect to these two points:

- Ofgem conceded that the indexation approach it proposed would lead to an allowed cost of debt approximately 0.2% lower than DNOs' actual cost of debt, but felt that this was acceptable as the index was only ever intended to produce a "reasonable estimate" of the cost of debt and the cost of debt index was not intended to "precisely match actual costs";¹⁶ and
- Ofgem continues to consider that DNOs are able to issue bonds at lower coupons than the benchmark yields (included in the index) suggest. This 'halo effect' meant that the index provided sufficient allowance for debt issuance costs, such that no further allowance was required.

As in the DDs, Ofgem argues that the FDs enable the 10 DNOs to maintain an investment grade credit rating, despite acknowledging that the proposed price controls mean there is a risk that each of the DNOs will be downgraded one

⁹ Because the cost of debt is indexed it will change from year to year. Consequently, so will the allowed WACC.

¹⁰ Asset lives for new assets will not switch from 20 to 45 years immediately, but rather there will be a gradual transition over the eight year ED1 period.

¹¹ Compound annual growth rate of RAV for the five DNO ownership groups varies between 0.8% (SSEPD and UKPN) and 1.2% (SPEN) in real terms. While the range of growth rates is broadly similar to DDs, the growth rates of different DNO groups' RAV has changed in some cases, consistent with the revisions to the totex assessment discussed above and revisions to capitalisation rates for some of the DNOs. For example, ENWL's RAV will grow around 7.6% in real terms over the ED1 period under the FDs, lower than the 10.9% growth forecast in the DDs.

¹² Costs related to Shetland island's electricity system had previously been treated as a pass-through item (meaning the costs were remunerated through 'fast money'), outside of the totex regime and associated efficiency challenges. Ofgem decided to revise its approach to these costs for FDs, bringing them inside the totex regime. A consequence of this was a need to adjust capitalisation rates to avoid impacting on the amount of 'fast money' allowed for SSEH.

¹³ Ofgem (2014) "Decision on our methodology for assessing the equity market return for the purpose of setting RIIO-ED1 price controls", February.

¹⁴ Ofgem (2013) "Strategy decision for the RIIO-ED1 electricity distribution price control – Overview", p43, March.

¹⁵ Ofgem (2014) "RIIO-ED1: Final determinations for the slow-track electricity distribution companies – Overview", p94, November.

¹⁶ Ofgem (2014) "RIIO-ED1: Final determinations for the slow-track electricity distribution companies – Overview", p42, November.

notch (from the A- / BBB+ ratings they currently have). Whether the rating agencies agree remains to be seen (though Moody's considered the DDs, which are very similar to the FDs, to be in line with its expectations), but Ofgem's continued failure to publish its projected financial ratios for the 10 slow track DNOs does not engender confidence.¹⁷ Further questions arise because Ofgem has continued to rely on a controversial new credit metric, PMICR_G, as part of its suite of financeability tests.¹⁸ This metric is a variant of the standard PMICR used by rating agencies, but one which Ofgem argues is more focused on the "quality of capital" by adjusting for differences between real and nominal elements of the numerator and denominator in the PMICR. While the exact weight ascribed to this metric by Ofgem is unclear (and there is certainly less discussion of the PMICR_G in the FDs than the DDs), the metric has not been adopted by any of the rating agencies and Moody's recently commented that PMICR_G was "an interesting amendment, [but] the measurement of three different cash flows (internal sources of liquidity, RAB indexation and real RAB growth) blurs together different risks and weakens the standalone significance of the ratio".¹⁹

Incentives

Key features of the FDs include:

- rewards and penalties are available for companies in relation to their performance in a range of areas including safety, customer service, environmental targets and reliability; and
- Ofgem's package of rewards, penalties and incentives will enable strong performing DNOs to enhance returns above the 6.0% base return Ofgem has allowed (though the opposite is also true). In Ofgem's view, DNOs should expect to earn a return on equity in a range of roughly 2 – 10.5% (at 65% gearing), depending on how well they perform.

Main changes since the DDs:

- Ofgem revised its Information Quality Incentive (IQI) incentive scheme – which determines the rewards and penalties for totex out- or under-performance – so that all the rewards and penalties are in post-tax terms (whereas at DDs, the ex-ante additional income allowance was in pre-tax terms);
- changes to companies' cost submissions and Ofgem's cost assessment meant that IQI scores, and associated outperformance sharing rates were revised; and
- minor changes to the package of outputs DNOs need to deliver under RIIO-ED1.

