FINANCING NETWORKS

The response from CE Electric UK Funding Company, Northern Electric Distribution Limited and Yorkshire Electricity Distribution plc to the discussion paper published by Ofwat and Ofgem in February 2006.

18 May 2006

INTRODUCTION

1. The comments set out below represent the views of CE Electric UK Funding Company (CE), Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL) in reponce to the joint Ofwat and Ofgem discussion paper *Financing Networks* published in February 2006 (the discussion paper).

2. Our comments are set out by reference to the specific questions raised in the discussion paper (for ease of reference the questions are italicised and appear in boxes).

3. Before proceeding to the specific questions we offer the general observation that a price control review based on a combination of sound principles and sound data should provide a financial outcome that does not give rise to the need for any financeability adjustments. The need for financeability adjustments in previous reviews indicates that either the assumptions, or the process, suffer from some fundamental flaw. This is especially so when one considers that the adjustments are made within a theoretical context of the regulators' modelling and not as a result of reference to companies' actual balance sheets or expectations of performance.

> *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 appropriate and what might be the costs and benefits of these?*

4. We believe that there is no need to strengthen the financial ring fencing provisions included in the licences of electricity distribution network operators (DNOs).

5. We recognise that there is a balance to be struck between protecting customers and allowing commercial freedom to the companies such that the ring fence does not become a straitjacket. The ring fencing arrangements that already apply to DNOs include the following features:

- confinement of the licensee and its subsidiaries to licensed activities;
- an obligation to ensure that the licensee has adequate resources available and to certify this periodically to Ofgem (supported by an auditor's report);
- pre-notification to Ofgem of dividends (with further certification of adequacy of resources);
- undertakings from the licensee's ultimate controller that it will not cause the licensee to breach its obligations (including the ring fencing obligations);
- an obligation to maintain an investment grade issuer credit rating;
- a prohibition on undertaking indebtedness or entering into guarantees other than on an arm's length basis, on normal commercial terms and for the purposes of the licensed activities;
- restrictions on transfers of cash or other assets to affiliates;
- prohibitions on cross default obligations in any agreements entered into by the licensee; and
- a cash lock up mechanism, including triggers at the lowest investment grade rating where a credit downgrade has been signalled as a possibility by the credit rating agencies.

6. The present requirements provide a significant regulatory protection and are sufficient to ensure that the licensed business is protected from any financial strain at the holding company level or elsewhere in the group. There is no evidence that these ring fencing arrangements have been inadequate to deal with such circumstances as they have arisen in the sector to date.

7. In particular, the present arrangements allow Ofgem to step in when problems arise to enhance the ring fence in the light of the specific areas of concern. This allows a degree of flexibility which would be hard to achieve in a more rigid set of generic constraints and would, therefore, suggest a more explicit mechanism is not appropriate.

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?

8. These questions introduce the discussion that has been stimulated by Dieter Helm's suggestion that the regulatory asset value (RAV) represents a low risk investment that should be largely debt funded whereas the carrying out of new capital investment and the operation of the licensee's assets are higher risk activities that it is appropriate to fund largely through equity finance.[1] Since the RAV represents the dominant part of a licensee's costs, Helm argues that if regulators were to adopt a split cost of capital approach the gains to customers in the form of lower prices would be significant.

9. Helm is careful to emphasise that the benefits he claims from this approach arise when the package is considered as a whole. An important part of this package is the guarantee of the RAV which justifies the high debt component of the funding. Since there can be no free lunches in financing a business, it follows that any reduction in the weighted average cost of capital (WACC) must arise from something other than

[1] See e.g. Dieter Helm, *Ownership, utility regulation and financial structures: an emerging model,* 14 January 2006.

merely *attributing* debt to the RAV and equity to the non-RAV components of a licensee's activities. To reduce the overall cost of capital risk must be reduced or, as Helm correctly observes, transferred elsewhere.

