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Investor Survey: Ofgem's DPCR5 Initial Proposals

Report by Indepen

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Summary

This report presents the results of the first survey of investors in the UK electricity distribution sector. The survey captures the investment community's views on Ofgem's Initial Proposals for the 2010-15 price controls in order to better inform the debate between the regulator and companies before the final determination of price limits.

The survey was sponsored by the companies and Ofgem was represented on the Project's Steering Group. The key findings from equity and debt investors, advisors and analysts as well as the three rating agencies are set out below.

Key findings

Overall responses

In overall terms two-thirds of respondents indicated that the Initial Proposals had a neutral effect on the sector. They referred to the continuation of many of the fundamentals of the regime. Of the remainder more had a negative than a positive view.

Respondents were disappointed that Ofgem had not made decisions on key issues such as the cost of capital and pensions which meant that a wide range of outcomes was still possible and hence it was difficult to form a view on the overall package.

Financial assumptions

Ofgem did not offer a view on the appropriate cost of capital to include in price limits. For modelling purposes it used its DPCR4 assumption and published its consultant PwC's report on the cost of capital at the same time as it own Initial Proposals. Our questionnaire explored investors' views on PwC's range for the cost of capital and its component parts.

The key observations on PwC's report were that the cost of capital range was too wide and the low end was unrealistic. Views were expressed that PwC had failed to reflect recent market evidence and volatility in its assumptions.

Investors were generally supportive of Ofgem's gearing assumption (57.5%) for modelling. Views were mixed to positive about Ofgem's approach to financeability with some support for its three credit ratios. Additional metrics were also proposed. The majority of responses suggested that Ofgem should target a rating in the A- to BBB+ range. Some indicated that Ofgem should take a cautious view of companies' financeability given current economic conditions.

Risk

The vast majority of respondents considered that risk had risen since the last determination with many highlighting the more volatile and uncertain economic and funding conditions. There were mixed views on whether Ofgem's risk mitigation measures were clear and whether they were appropriate. Some would require more clarity on the mechanisms before attributing any value to the mitigations and some would rather that risk were reflected in the cost of capital assumption.

1 Introduction

1.1 Background

On 4 August 2009, Ofgem published *'Electricity Distribution Price Control Review - Initial Proposals'* which set out the draft view of the revenues that the 14 distribution network operators (DNOs) would be allowed to earn from 2010-2015.

Given recent and continued economic and financial volatility and uncertainty, combined with the challenges of a transition to a low carbon economy, Ofgem faces considerable challenges in setting a five year price control.

To inform discussions on the final proposals between the regulator and companies, the DNOs have sponsored the first survey of investors in the sector. The purpose of the survey is to capture the investment community's views on Ofgem's Initial Proposals. The approach was agreed jointly by the companies and Ofgem, both of whom were represented on our Project Steering Group. The survey took the form of a questionnaire distributed and completed by email.

We targeted relevant and well informed individuals in key institutions. The results therefore reflect the views of equity and debt investors, advisors and analysts as well as the three rating agencies.

1.2 Approach

The survey was sponsored by the 14 UK electricity distribution companies and guided by a Steering Group including representatives from the companies, Ofgem and the Energy Networks Association (ENA). The project was led by Matthew Parr who was supported by John Hargreaves and Tom Walker.

It focused on Ofgem's document *'Electricity Price Control Review: Initial Proposals'* published on 4 August 2009. This set out Ofgem's proposals for the companies' allowed revenues in the next five years and included proposed new obligations and incentives. It consulted on Ofgem's approach to setting the cost of capital and the balance of risk and reward in the settlement.

The Steering Group opted for a questionnaire, rather than face to face interviews. The survey's targets were selected in discussion with the Steering Group to reflect the range of equity and debt investors, advisors and analysts that deal with the sector. The appendix lists the institutions and individuals who completed the questionnaire and were willing to be identified in the report. All contributions to the questionnaire remain non-attributable.

The numbers of respondents by type were as follows.

- Nine equity – representing infrastructure funds, fund managers, advisors and analysts
- Five debt – representing bondholders, lenders, advisors and analysts
- Three representing the rating agencies.

The questionnaire included 33 questions and had the following sections.

- Overall perspectives
- Financing elements, specifically the cost of capital
- Risk.

We distributed the questionnaire by email on 10 August and received responses between 10 August and 28 September 2009. We distributed 34 questionnaires and received responses from 17, a response rate of 50%.

This report summarises the answers to each of the questions. Where relevant we have reported the results separately for equity, debt and the rating agencies. We have tended to focus the report on the views of the first two groups as the rating agencies said that their role was to rate the sector rather than comment on it and they were not in a position to answer some of the questions. The charts show the proportions who gave various responses (excluding the rating agencies) but not those that did not or could not answer the question.

While some of the questions (for example, 8, 10 and 18) generated only a small number of responses, we have still included them in this report.

We thank all those who took part in the survey for their contributions.

2 Summary of responses

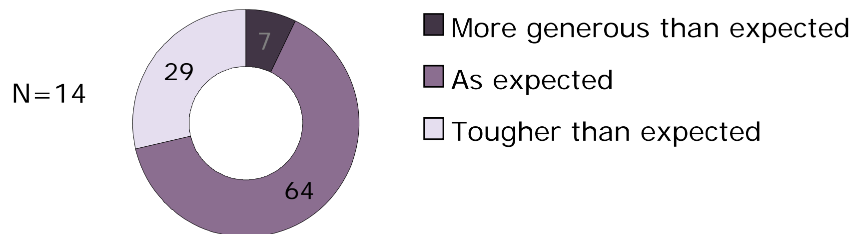
The summary follows the structure we used in the interviews and has the following headings.

- Overall perspectives
- Financial elements
- Risk.

2.1 Overall perspectives

Q1. In overall terms, what do you think about Ofgem's Initial Proposals?
Q2. How do the Initial Proposals compare with your expectations?

Ten of the 14 respondents considered that Ofgem's Initial Proposals were broadly sensible with all but one of the ten stating that the proposals were as expected (see figure below).



However, eight referred to a lack of detail on key aspects of the proposals particularly the cost of capital. As Ofgem had not indicated a specific weighted average cost of capital (WACC), investors stated that they were not able to form a view of the overall package. In addition, there was disappointment that the WACC range was so wide and many thought that the bottom end of the range was not plausible. Specific issues mentioned on which they required more information were

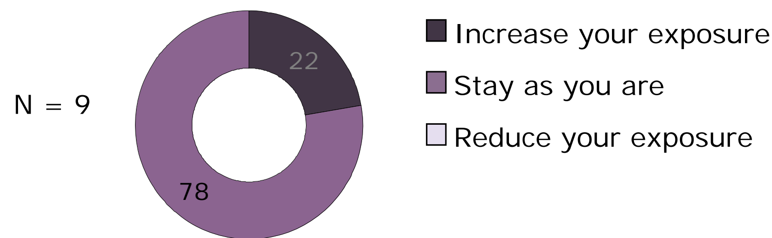
- The cost of capital
- Pensions
- Tax.

