



Financing Networks : Summary of responses

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Introduction

Ofgem and Ofwat published a discussion document 'Financing Networks' (February 2006) raising eight key issues and invited responses to them. Some other issues were discussed in the document and responses to these were at the reader's option.

Thirty six parties responded to the discussion document and they are listed below. They comprise mainly of regulated utility companies along with other parties with specialist interest in various aspects of the utilities sector. There were only limited responses received from the consumer perspective. Many of the responses build on discussions at the Financing Networks seminar held on 27 April 2006. The seminar was well attended with over 150 people from regulated companies, consultants, academics and the financial sector. The discussion document was generally welcomed as covering the key issues that need to be addressed in financing networks. The full non-confidential responses are published on the Ofgem and Ofwat websites (www.ofgem.gov.uk; www.ofwat.gov.uk).

This document summarises written responses to the "Financing Networks" discussion paper but also incorporates the substance of issues that arose from the April seminar.

List of respondents

Anglian Water Services Limited
Box Ten Ltd
CE Electric UK Funding Company
Central Networks plc
Centrica plc
Dr J Cuthbert
EDF Energy Networks Ltd
Energy Networks Association
Energywatch
First Economics
Invesco Perpetual
Macquarie Bank Limited
M & G Investment Management Limited
Mid Kent Water Ltd
National Grid plc
Nera
Northumbrian Water Limited
Northern Gas Networks Limited
Portsmouth Water Ltd
Scottish & Southern Energy plc
Severn Trent Water Ltd
South East Water Ltd
South Staffordshire Water plc
South West Water Limited

Southern Water Services Limited
SP Transmission & Distribution
Thames Water Utilities Ltd
Three Valleys Water plc
United Utilities plc
Veolia Water UK plc
Wales & West Utilities Limited
Water UK
Dŵr Cymru Welsh Water
Wessex Water Services Limited
Western Power Distribution plc
Yorkshire Water Services Limited

Overall summary of responses

The general message from regulated businesses and investors is one of opposition to radical change, of general support for the regulatory framework and recent developments, and calls for more consistency and stability.

Ring fencing provisions

Regulated business generally believe ring fencing arrangements in licences are appropriate and are against extending them especially any further introduction or tightening of cash lock up provisions. Some suggest that cash lock up provisions are a deterrent for equity investors and from a debt perspective will be put in place as part of debt covenants for particular financial structures. However, some licence holders where the cash lock-up is already a standard licence condition, believe it may be beneficial in supporting debt.

Split cost of capital

Respondents appreciated that the proposals for regulatory reform have brought focus to the issue of risk and how it is allocated in the utility businesses.

However, strong opposition was voiced to having a split cost of capital but there is a range of views on what this means. Many respondents argue that segregating risks within a business is not practical and would not reduce the overall risk of the business as a whole and of that to which investors are exposed. Respondents were concerned about the overall premise that risks of investment in asset maintenance and growth in the asset base can be separated. Many respondents put forward arguments that assets in the Regulatory Asset Value (RAV) do not carry low risk and that a lower rate of return for them is inappropriate. Furthermore it was not the expectation when the investment was made.

Regulatory commitment

Respondents see regulatory commitment to the RAV as key to reducing regulatory risk. Clear, consistently applied rules for calculating RAVs are seen as important as the allowed rate of return. There is therefore support for publishing annual RAV data. Regulatory commitment and the associated risk is also seen as an important factor in attracting equity investment in regulated businesses. Many respondents believe that it is possible to achieve some of the principles around increasing regulatory commitment and risk reduction mechanisms without the need for a split cost of capital. The existing regulators' inability to fetter future regulatory outcomes and regimes is seen as an issue that increases regulatory risk. With regard to the current price control period a key comment from the seminar was that the incentive based regulation in the UK has proved a lower risk and less susceptible to ratings shocks than prior periods. It was also noted that a balance needs to be struck between regulatory commitment and getting the best deal for customers.

Index-linked debt

Arguments are presented against an assumption by regulators that companies will use index-linked debt as part of their capital structures on the grounds that it would become expensive, there is only a limited market and that financing structures are best left to business managers rather than regulators. However, some respondents suggest that it would be reasonable for the regulator to assume a proportion of index-linked debt but with important caveats. One large investor suggests however that an assumption on index-linked debt by the regulator may generate liquidity in the corporate index-linked debt market that is currently lacking, though it felt that forcing companies to use index-linked debt would be heavy handed. An additional issue raised at the seminar was the volatility that certain index-linked instruments introduces to internationally listed companies profit and loss accounts undermines the attractiveness of index-linked debt.