10. It appears to us that if any reduction in the overall cost of capital is possible under Helm's approach, this must come from the reduction of regulatory risk that he posits in relation to the guaranteeing of the RAV. Without such a guarantee Helm's debt funding assumption does not hold. Of course if a regulator wished to guarantee the RAV, it could do so and if the financial community had confidence in that guarantee it would follow that licensees could take on more debt without breaching their investment grade status and, in due course, regulators would be justified in using higher gearing assumptions in their cost of capital calculations at price control reviews. The key, however, is in the willingness to guarantee the RAV and in the credibility of such a commitment. (This is dealt with in more detail below). The reduction in the cost of capital, if it occurs at all, would occur as a result of the reduction in regulatory risk rather than as a result of a regulator splitting the cost of capital and allocating debt to the RAV and equity to the non-RAV components.

11. At the recent Ofwat/Ofgem seminar Dieter Helm conceded that it would be wrong to seek to apply his proposals to the existing RAVs of licensees. Past investments in the RAV have been made in the expectation that at each price control review that investment will be remunerated at the WACC determined at the review. We may assume that investors who provided funds for these investments understood that the WACC may go up or down and we may also assume that they took that risk into account when funding the investments. However, it would be an act of confiscation to decide that for the remaining life of the assets they should earn only the cost of debt. That would impact severely on regulatory credibility and introduce higher regulatory risk into the sector.

12. If we understood Helm correctly in his presentation to the joint Ofwat/Ofgem seminar he argued that it would not be possible for a licensee to secure additional equity from

a rights issue where the additional funds were necessary to carry out significant new investment. Such funds would not be forthcoming because the risks attaching to the new investment would be perceived by equity investors as greater than the risk implied in the WACC allowed by the regulator.

13. This analysis seems to us to be flawed. The risk taken by the equity investor in these circumstances is *not* the marginal risk attaching to the new investment (which may indeed be higher than the risk that would be commensurate with the WACC). It is the weighted average of the risk attaching to *all* the activities of the company in which he is investing. That risk may be increasing if the new investment is significant in relation to existing activities, but it is not the same as the marginal risk attaching to the new investments.

14. The true insight that can be derived from Helm's analysis is that, far from splitting the cost of capital, regulators should emphasise its unitary nature. If funds for new investment are to be forthcoming investors must have confidence that the short term risks which are remunerated at a rate that is lower than the true *marginal* WACC will in due course pass into the RAV and be remunerated at the *average* WACC (which is higher than is implied by the risk attaching to the low risk RAV). The link between funding new investment and remunerating past investments must be emphasised with regulatory commitment or investors will be reluctant to fund new investment at the average WACC.

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?

15. The RAV is a concept unknown to primary legislation and, indeed, unknown to the licences. The concept of the RAV emerged from the processes used to carry out the initial price control reviews and the possibility that it might be discarded cannot be

ruled out altogether. We think, however, that this is a very unlikely scenario indeed and, moreover, we believe that providers of finance have some confidence that regulators will continue to respect the RAVs in their conduct of price control reviews. At the last price control review Ofgem took the important step of setting out how investment made during the DPCR4 would be reflected in the RAV at DPCR5.

16. Although investors may have confidence that once investment enters the RAV it is very unlikely to be subject to regulatory disallowance this, although important, is not the only significant regulatory risk. Commitment to the RAV inspires confidence in investors only to the extent that the investor believes that the purposes for which the RAV is used will also be fairly, transparently and consistently exercised in the conduct of a price control review. A regulator's commitment to the RAV has value only in conjunction with two other regulatory judgements, namely in the cost of capital and depreciation assumptions to be applied to that RAV. Regulators' undoubted commitment to the RAV is welcome but without confidence that the rate of return and depreciation will be properly calculated from that RAV, such a commitment is of very limited worth.

17. The most recent water and electricity distribution reviews have gone some way towards establishing greater confidence in how regulators will behave but regulators could do more to commit to transparent and consistent methodologies for determining the other important components. At the recent Ofwat/Ofgem seminar it was notable that, after a sequence of speakers had congratulated Ofwat on the greater confidence that its behaviour at the last price control review had given investors, the Chair of the Water Services Regulatory Authority felt obliged to remind participants that just because the last review had been carried out on one basis that was no indication of how the next one would be carried out. Such frank admissions are a timely reminder of the value that regulators place on freedom of action at price control reviews. But a regulator's freedom of action is an investor's regulatory risk.