Three responses were disappointed in Ofgem's cuts to companies' investment plans. While one debt response welcomed Ofgem getting a tighter grip on investment and cost issues another (equity) thought the regulator had been reasonably balanced, compared to the Initial Proposals at GDPCR 2008-13 and the recent Ofwat PR09 Draft Determinations.

One respondent said Ofgem had weakened the incentives to manage distribution losses and another that it was not clear how the incentive mechanisms (eg innovation funding incentive, customer interruptions, customer minutes lost) affected the different companies.

Q3. Relative to your current position, are you likely to increase your exposure, stay as you are, reduce your exposure or not applicable?

Seven of the nine that responded said they would not alter their exposure to the sector as a result of the Initial Proposals. One debt and one equity investor suggested they would increase their exposure. The debt investor is a specialist lender and indicated it would continue to lend, even if other parties found it difficult, subject to acceptable DNO financeability. The equity investor believed risk/return was fairly well balanced provided Ofgem's WACC assumption did not fall in the final proposals.



Q4. How have the Initial Proposals affected the attractiveness of the sector to investors?

The attractiveness of the sector appears to have been largely unaffected by the Initial Proposals. Views were as follows

- two were positive referring to regulatory consistency or the low risk nature of the sector
- four were neutral (with one subject to a reasonable WACC)
- three were negative (referring to WACC uncertainty and Ofwat's WACC assumption in its Draft Determinations, pensions and capex cuts)
- five preferred not to say due to uncertainties in the package (WACC, tax, pensions, insufficient public information to assess the acceptability of the proposals).

From this we can see that many investors found that without important details it was difficult to gauge the attractiveness of the package for the sector.

Two debt respondents were positive about the consistency of Ofgem's regulatory approach. An equity investor commented that the information on the WACC and taxation were not positive. One respondent welcomed the increase in capex compared with historical levels while another questioned why Ofgem had cut companies' proposed investment plans.

Q5. Are there any aspects of Ofgem's Initial Proposals about which you need more information?

Six equity, one debt and two rating agencies said they required more clarity about the WACC.

Six respondents (mostly equity) indicated that more information was required on the treatment of the sector's pension deficit. Of those that commented on pensions, some noted that further clarification on the matter would be forthcoming in September.

Two, both equity, said they required clarification on the treatment of taxation changes.

Two respondents did not require additional information.

Individual issues for clarification included

- the proposed Low Carbon Network Fund and its relation to smart meter roll-out
- the breakdown of network investment by company (opex vs capex)
- reconciliation between the Initial Proposals and companies' plans
- reconciliation of the opening RAV
- Ofgem's approach to revenue profiling.

2.2 Financial aspects

PwC had prepared a report on the cost of capital for Ofgem entitled '*Advice on the cost of capital analysis for DPCR5*', 28 July 2009. The document contained ranges for the component parts of the cost of capital. Many of the questions in this section capture respondent's views on PwC's report.

Q6. What do you think about PwC's range for the cost of debt?

PwC's range for the pre tax real cost of debt was 3.1% - 4.0%. The survey captured the following views on this

- 11 of the 14 who responded thought the bottom end of PwC's range was inappropriate or that the cost of debt lay in the top half/top end of the range. One rating agency also held this view
- 2 debt respondents and one rating agency thought the range was too wide.

Reasons given for views that the cost of debt was too low included the following.

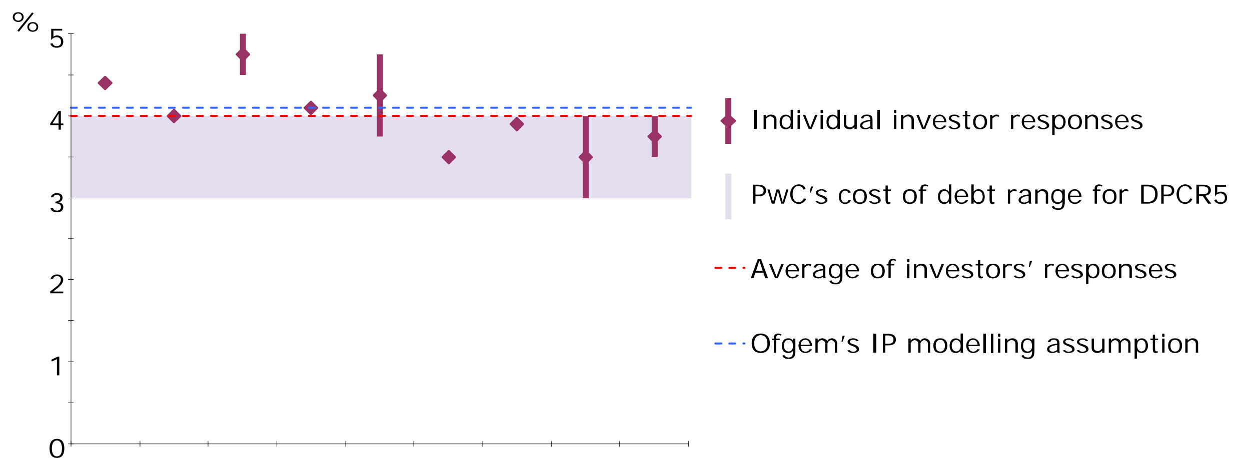
- PwC had failed to take into account long-dated embedded debt at higher rates. It was noted that the DNOs had not benefited as much as water companies from index linked debt (ILD).
- A low cost of debt would encourage short-dated debt which would increase re-financing risk.
- PwC did not reflect fundamental changes in the credit markets since 2007 including higher fees for refinancing and commitment/liquidity facilities
- The significant levels of DNO debt that will need to be raised to finance RAV growth in a more difficult environment.

Two respondents (both equity) felt that the range was fair although one stated that the figure should be in the upper end of the range. One equity respondent, unprompted, indicated that clear mitigation measures were necessary to deal with uncertainty over the cost of debt finance.

Q7. What is your estimate of the current cost of debt for the sector?

We received nine responses which ranged from 3.5% to 4.75% (taking spot estimates and the mid point of individual ranges).