Facilitating equity injections

Respondents concentrate on two main themes. The first is that increasing regulatory commitment or reducing regulatory risk would encourage equity investment. The second is that the regulators would need to allow the costs of issuing equity to be recovered via the price control. Some respondents thought that to allow a higher cost of equity would incentivise further gearing up and regulators should positively incentivise conventional levels of gearing. One point raised in the seminar was that the markets might view rights issues as an indication of financial distress creating an inherent reluctance to raise capital in this way.

Flexible dividend modelling by regulators

Respondents were not in favour of a more flexible approach to modelling dividends and using them as a way to stabilise gearing. The majority argue that variability in dividends would deter equity investment as equity investors perceive utilities as yield stocks.

Financial ratios and debt structure

The majority of responses favour a continuation of the approach to using financial ratios, in accordance with the credit rating agencies practices, when assessing financial viability and credit rating. Alternative credit metrics would only have value if recognised by the capital markets. There was some argument made in responses and at the seminar that financial ratio tests would not be necessary if the cost of capital is "right". Respondents do not favour a significant number of companies having a BBB (Baa2) rating on the grounds that debt would be more expensive and the chances of companies falling below investment grade due to a lack of headroom in responding to a cost shock would be significantly increased. There was some difference of opinion about the role of the credit rating agencies raised in the seminars. Some felt that there

was excessive reliance placed on the credit rating agencies. Others noted their importance but felt that regulators should not put too much weight on them. A third view was that regulators should closely follow the ratios used by credit rating agencies and that regulators should work more closely with them.

Financeability adjustments

There was a general view that companies should be left to make their own decisions about how to finance their businesses. Some respondents argued that if the cost of capital is correct then allowing returns equal to the cost of capital should enable efficient companies to finance their businesses. On balance, however, respondents felt that regulators are right to test for financeability and there may need to be regulatory intervention under some conditions.

A theme emerging from the responses and comments at the seminar was that government/regulators create financeability problems by imposing what in some sectors are essentially obligatory and significant capital programmes. Regulators therefore could not then leave the problem solely for the capital markets to resolve.

Different solutions to financeability may be appropriate in different sectors with clear explanation as to why this is the case. There is an element of past experience in these views since colouring the option of accelerated depreciation was favoured by most of the electricity companies and revenue uplift was the preference of most of the water company respondents. Some respondents felt that to implement the revenue uplift in an NPV neutral manner would be fairer to customers although there may be practical issues with this approach.

The use of a nominal weighted average cost of capital, to overcome the cash flow timing problems associated with a real return and nominal financing costs, was specifically rejected in one of the seminars because of its significant implications for customers.. It would result in a large incremental increase to prices and may ultimately not resolve financeability issues over the longer term.

Key issue 1: Ring fencing provisions

Should financial ring fencing arrangements be extended to cover all monopoly businesses and modified so that they all include cash lock-up provisions? How might the introduction of cash lock-up provisions affect existing financial structures including holding company debt? Are the current ring fencing provisions sufficient to allow the activities of the licensed undertaker to be fully separated from other group entities? If not, what additional ring fencing provisions might be the costs and benefits of these?

The vast majority of respondents saw no problems with existing financial ring fencing arrangements indicating that they were sufficient to preserve the financial integrity of the monopoly businesses and allow the activities of the licence holder to be fully separated from other group activities. The case of Enron/Wessex Water was quoted as an example of a situation where financial ring fencing conditions were shown to be effective.

There was some appetite for introducing financial ring fencing conditions to all monopoly businesses. However, it was suggested that before seeking to extend financial ring fencing arrangements across sectors there should be some investigations in to whether or not these protections could be provided with market based arrangements such as covenants.

Ring fencing provisions are not currently consistent across all water companies. Each water company's position on what was the appropriate set of licence conditions tended to reflect the state of its current licence.

Currently no water company licence includes a cash lock-up provision. Some companies from the water sector were therefore hostile to the notion of introducing such a provision. There were two main reasons given for this:

- That the introduction of such provisions will discourage equity injections because they impose a restriction on the amount of equity returns that can be taken out of the business; and
- That if such provisions are required or will be required in order to provide additional security for debt investors then they are already in place or will be put in place via debt covenants.