Ofgem's IQI mechanism relies on a complex matrix of rewards and penalties associated with different cost proposals and outturn costs to incentivise DNOs to forecast their expenditures as accurately as possible. Rewards and penalties flow to DNOs in two ways: (i) an adjustment to revenues during the ED1 period, reflecting the ratio (known as the IQI score) of the DNO's cost submission to Ofgem's baseline cost assessment; and (ii) an additional adjustment to ED2 revenues to reflect outturn expenditures during the ED1 period, the matrix and the IQI score set at RIIO-ED1. At the DDs Ofgem had set the first element in pre-tax terms, but the second in post-tax terms. However, following responses to the DDs – which highlighted this inconsistency – Ofgem has decided to set both revenue adjustments in post-tax terms.²⁰ In combination with the revisions to DNO cost submissions and Ofgem's assessment of the appropriate level of totex (both discussed above), there have been some revisions to the cost sharing rates offered to DNOs. DNOs will now bear (or retain) 53 - 58% of any over (or under) spend, compared to 53 - 57% in the DDs.²¹ The remainder will be passed on to customers.

As was the case in the DDs, Ofgem's package of rewards, penalties and incentives will enable each DNO to earn a return on equity in a range of roughly 2 – 10.5% (at 65% gearing), substantially lower than for the fast tracked WPD DNOs (as Figure 2 below illustrates). While some of the reduction in the return on regulatory equity (RoRE) range can be attributed to the reduction in the base cost of equity allowance (6.0% for the slow track DNOs compared to 6.4% for WPD), a bottom end of the range of 2% is somewhat lower than the cost of debt and consistent with a widening of the RoRE range relative to past RIIO-T1 and RIIO-GD1 price control determinations for National Grid Electricity Transmission (NGET), National Grid Gas Transmission (NGGT) and the GDNs as Figure 2 below shows.

¹⁷ The FD financial model (published by Ofgem) does not include the "FinancialStatements" or "FinancialRatios" tabs (which set out Ofgem's projections of key credit rating metrics) that the WPD Fast Track Final Determination financial model includes.

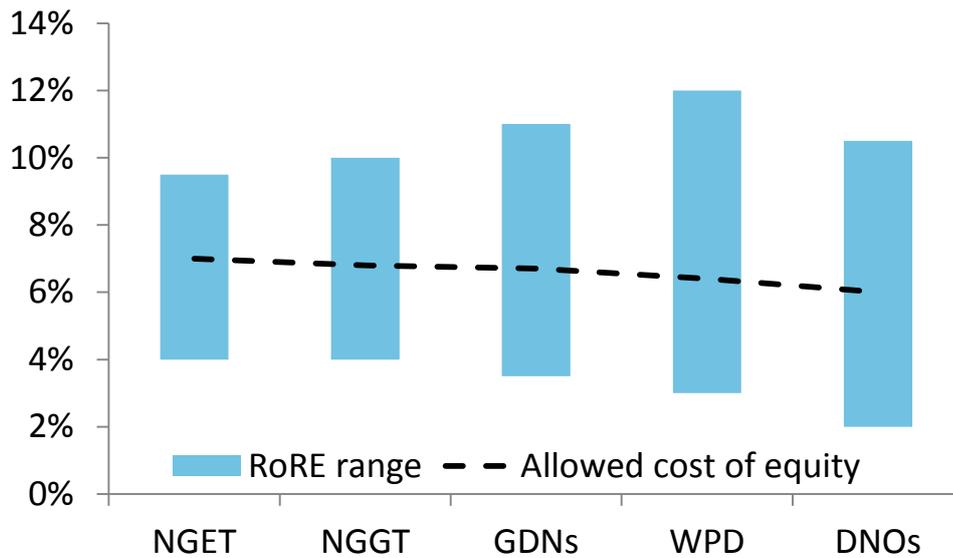
¹⁸ PMICR is the Post-Maintenance Interest Cover Ratio.

¹⁹ See Moody's (2014) "UK Electricity Networks: RIIO-ED1 Draft Determinations In-Line With Expectations", p8, September.