The figure below compares the results from the questionnaire with PwC's range and Ofgem's current modelling assumption. The average view of respondents was 4.0%, just below Ofgem's 4.1% modelling assumption and at the top of PwC's range.



Q8. What was an equivalent cost (of debt) in 2004?

There were only five responses to this question ranging from 3.5[1]% to 4.25% (3.5%, 3.7%, 3.8%, 4.0% and 4.25%). At DPCR4 Ofgem assumed a cost of debt of 4.1% (pre tax real).

Q9 Briefly, what are the main factors that will affect the cost of debt, and what effects do you think they will have?

Factors were mentioned under the following broad headings.

- Macroeconomic conditions and the Government's response (17 references)
- Banking and credit market factors (15)
- Industry and company specific factors (6).

Respondents were often not very clear in terms of the causes and potential effects or even direction of causality. Understandably this might be due to the high levels of uncertainty about the future of the economy and consequences of current economic policies.

[1] 3.5% represents the mid-point of a respondents view that the cost of debt in 2004 was 3.4%-3.6%

Macroeconomic conditions and the Government's response

Respondents saw the macroeconomic environment and the Government's response as a key factor. Most tended to focus on the UK economy, the government's response and how that might affect the markets. Of particular note were the government's policy of quantitative easing, budget deficit and subsequent high levels of borrowing (gilt issuance). The impact being a possible deterioration in the UK credit rating, higher gilt yields, risk free rate and cost of borrowing for UK companies. Volatility in and potentially higher inflation was mentioned with a consequence that the UK monetary policy would need to respond by raising interest rates leading to higher borrowing costs.

Respondents also mentioned global economic developments, UK corporate failures and shifts in credit spreads.

Banking and credit market factors

Respondents saw liquidity and the availability of credit as problematic and made 15 separate references to banking and credit market conditions.

- Six respondents discussed capital constraints and reduced liquidity in particular in relation to bank lending, higher hurdle rates, higher commitment fees, a focus on higher quality credit and continued volatility
- One respondent described the macro credit environment and anticipated increase in the risk free rate
- One respondent suggested a lack of available equity could lead to spreads widening
- Three respondents considered that the availability of ILD was a particular problem
- Two respondents noted some improvements in capital market liquidity and spreads narrowing although one suggested they would not return to 2004-07 levels.

Industry and company specific factors

Five respondents cited the sector's risk profile and associated credit rating including the risk that an unfavourable determination could affect credit spreads.

Q10. Given these factors and effects, can you say what you expect the cost of debt to be in 2015?

Unsurprisingly, the majority of respondents did not provide an estimate of the cost of debt for 2015. We received two responses which were 4.4% and 5.0%.

Q11. Do you have any concerns about the funding environment for DNOs in the DPCR5 period?

Responses indicate that investors believe the DNOs should be well positioned to access credit finance, particularly if they have a strong credit rating. Six respondents (a mix of equity, debt and a rating agency) noted that utilities tend to be able to access the markets even when the environment is difficult. However, one debt analyst could conceive of periods when markets would be closed and over half raised specific concerns over the funding environment. These included

- reduced commercial bank market liquidity, at a higher cost and shorter term (i.e. to encourage companies raise debt in the capital markets)
- volatility leading to increased spreads
- possibility of saturation affecting investors' appetite for and the pricing of the sterling bond market
- absence of monoline insurers
- decreased availability of ILD, derivatives (thus negatively impacting on interest covers) and long dated bonds.

Q12. What do you think about PwC's range for the cost of equity that is included in Ofgem's Initial Proposals?

PwC had included a range of 4%-8.5% for the cost of equity. Respondents made two main points

- Eight considered the bottom end of the range was inappropriate or that the cost of equity should be in the top half or at the top end of the range.
- Unprompted seven of the 12 responses suggested the range was too broad. This was viewed as unhelpful and sapping confidence. One investor noted that a wide range was theoretically possible although the low end of PwC's range did not accord with market practice or theory. A rating agency also considered the range to be too broad.

Additional views from equity included the following

- In reference to the lower end of PwC's range not being sensible – *'the lowest cost of equity recently quoted by any analyst of the regulated sector was 7% (National Grid)'*. Reference was made to private equity demanding higher returns than recently (a shift from low to mid teens) and to it being *'difficult to believe that the cost of equity has fallen just because gilt yields are low'*.

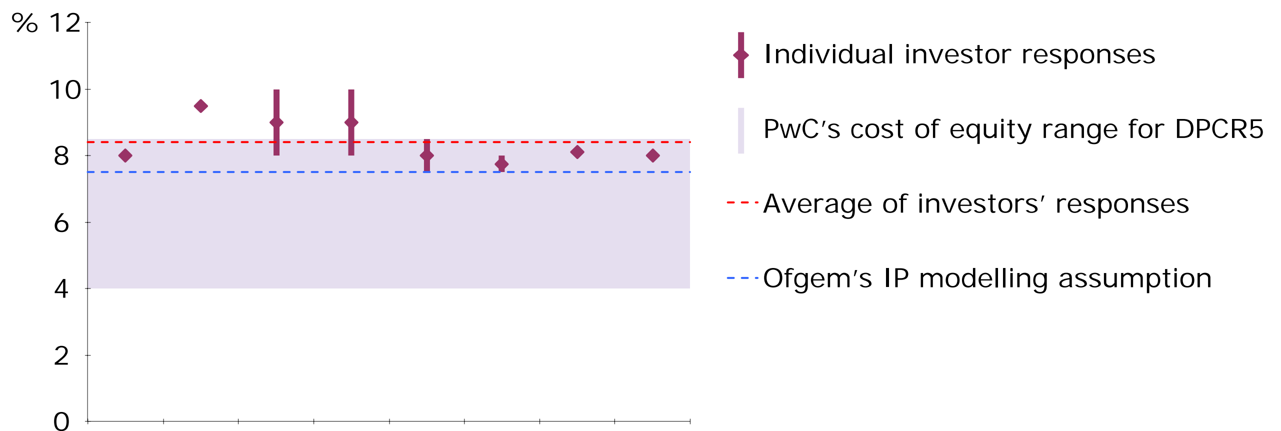
- *'DNOs are on an upward trajectory of investment that needs to attract equity. The assumed cost of equity needs to be attractive to investors who need reassurance that the RAV will be properly remunerated at all price reviews. Postulating a very wide range for the cost of equity with low top and bottom ends to that range is unhelpful in maintaining the equity investors' confidence in a sector that must continue to have an investment focus. At DPCR4 the rate was set at 7.5%. We believe that the cost of equity has since risen'.*
- *'Equity investors appear to be targeting returns of c. 11% nominal. Based on a long term inflation rate of 2.7% as per HM Treasury Survey (Aug 2009), this would imply a post tax cost of equity of c 8.1%'.*
- One response indicated a cost of equity at the top end or above the PwC range. This respondent said *'the low end is unachievable, even in more favourable capital market conditions'* and when compared with the PwC's own cost of debt range *'represents little to no incentive (0-90bps) to bear the additional risk associated with equity'.*

No response indicated the cost of equity was in the bottom half of PwC's range.