In addition two respondents expressed concern about the effect that cash lock up provisions would have on the ability of a holding company of a regulated business to raise debt finance.

However, some licence holders, where the cash lock up provision already forms part of the standard ring fencing provisions, believe it may be beneficial in supporting debt. They also considered they were appropriate to provide protection where licensees fell to the limit of or below investment grade status.

Key issue 2: Split cost of capital

Would the separation of past and future capital investment improve the incentives for investment, lower the overall risk of regulated businesses and reduce the cost of finance? Are there any practical implications if such an approach was adopted?

The key point emerging from the seminar, and reflected by a number of respondents, was that the introduction of a split cost of capital would increase perceived regulatory risk as changing the regulatory regime in a fundamental way would undermine current investors' expectations of the returns they receive on their investment. The practical issue of transferring assets from being classified as 'new' into the RAV is also mentioned as a potential source of risk.

Whilst recognising the focus that proposals for regulatory reform had brought to risk allocation in utility businesses, respondents were overwhelmingly unfavourable towards the separation of past and future capital expenditure otherwise known as the 'split cost of capital'. Two conclusions reached by the majority of respondents are:

- that it will lead to an increase in the proportion of debt finance in companies' financial structure; and
- that of itself it will not lead to a reduction in risk and therefore the overall cost of capital will remain the same and that risk can only be reduced if it is transferred elsewhere.

In the electricity and water sectors assets under construction typically form only a small proportion of the overall asset base. Therefore, respondents argued, if equity was used to fund only operating costs and the delivery of new investment then it would play only a limited role in the financial structure of companies within these sectors.

The general consensus is that the risk of the regulated business, comprising of business, regulatory and political risk, will remain the same despite the adoption of a split cost of capital. It would be practically very difficult to separate the risks associated with asset growth from asset maintenance.

Respondents felt that the proposals by Helm understate the nature of the risk of the RAV. They consider the RAV to carry significant risk not least because a large proportion of a regulated businesses capital expenditure relates to the maintenance of assets contained in it. At the seminar the example of Railtrack and the Hatfield rail crash was cited as an example of the risk associated with existing assets in the RAV.

In addition a number of respondents pointed out that the concept of a split cost of capital is unlikely to be in the public interest as long as assets continue to be remunerated over a longer period than the regulatory cycle.

A number of respondents argue that implementing the split cost of capital would only lead to a reduction in the overall risk of regulated businesses if either:

- it reveals that business risk is lower than previously thought; and/or
- it were accompanied by an increase in regulatory commitment.

Consequently they do not believe that the split cost of capital would lead to a lower overall cost of capital.

There is some support for the idea that a differential cost of capital could be applied to large investment projects. Heathrow's Terminal Five construction project is cited as an example where such a regulatory approach has been applied. It is, however, pointed out by respondents that the vast majority of investment projects undertaken in the water, electricity and gas sectors are relatively small and limited in duration although it is recognised that this may not remain the case in the future.

Key issue 3: Regulatory commitment

Is there any evidence of a lack of regulatory commitment to regulatory asset values or equity funding and if so how might this be best rectified?

The responses from electricity companies indicated that they were broadly satisfied with regulatory commitment to the RAV. Specific mention was made of Ofgem's increased level of engagement with key stakeholders and the increased transparency that resulted from this during the DPCR4. There was a degree of concern, however, that there is a lack of clarity surrounding the rules which govern inclusion of new investment in the RAV. The consensus was that if the regulator were to provide greater clarity on this issue and publish the RAV annually then this would have the effect of increasing perceptions of regulatory commitment.

In the case of the water companies the responses indicated a general level of satisfaction with regulatory commitment following PR04 during which an increased level of transparency led to an increase in investor confidence. Although a note of caution is sounded by some respondents who argue that the new found confidence is fragile and that indicators of investor confidence such as market premia to RCV may just be a function of the certainty that results from being at the beginning of the regulatory cycle and conditions in the market itself. The annual publication of the RCV in the water sector was also widely welcomed as a step towards increased regulatory commitment.

Some respondents argue that a further way that regulatory commitment to RCVs could be enhanced would be for them to be included in the licence with commitment from the regulators to the principles whereby past RCV decisions might be revisited. There is some concern amongst water companies that the asymmetric treatment of capital overspends (which are capped) and underspends (which are treated as efficiency) undermines regulatory commitment to the RAV and reduces the incentives for discretionary investment and may be a negative factor from an equity investor's perspective.