²⁰ Ofgem (2014) "RIIO-ED1: Final determinations for the slow-track electricity distribution companies – Overview", p37, November.

²¹ ENWL, NPG and SSEPD all had a small increase in their cost sharing rate from DDs to FDs.

Figure 2: Approximate Return on Regulatory Equity (RoRE) ranges from recent Ofgem price control determinations



The difference in RoRE ranges for WPD and slow track DNOs illustrates some of the benefits fast tracking has secured for WPD. Whether those benefits are too large remains open to debate, though Ofgem has responded to the challenges to its DDs on this issue: in Ofgem's view the fast track process has delivered a range of benefits (including unlocking £700m of totex savings for the slow track DNOs), which significantly outweigh the benefits accruing to WPD.²² However, whether Ofgem's assessment of the benefits is right or not, the benefits it highlights appear to accrue predominantly to customers of non-WPD DNOs, raising the question whether WPD's customers have benefitted from the fast tracking procedure.

One other aspect of Ofgem's FDs which is noteworthy – given it is a problem regulators and network operators wrestle over in many countries – is the approach to reducing losses.²³ As for the DDs, Ofgem has decided that in the absence of robust data on losses there will be no losses incentive mechanism over ED1, with DNOs incentivised to keep their losses as low as reasonably possible through a licence condition. While this a pragmatic decision given that historic losses data has proved unreliable and there have been significant issues trying to determine rewards and penalties for losses performance over the DPCR4 period (which ended in 2010), Ofgem's RIIO-ED1 approach is not entirely satisfactory. In particular, it relies on DNOs setting out clear and measurable loss reduction strategies (something which Ofgem's comments in the FDs indicates at least some DNOs have not been able to do so far) and on "as low as reasonably possible" being capable of objective determination. Given these uncertainties, the possibility that losses performance will be the subject of renewed dispute between DNOs and Ofgem in future cannot be ruled out.

²² Ofgem (2014) "RIIO-ED1: Final determinations for the slow-track electricity distribution companies – Overview", p9, November.

²³ Losses are the difference between the metered volume of electricity entering the distribution network and the volume of electricity metered as leaving the network.

Next Steps

The FDs will be implemented through modifications to the DNOs' licences. To achieve this Ofgem will publish a consultation on the changes to licences in December 2014 before issuing revised licences in February 2015. Following the issuance of these revised licences, each of the DNOs will then have the option to appeal to the Competition and Markets Authority (CMA) if they are dissatisfied with Ofgem's FD.

Looking further ahead

While traditionally the FDs would have laid out the precise cost and revenue allowances for the slow track DNOs until 2023, various elements of the DNOs' allowances will be revisited ahead of that date under a range of mechanisms Ofgem has included in the RIIO-ED1 FDs. For example, there are several categories of costs subject to re-openers or other forms of uncertainty mechanism. The cost of debt is also indexed to market movements, as discussed above. Further, a mid-period review of outputs will take effect from 2019, which might see revisions to cost allowances if DNOs need to deliver different outputs e.g. due to changes in external circumstances. Actual performance and expenditure is also reflected in allowed revenue, typically with a two-year lag. Consequently, Ofgem will publish updates to its revenue allowances for the remainder of the ED1 period each year to take these factors into account.

Looking even further ahead, while the FDs have laid out the regulatory framework that will apply to the DNOs till 2023, Ofgem has signalled a number of aspects of its methodology will be reviewed for RIIO-ED2 (from 2023). These include:

- indexation of the cost of equity i.e. whether the cost of equity, like the cost of debt, could be subject to some automated annual adjustment process;²⁴ and
- the approach to determining RPEs e.g. whether, given the relatively higher degree of uncertainty around these cost allowances, some form of indexation or ex-post adjustment of these allowances would be feasible.²⁵

Since these issues are equally applicable to gas and electricity transmission and gas distribution businesses, Ofgem may revisit these ahead of RIIO-T2 and GD2 (which are due to take effect from 2021).

²⁴ See Ofgem (2014) "Decision on our methodology for assessing the equity market return for the purpose of setting RIIO-ED1 price controls", pp10-11, February.

²⁵ See Ofgem (2014) "Reasons for our decision on the treatment of real price effects for RIIO-ED1 slow-track electricity distribution network operators", p6, November.



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