Q13. What do you think is the actual cost of equity for the sector now?

We received eight responses on the (actual) current cost of equity which were either point estimates or ranges. Taking the mid-points of individual ranges together with point estimates then the range was 7.75% to 9.5%[2]. This compares with PwC's range of 4%-8.5% and Ofgem's DPCR4 assumption of 7.5%.

The average view of respondents was 8.4%, which lies at the top end of PwC's range and above Ofgem's 7.5% modelling assumption.



[2] The response of 9.5% actually stated 'at least 9.5%'. For the purposes of this report we have included the response as 9.5%

Q14. What do you think about PwC's range for the equity risk premium that is included in Ofgem's Initial Proposals?

PwC included a range of 4%-5.5% for the equity risk premium in their July report. We received the following responses

- Four of 12 responses suggested the range was fair of which one that it was *'at the low end of reasonable'.* A further two suggested the range was reasonable compared to commonly used ranges but it did not take account of recent market volatility
- Five suggested the low end of the range was inappropriate or that Ofgem's assumption should be at the high end of the range
- One thought the equity risk premium should be above the PwC range and that Ofgem's DPCR4 figure of 4.75% was now unrealistic
- None thought the cost of equity was in the bottom half of the PwC range.

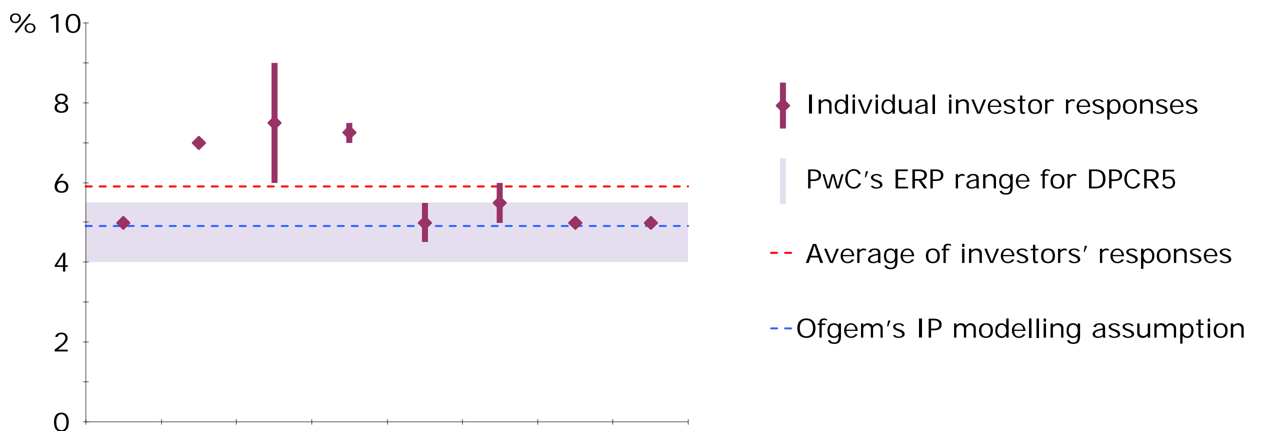
Investors considered that PwC had failed to take account of recent market volatility and evidence on the equity risk premium, with one referring to an implied current equity risk premium of c7-7.5 and another an assessment of 5% over 2000-09. In addition there was a lack of evidence suggesting an improvement in the medium term prospects for equity.

One equity respondent drew comparisons with Ofwat's Draft Determinations which had an equity risk premium of 5.4%. The respondent suggested that, compared with Ofwat's Draft Determinations, the balance of risks was slightly more favourable in DPCR5, due to the treatment of the pension deficit and the reopener for changes in the tax legislation. For these reasons Ofgem should set an equity risk premium equal to or slightly lower than Ofwat's.

Q15. What do you think the equity risk premium is currently?

Taking the mid point of ranges then all eight responses suggested an equity risk premium at or above 5% (ranging from 5%-7.50%). Five were within PwC's ERP range of 4%-5.5%, albeit in the top half.

The average view of respondents was 5.9%, which is 40bps above the top of PwC's range and 100bps above Ofgem's 4.9% modelling assumption.



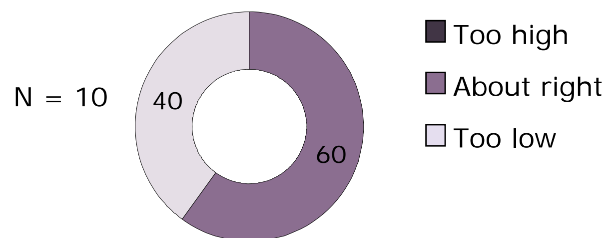
Q16. What has happened to the equity risk premium since DPCR4?

All nine who offered a view felt that the equity risk premium had increased since DPCR4. No respondents suggested it was the same or lower.

Q17. Do you think Ofgem's assumption on dividend yield (5%) is too high, about right, too low, don't know or not applicable?

Of the 10 that offered a view, six thought Ofgem's dividend assumption was about right and four that it was too low. Three of the four 'too low' responses came from equity.

None of the responses thought the Ofgem yield assumption was too high.



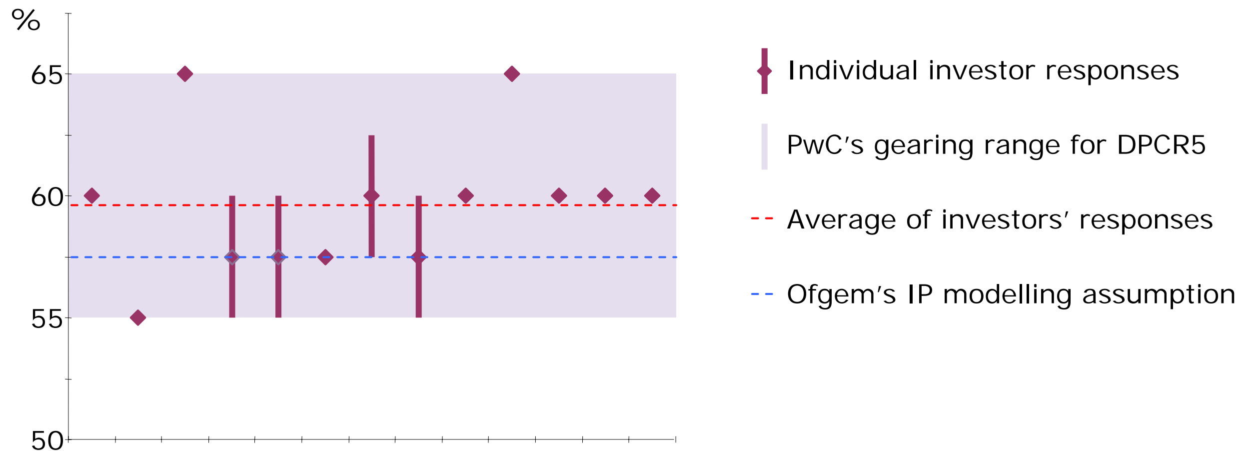
Q18. What real dividend growth do you require from the DNOs for DPCR5?