A number of electricity distribution companies point out that whilst regulatory commitment to the RAV is important this is of little value without confidence that the rate of return and the depreciation of the RAV will be calculated correctly.

Key issue 4: Index-linked debt

Should regulators assume that a proportion of debt is index-linked when setting price controls? Is access to the index-linked debt markets (or related instruments) available to all companies regardless of their specific financial/corporate structure? Are there longer-term implications for the companies' financial stability of adopting a significant proportion of index-linked debt? What is the demand for corporate index-linked debt and are there constraints on investors portfolios? Would it be more expensive?

There is a mixed view about whether regulators should assume that companies' debt portfolios comprise a proportion of index-linked debt (ILD). Some water sector respondents were of the view that this would be a reasonable regulatory assumption subject to certain caveats, for example:

- that it would be reasonable only if it is apparent that this is what the sector is doing in practice; and
- that any assumed proportion should be limited to the weighted average for the sector.

However, energy sector respondents were generally of the view that decisions on the overall mix of debt instruments in a company's portfolio should be taken by companies and not the regulator and this is consistent with a view that decisions on capital structure lie with companies.

One large investor suggests however that a regulatory assumption on ILD may generate liquidity in the corporate ILD market that is currently lacking though it felt that forcing companies to use ILD would be heavy handed.

The vast majority of respondents agree that ILD does have some advantages for companies in that the profile of the debt reflects that of the inflation adjusted RAV and therefore there is a better match between the allowed return in price limits and companies' payments to investors. Some respondents believe that this advantage will result in companies adopting an appropriate level of ILD and that it would be reasonable for the regulator to take this into account when price controls are set. Although it was recognised that whilst it may help cash flow in the short term it does not fundamentally alter the debt position of the company going forward. Those respondents against regulators assuming a proportion of ILD cite the following reasons:

- The ILD market is historically small and immature consequently the ability of companies to issue ILD may be limited.
- The index-linked swaps (ILS) market is based upon banking intermediaries who, unlike pension funds will not be prepared to accept growth in asset values as compensation for inflation and hence ILS will use up more credit capacity than conventional swaps.

- ILS do not qualify for hedge accounting under IAS 39 and could therefore introduce significant volatility in reported earnings which would be of concern to shareholders
- Whilst ILD will improve some ratios that are considered by rating agencies such as earnings and debt cover ratios it will not improve gearing and debt coverage.

Key issue 5: Facilitating equity injections

Are there any changes that would be required to the regulatory regime in order to facilitate equity injections? What would be the implications for the highly geared companies?

A constant theme emerging from the seminar was the principle that greater regulatory commitment and transparency would lead to improved investor confidence. This principle was cited in relation to the appetite for issues of new equity.

However, a number of respondents make the point that equity funding is already available, particularly to well run companies. Evidence cited for this is the rights issue by United Utilities and the fact that equity funding was available to facilitate the acquisition of the gas distribution networks (GDNs) in 2005.

In addition it was argued that there are no significant issues surrounding the ability of regulated energy transporters to attract equity at reasonable cost. Furthermore, it was felt that the fact that network businesses such as Lattice and the GDN's have recently changed hands at a premium to RAV suggests considerable appetite among the investment community and indicates (in hindsight) that past price control reviews could have been somewhat tighter than they were.

The allowed return on equity is highlighted as a key determinant of the ability of companies to raise equity finance. Some respondents believed that the costs of issuing equity are potentially prohibitive and suggest the regulator should specifically allow for these costs in price determinations.

However, some respondents argue an assumed higher cost of equity might not necessarily lead to companies adopting financial structure that contains an increased proportion of equity and that it might actually incentivise companies to adopt higher gearing. Some respondents believe that regulators have some power to lower the cost of equity and hence encourage equity formation. Some conventionally structured companies argue that if concerns persist about higher gearing then this can only be addressed by positively incentivising conventional gearing by allowing higher returns for lower geared companies.

Key issue 6: Flexible dividend modelling by regulators

Would it be reasonable for regulators to be more flexible in their approach to modelling dividends as a method for stabilising gearing and easing any financing constraints? Would such an approach require changes to the regulatory regime in order to increase certainty and if so what sort of changes would be most appropriate?

The regulated businesses that responded specifically to this question do not think that it would be reasonable for the regulator to be flexible in its approach to modelling dividends. A more flexible approach is interpreted by these companies as a dividend cut in the short term with the expectation of higher dividends in the future. It is argued strongly that investors see utilities as income stock and are attracted to their specific characteristics of high yield and low but stable inflation linked growth. A deviation from this dividend policy would, it is argued, make utilities less attractive to equity investors.