Individual dividend growth assumptions were 2%, 1%-4%, 3%, 4% and 5%. In addition one investor stated that Ofgem's 5% yield assumption was too low but in that context a 4.5% growth assumption would be appropriate.

Separately, an equity respondent suggested it was difficult to determine given the balance between yield, capital appreciation and other factors. He referred to scepticism about National Grid's 8% (nominal dividend growth) and noted that water companies appear to be able to sustain 3% real growth.

Q19. What gearing assumption do you think Ofgem should make?

We received 13 responses from a low of 55% to a high of 65%. All responses were within PwC's gearing range with the average (59.6%) slightly above Ofgem's modelling assumption of 57.5%.



Q20. What do you think about PwC's range for the vanilla WACC included in Ofgem's Initial Proposals?

PwC's range for the vanilla WACC in its July report was 3.5%-5.6%. Ten of 14 responses considered PwC's range to be too wide while one thought it was reasonable.

Six thought Ofgem should target the top half of the range with one respondent opting for a figure around the middle of the range. No responses suggested a figure in the bottom half of the PwC range.

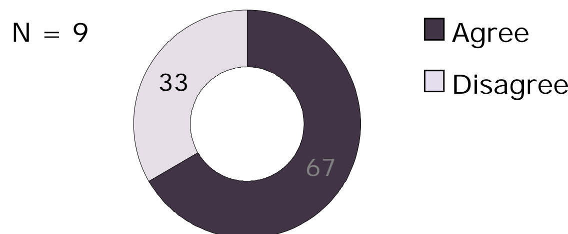
Additional observations on changes to the market and investor expectations came from equity respondents

- *'Given the impact of the recent market turmoil, to consider a range effectively below the DPCR4 settlement is inconsistent with the cost of funds and the risk profile of the industry. The low end of the range is wholly unrepresentative of this industry or any other.'*
- *'PwC's WACC range is very wide therefore it is hard to comment. Ofgem should consider the asymmetric risk of setting the WACC too low (flight of equity). As noted in the Final Proposals in DPCR4 (page 103), "investors… have competing uses for capital which offer more attractive risk-adjusted returns and that too low a cost of capital figure would therefore result in under-investment in the electricity distribution sector".'*

- In a capital constrained environment, given the demand for infrastructure investment across Europe, investor perceptions of the quality of regulatory regimes and the returns that are available will be important as they make difficult choices about where to focus investment. *'Ofgem and the UK policy community more broadly need to ensure that the UK retains its market perception as a well established, predictable and fair regulatory regime - the cost of losing this perception (on investors' future return requirements and willingness to invest) will far outweigh many more marginal benefits from reduced WACC, altered regulatory mechanisms, etc.'*
- *'The allowed WACC needs to give sufficient weight to the prospect that even 10 year averages of past history may not be reflective of the requirements investors will have for returns during the DPCR5 period as a whole. The recent crisis has shifted perspectives on many risk issues - and whilst there has clearly been some reversion from the data seen 6-12 months ago to more 'normal' levels there is still considerable volatility and uncertainty. In my view, the scale of recently experienced volatility and the likelihood that the past will not be a perfect guide to the future argue for a WACC at the higher end of PwC's range.'*

Q21. What do you think about Ofgem's proposed treatment of financeability? Q22: Why do you think this?

Responses to Ofgem's financeability proposals were mixed with six agreeing and three disagreeing. One rating agency also disagreed.



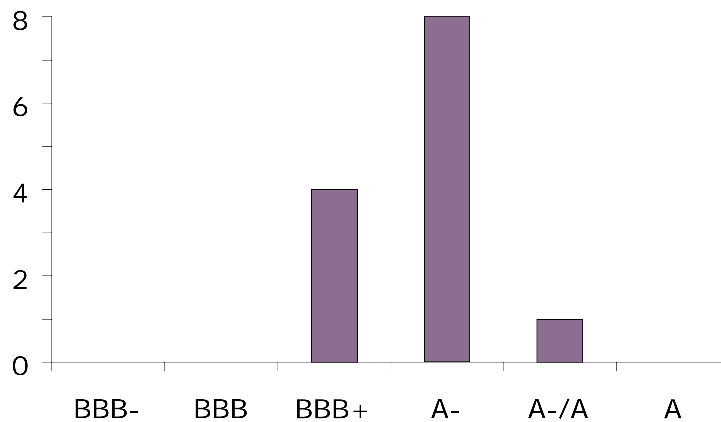
Observations included

- An equity investor said that financeability adjustments should not be seen as a means to correct for the cost of capital being set too low. It is possible to envisage circumstances where a financeability adjustment would be necessary even with the correct cost of capital.
- An equity respondent said it was hard to comment whether financeability adjustments will be required as Ofgem would reduce the cost of capital assumption for the final determinations and this might change things.
- Two equity respondents suggested it was broadly consistent with the past.
- An equity response suggested that as regulated utilities had always targeted a strong investment grade rating (A-/A3) and that this allowed them greater access to the capital markets (at reasonable rates) then Ofgem should target ratios commensurate with A-/A3.
- One equity respondent suggested the ratios seemed consistent with low A ratings.

- A debt respondent considered Ofgem should recognise the sector's higher capex demands to ensure the sector remains attractive.
- One debt respondent suggested the test should be in line with investment grade ratios.
- One rating agency believed the test should include post maintenance interest cover ratio (PMICR).

Q23. What credit rating do you think Ofgem should target?

We received 13 responses from debt and equity to what credit rating Ofgem should target in setting prices ranging from BBB+ to A-/A. Equity had a preference for A- or above (7 of the 9) and debt for BBB+ (3 of the 4).



Q24. What balance should Ofgem strike on the trade off between the cost of capital and the scope the settlement provides for shareholders to earn more through out-performance on incentive schemes?

This question was included to reflect the request in the Initial Proposals for responses on this topic.

Investors seemed unconvinced by Ofgem's proposals. Due to the detailed nature of the issue we have provided fuller responses below. Responses tended to highlight the certainty provided by an ex ante WACC as opposed to the potential benefits from incentive schemes. There were also questions about whether regulators should regard incentive mechanisms as compensation for the risks taken by companies or as contributing to those risks.

Equity responses

- *'WACC is about the "right" remuneration of capital against the risk on capital. Trade offs should be against risk mitigation mechanisms and not outperformance. Incentives and penalties should be dissociated from the WACC and a minimum outperformance assumption should not be used to cover shortfalls in the WACC - this would be a distortion of a very clear incentive mechanism. Incentives/penalties should allow shareholders to be remunerated more or less than the "right" (level of) remuneration depending on how well they perform.'*
- *'Balance needs to be such that an adequate level of operational performance delivers adequate (normal) returns on capital. While incentive schemes can be valuable in driving performance, "base case" returns need to provide an adequate cost of capital to allow investors who can bring capital efficiency (financially-driven investors) as well as those with a strategic / operational view to find DNO assets attractive.'*
- *'Ofgem's description of "package B"*[3] *in the Initial Proposals presentation appears consistent with this approach.'*
- *'The DNO risk profile had increased between DPCR4 and DPCR5 but Ofgem had indicated that this is compensated by incentive schemes. Companies should receive an adequate cost of capital.'*
- An equity investor drew comparisons between Ofwat's CIS mechanisms and Ofgem's IQI with the former *'increasing risk and the latter potentially reducing risk. The cost of capital should reflect the impact of regulatory mechanisms on risk'*.
- *'Investors focus on a firm outcome of WACC rather than potential benefits from incentive schemes.'*
- *'Higher incentives rewards/penalties require a higher WACC not lower.'*
- Incentives should reward or penalise performance but the relationship may be affected by the regulator assuming too low a cost of capital (i.e. risk asymmetry).
- *'Well designed and targeted mechanisms with strong, transparent, uncapped outcomes were welcome.'*

Debt responses referred to the following issues.

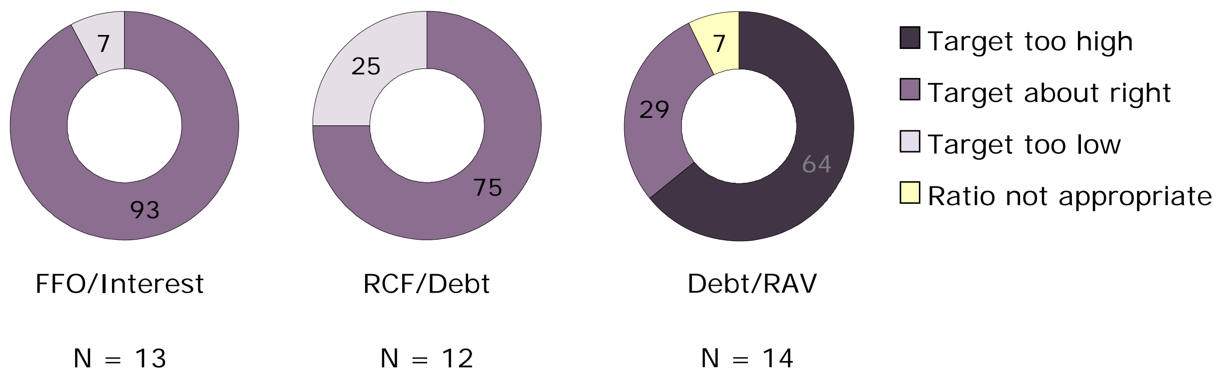
- The cost of capital and potential upside from incentive schemes *'are two distinct considerations as operating outperformance and financial incentives should not be mingled'*.
- One debt analyst considered that there should be an even balance between the two while the other that it was an equity question and any underperformance should be reflected in lower dividends.

[3] In reference to Ofgem's proposals for regulatory equity calibrating the package the respondent preferred Option B from an Ofgem City presentation. This is represented by a tough view on cost allowances, a mid range cost of capital and a narrower range of symmetric opportunities to improve or face a deterioration in the return on equity.

Two rating agencies expressed views.

- The adjusted interest cover ratio would be neutral between high WACC/limited outperformance and low WACC/significant outperformance. However the rating agency's assessment of future performance would possibly be more cautious in a low WACC/high out-performance scenario.
- The risks/rewards of under/out performance should be carried primarily by equity investors and pose a negligible risk to bond holders.

Q25i. With respect to Ratio of Funds from Operations (FFO) to Interest (3x), do you think the ratio is appropriate? If so, do you think the level targeted is too low, about right or too high?
Q25ii. With respect to Ratio of Retained Cash Flow (RCF) to Debt (9%), do you think the ratio is appropriate? If so, do you think the level targeted is too low, about right or too high?
Q25iii. With respect to Ratio of Debt to RAV (65%), do you think the ratio is appropriate? If so, do you think the level targeted is too low, about right or too high?



Generally responses supported the levels for the first two ratios although there was more caution about the gearing financeability check of 65%.

- FFO to interest (3x): 93% of respondents thought the ratio was about right. One equity investor thought the target was too low.
- RCF to debt (9%): The majority (75%) thought the target was about right. Three respondents (25%) thought the ratio was too low (two equity and one debt).
- Debt to RAV (65%): Almost two thirds (64%) thought the ratio was too high while nearly a third thought it was about right (two equity and two debt). One response did not think the use of the ratio was appropriate.

Questions 26 and 27 explore respondent views on financeability in more detail.

Q26. Please give your reasons for any disagreements with Ofgem's proposals (re financeability ratios)
Q27. Are there any other indicators that you think would be relevant? If there are, please define them, give reasons for their use and indicate the target levels you would propose for each of them.

In general the responses considered that Ofgem should be cautious given current economic conditions. A number of additional ratios were also proposed.