There was a dissenting voice who suggests that it is reasonable for regulators to be flexible in their approach to dividends and that this should not require material changes to the regulatory regime. This respondent indicated that the capital markets provide a range of options for companies to fund a growing capital investment programme. However, it points out that a capital expenditure programme that causes financial ratios to deteriorate materially will require some form of financing compensation.

Key issue 7: Financial ratios and debt structure

Should regulators adopt pragmatic definitions of ratios used by the credit rating agencies? Is the specific level of any particular ratios critical to credit worthiness? Is it the overall level and trend of ratios that is important? Would there be significant difficulties for companies if the majority of ratings were BBB?

The vast majority of respondents believe that when conducting financeability tests the regulator should adopt definitions of ratios that are consistent with those used by credit rating agencies, accepting that there are different approaches between various agencies. The consensus is that the adoption of different ratios would not only have little effect on the capital markets' assessment of companies' financial strength but could increase perceptions of regulatory risk.

Opinion is that it is the overall level and trend of the ratios that is important to credit quality. This is the approach taken by credit rating agencies and the regulators should mirror this approach.

There is widespread concern over having a majority of utilities companies with a BBB/Baa2 credit rating. A BBB/Baa2 credit rating would leave little headroom against cost shocks and as a result there is a danger that a number of firms could fall below investment grade credit rating. The implication for the utilities sector of firms falling below investment grade credit rating could be a significant increase in the cost of debt finance.

Key issue 8: Financeability adjustments

If there are remaining issues of financeability what are the advantages and disadvantages of (a) revenue uplift (and should this be PV neutral) (b) accelerated depreciation (c) profiling returns on a nominal basis?

There was a general view that companies should be left to make their own decisions about how to finance their businesses. Some respondents argued that if the cost of capital is correct then efficient companies should not have a problem financing their businesses. On balance, however, respondents felt that regulators are right to test for financeability and there may need to be regulatory intervention under some conditions.

The option of profiling returns on a nominal basis was disliked by all respondents who commented upon it. The option of accelerated depreciation was favoured by most of the electricity companies who responded and revenue uplift was the preference of most of the water company respondents.

Profiling returns on a nominal basis was not liked because:

- It represented a substantial change in the form of regulation; and
- The short term impact would be a substantial step change in customers' bills.

Accelerated depreciation was preferred by most respondents from the electricity sectors because of its NPV neutrality and its predictability. A number of respondents, in particular those respondents from the water sector, indicated that they believed that accelerated depreciation would simply store up a financeability problem for the future and that the problem may worsen over the longer-term as a consequence. Other concerns are that accelerated depreciation would cause problems of intergenerational equity and increase the disparity between the market and regulatory value of assets.

Revenue uplifts as implemented in PR04 were generally perceived by water companies as being a successful method of dealing with the financeability issue. Some water companies and investor respondents accepted that these uplifts should, in principle, be NPV neutral. However, most of these pointed out that in the face of continuing capital investment requirements in the water industry it was difficult to see how this could be the case in practice.

A few respondents suggested that the need for these revenue uplifts was an indication that the determination of the cost of capital that was made at PR04 was incorrect and therefore it is appropriate that they are NPV positive.

A couple of respondents noted concern that revenue uplifts could have the potential to reward an operator who performs badly whilst a well performing operator would not receive a corresponding uplift. The result of this could be a reduction in the incentive for companies to perform well.

Some of the water companies suggest that the financeability adjustments at PR04

were 'not large' in the context of overall revenues and therefore solving the issue did not involve wholesale reassessment of the regulatory regime. It was also suggested that the debate should address what the appropriate pace of capital investment should be given that, to a large extent, it causes the financeability problem.

A water only company suggests that there is an inconsistency between the small company premium and the fact that the same financeability tests are used for water only and water and sewerage companies. It argues that the increased risk of small companies means that they require a higher level for given ratios to achieve a particular credit rating.

Other responses

One response suggests that there may need to be a review of the regulatory methodology whereby some capital expenditure is added to the RAV with the price control allowing the recovery of regulatory depreciation and a return on investment. This suggestion is based on a view that customers are disadvantaged in terms of pricing under the 'RCV method' compared to an alternative 'historic cost approach' which is set out in the response. The respondent argues that this may distort utility behaviour in a number of aspects.