Comments by equity included

- *'These ratios are too aggressive and would lead to credit deterioration. The industry should prudently operate in the A credit rating category to help companies withstand financial dislocation which has recently caused the worst financial crisis the UK has experienced in years.'* The respondent suggested including FFO/Net Debt with a target of 12% to 20%, adjusted interest cover ratio targeted between 2x and 4x, and RCF/Capex at 1.5x to 2.5x.
- *'Access to capital is constrained post banking crisis; prudent to reduce leverage.'*
- *'A covenant of 65% for Debt to RAV represents headroom of 7.5% to the ratio implied in the WACC. We believe a target of 60.0 - 62.5% would be more appropriate.'*
- *'Debt/RAV offers a useful benchmark which should be retained for reference but should be a 'cross check' rather than driver of judgments. Debt investors, rating agencies and others in fixed income markets appear more focused on cash-flow based metrics - this should be reflected in Ofgem's thinking as it is the driver of the availability of appropriately priced debt.'*
- *'RCF/Debt at 9.0% is the lower end of the range even for BBB+/BBB, whereas the recommended rating for companies in this space would be A-/A3. (Debt to RAV should be aligned with the WACC calculations, i.e. 57.5% - 60.0%, otherwise the WACC allowed for a company that is 57.5% geared may not be sufficient to maintain a gearing of 57.5%, i.e. A/A-).'* The respondent suggested including FFO/Net Debt and adjusted interest cover ratio.
- *'Credit rating agencies also consider FFO/Debt in their analysis for utilities. In S&P's recent review of UK utilities, it appears to place greater emphasis on FFO/Debt versus FFO/Interest. Hence, we suggest that Ofgem could also take into consideration the FFO/Debt ratio when determining the allowed vanilla cost of capital. We believe that the following credit ratios: 13% to 15% FFO/Debt, 3.0x to 4.0x FFO/Interest and 9% to 11% RCF/Debt would be appropriate for a company targeting a credit rating of A-.'*
- *'The regulator should be more visible about what ratios they use.'*

Debt responses

- *'Leverage target slightly high. Would prefer 60%.'*
- *'Being on the A-/BBB+ borderline seen as pushing the envelope, rather than safe A-. A broad range of ratios makes sense, but these three capture the main elements.'*
- *'Ofgem should aim at a ratio of 55-60% as economic conditions might further deteriorate in the next 1-2years, and bad debt might hit some of the DNOs.'*
- A suggestion of including PMICR targeted at 1.3x or more for reasons of comparability with the water sector and the fact that it is an important ratio for the rating agencies.

Observations from credit rating agencies

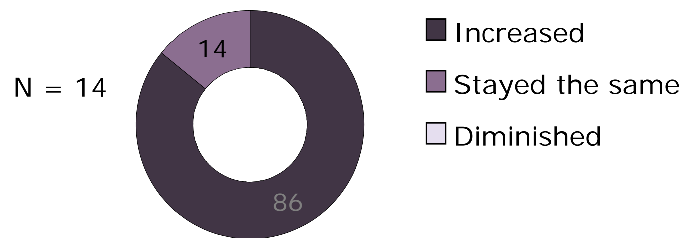
- The key credit metrics that should be considered are Adjusted ICR, Net Debt/RAV, FFO/Net Debt and RCF/Capex.
- Ofgem's ratio levels were not necessarily consistent with maintaining current credit ratings. PMICR should be included by Ofgem with a target of between 1.5x to 2x.

2.3 Risk

Q28. What do you think has happened to the risks facing the DNOs, following the credit crunch and the recession?

Q29. If there has been a change in risk, please indicate what has changed, how long do you think the new conditions will continue and what will then happen?

The majority of responses (12 out of 14) considered that risks had risen with two (both debt) observing that they had not changed.



In response to the possible effects of a change in risk, individual equity responses suggested

- *'Access to risk capital (is) constrained - at least a five year effect.'*
- *'The cost and availability of funds have been affected, it is clear that the cost has increased and the level of liquidity has decreased. This puts equity investors under greater pressure.'*
- *'The level of volatility, most notably in the capital markets, has increased since the onset of the credit crunch. Accordingly, uncertainty and hence risk have increased.'*
- *'There is increased volatility in both macro variables (inflation, economic growth - and hence volume growth, FX, etc.) and market variables (cost of equity and debt financing). Although conditions across markets appear to have stabilised significantly over the last 6 months in particular, the outlook remains highly uncertain - and in particular whether recent 'pre credit crunch' history offers a solid guide to the future or will in retrospect be seen as reflecting features dependent on a particular expansionary period in the monetary / business cycle (asset price growth, easy availability of credit at narrow absolute and relative credit spreads, etc.). Framework for DPCR5 needs to allow for potentially widely varying outcomes in relation to the level and volatility of these variables over the next 5 years.'*
- *'The market is more volatile and therefore more difficult to predict. The general view is that low cost of debt and liquid markets from 2004-2007 may have been the exception rather than the norm. Timing for recovery of the market is uncertain.'*
  The response indicated that debt was both more expensive and less available than it had been and that companies faced uncertainty over the economy, supply chain and core costs. Companies also faced regulatory, legislative and political risk.
- *'Since the onset of the credit crisis from August 2007, we view that the risks facing DNOs have increased. This has been highlighted by challenging markets and the decline in economic activity - limited access to debt finance, credit spreads widening and equity risk premiums rising (reflected by the significant decline in share prices for publicly traded companies) and deflationary pressures.'*

- *'Increased (risk) for financing costs and financing uncertainty that may limit access to liquidity or mean it is only available at premium pricing. Cost of equity has increased. Due to increased returns in other sectors there is increased risk of investors putting their equity into other investments that provide a better risk / return trade-off. Significantly increased pension deficits.'*
- *'Uncertainty over credit availability and cost is clearly a threat. Equity market's attitude has also changed.'*

Debt commented as follows.

- The world is a more uncertain place, with higher volatility and capital markets potentially less accessible. Funding/refinancing and counter-party risks have all risen.
- More leveraged structures in the sector and deflationary concerns.
- Increase in capex and two-way nature of the network (complexity risk).

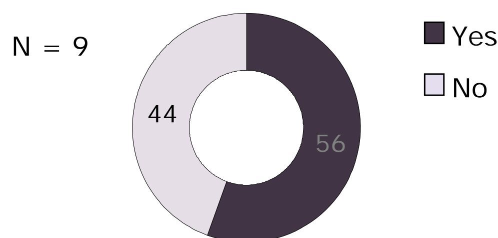
Two rating agencies offered the following views.

- Credit crunch/recession is driving exposure to deflation and capital access risk.
- Ability to access (cheap) credit on demand is more constrained although this is somewhat mitigated by the low risk nature of sector.

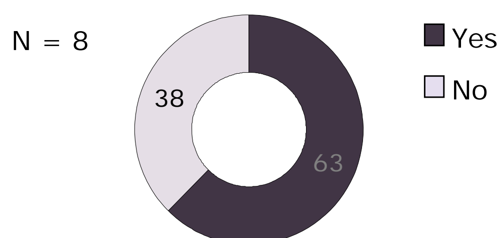
Q30. Is it clear how the measures in Ofgem's proposals will mitigate risks from uncertain economic conditions?

Q31. Do you think that Ofgem's proposals for mitigating these (uncertain economic) risks are appropriate?

Five out of nine responses thought Ofgem's proposals were clear about how they would mitigate risk from uncertain economic conditions. All four responses that stated it was not clear were equity.



Five out of eight thought Ofgem's proposals were appropriate with three (all equity) disagreeing.



Equity responses included the following.

- *'Evidence from the UK water sector suggests that correction mechanisms are hard to operate. As investors, we would prefer to be remunerated via cost of capital rather than uncertain correction mechanisms.'*
- *'Assuming that clarity – and an appropriate solution – to the uncertainty surrounding pensions and tax legislation is provided, we believe Ofgem has developed an appropriate framework to mitigate (risk).'*
- *'Broadly clear. Some specific evolutions in DPCR5 (notably the tax trigger) extremely helpful.'*
- *'I do not think Ofgem has been particularly clear in articulating the risk mitigating factors. A large part of these risks are not covered by reopeners etc and leave the companies exposed during the 5 year review period.'*
- *'Good intentions, but still many outstanding questions.'*

A debt analyst, in response to whether Ofgem's proposals were appropriate, said

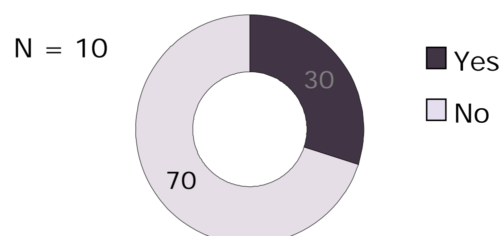
- *'Still by and large required to be tested, but general view is that Ofgem will "do the right thing" where a company faces a significant risk caused by something out of their control.'*

Rating agencies responses were as follows.

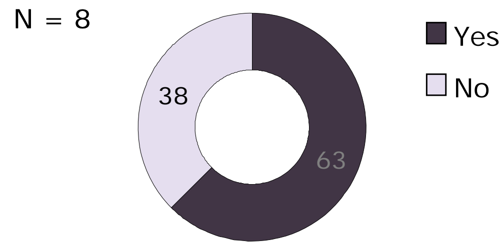
- *'The electricity distribution [has a] low business risk given the monopoly nature of distribution services and their relatively established and transparent regulation. This assessment of low business risk has been further supported by Ofgem's decision to replace the unit distributed revenue driver, thus reducing the networks' volume risk.'*
- *'The measures introduced should reduce DNO risk to a number of uncertainties. Elimination of volume driver for customer numbers and units of power distributed reduces risks (which are) beyond DNO's control and are often driven by broader economic developments.'*

Q32. Is it clear how the measures in Ofgem's proposals will mitigate risks associated with financing uncertainty?
Q33. Do you think that Ofgem's proposals for mitigating these (financing) risks are appropriate?

Only three of ten responses indicated that it was clear how Ofgem's proposals would mitigate risks while seven (mostly equity) said it was not clear.



Five of eight responses thought Ofgem's proposals were appropriate, although some with caveats, while three disagreed (all equity).



Equity responses include the following.

- *'Sensible, but do not eliminate this risk'.*
- *'The PwC options are not clear enough in the Initial Proposals to allow us to properly evaluate the impact. However, we are not attracted to these sorts of mechanisms. Rather as investors, we would prefer to see an appropriate cost of capital set at the beginning of the price control period.'*
- *'In maintaining the DPCR4 assumptions for the Initial Proposals, Ofgem has provided little guidance around a final WACC. This also makes it hard to assess financeability issues.'*
- *'There is a case for a form of "crisis provision" (e.g. substantial effect clause) in relation to funding costs - but (assuming the business has not become overlevered) this really benefits the equity holders rather than the regulated business itself (which should able to continue to fund its activities in any event). As PwC set out, the current regulatory framework arguably protects against real distress in any case. Arguably this 'insurance' should be reflected in a lower required equity return, and certainly raises broader questions about the allocation of risk in the DNOs. On balance I would agree with Ofgem that this is better suited to consideration in a broader discussion of regulatory principles (e.g. RPI-X@20) rather than a price review which already contains a number of important evolutions of regulatory practice. Regulated UK utilities have continued to fund themselves throughout the volatile environment of the last 12-18 months, including significant access to public debt markets. A number of highly levered water companies have needed to secure additional equity injections from their shareholders but this has been done.'*
- *'Not fully developed to allow investors/lenders to value and understand implications.'*
- *'The range for the allowed cost of capital (vanilla) proposed by PwC of 3.5% to 5.6% appears too wide and we would favour a target closer to the upper end of the range. This may allow the DNO's to exhibit credit ratios in line with a target rating of at least A-, thus enhancing the company's access to capital markets.'*
- *'The measures do not cover financing uncertainty. Whether this is appropriate depends on the level of return the companies receive and whether the return compensates the companies for the risk they are taking.'*
- *'Still not concrete enough.'*

Rating agencies had the following views.

- *'Ratings of the sector (and more generally, UK regulated utilities) are supported by our view that, should there be a long-term structural shift in market / economic conditions that would materially affect the DNOs, the regulator would likely take the appropriate steps to reflect such changes regardless of the specific mechanisms that are in place (in part due to its statutory duty to allow efficient businesses to finance themselves), although we recognize that the existence thereof might give creditors somewhat greater comfort than if there were none.'*
- *'Ofgem's current position is to continue with the existing approach for the cost of debt which does not make clear how an adjustment would be made should a crisis situation emerge and therefore does not clearly mitigate risks associated with financing uncertainty. The second option recommended by PwC is to go with a substantial effects clause similar to Ofwat - that would need to be very clearly defined before implementation.'*

Appendix: List of respondents

Aviva
Ryan Staszewski

BAS-ML
Fraser McLaren

European Investment Bank
Josef Bleckenwegner

First State Investments
Niall Mills

Fitch Ratings
Gavin MacFarlane
Andrew Steel

HSBC
Matthew Taylor

HSBC
Udetanshu

Lloyds Banking Group
Nick Walker

M & G Investments
Orlando Finzi

Macquarie Capital Funds (Europe) Limited
Unnamed equity investor

MidAmerican Energy Holdings Company
Patrick J Goodman

Moody's Investors Service
Unnamed rating analyst

Nomura International
Iain Smedley

Standard & Poor's
Mark Davidson
Beatrice de Taisne
Tania Tsoneva

Unnamed equity advisor

Unnamed equity advisor

Unnamed equity analyst