18. Regulators, even if they wished to, could never entirely remove regulatory risk. However, it is less true than it used to be that there are fundamental legal obstacles in the way of effective regulatory commitment. The old principle that a public authority may not fetter its discretion has developed sufficiently in recent years for it to be possible for a regulator to make statements that it intends others to rely on and which would give them legal grounds for redress if they were not subsequently honoured. If regulators really wish to enhance the perception of commitment to the RAV they might explore ways that they could make statements, perhaps to be included in the price control review final proposals, that were intended to be solemn commitments upon which others could expressly rely. Such statements would cover the rules by which new investments would be added to the RAV and the manner in which the return on, and the return of, that capital would be determined at subsequent price control reviews.

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?

19. The questions above are put in a manner that suggests that regulators do not currently assume that debt is index-linked. In fact the modelling assumptions in the Ofgem approach make sense *only* if it is assumed that all of the debt in the capital structure is index-linked. This is at odds with the actual capital structures of companies most of which contain no index-linked debt. As a consequence of this mismatch there is a shortfall between the actual cash generated and the actual interest paid each year over the review period. The impact of this annual cash shortfall falls on shareholders. As a result of lower cashflow the proportion of the expected return which can be paid as a dividend is reduced requiring more of the shareholders' return to be recovered through the capital appreciation of the RAV. This deferral of return is unlikely to be

fully reflected in the equity element of the cost of capital which will assume more general market proportions of annual return and capital appreciation.

20. Looking at the longer term there may be a greater refinancing risk in future as index-linked debt becomes due for repayment. It has to be remembered that there continues to be a mismatch between the normal commercial drive for long term debt matching long term assets with the short term nature of the price reviews which re-set interest rates, as allowed through the cost of capital, every five years. The cash flow deferral implicit in the assumption of index-linked debt must increase the risk that future regulation may not fully compensate for the delay at the appropriate rate. This must also be reflected in a higher cost of capital.

21. We understand that only a limited amount of index-linked debt has been issued over the past few years. Surely this must indicate that the commercial position at the time of the debt being issued was such that the overall costs of nominal versus index-linked over the lifetime of the debt was in favour of nominal debt. This would also suggest that the long term costs to the customer would also favour the issuing of nominal debt.

22. We therefore feel that regulators should reverse the policy of assuming that all debt is index-linked.

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?

23. The logic should be that, if the right assumptions are used, it would follow that each company should be able to finance increases in RAV from a mixture of debt and equity so that, over the long term, the level of gearing is maintained.

24. It seems reasonable that small increases would be most likely to be financed from lower cash dividends but significant increases would have to be funded from additional equity injections. This requires that the true cost of equity needs to be included within the cost of capital. If a lower return is implicit then customers are being subsidised as shareholders are being asked to put more money into a sub-optimal investment. This is not a recipe for long term stability.

25. The same concept applies irrespective of the level of gearing which shareholders have set as their long term aim. As RAV increases shareholders should be prepared to invest further equity in order to stabilise gearing. By the same token shareholders should also be able to reduce equity investments where the RAV is reducing.

26. The changes that would facilitate equity injections (where needed) therefore include:

- clearer commitment to the RAV (including the method to be used to determine the cost of capital and the depreciation of the RAV);

- a recognition that the capital asset pricing model (CAPM) is likely to underestimate the true equity cost of capital;

- a transparent method for determining the allowed cost of embedded debt (so that equity holders understand their residual risk if debt markets move against a licensee that has made reasonable decisions on re-financing); and

- explicit recognition that any financeability adjustments necessary in the short term will be NPV-positive (recognising that such adjustments are only necessary if some other component of the calculation is too low).

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?

27. As indicated above it seems reasonable that small increases in RAV could be financed by flexing the level of cash dividends but significant increases would have to be funded from additional equity injections.

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?

28. We do not see any rationale for regulators developing their own set of financial ratios when the existing credit ratings issued by the ratings agencies are an independent measure that gives comfort to debt markets and allows investors to compare relative risks across the market.

29. From the investors' perspective it will be a combination of a ratio's overall level and trend that provides guidance to their investment decisions.

30. Aiming for credit ratings which are within the BBB range will not provide much protection against any short term financial shocks that might be experienced by an individual company or for any shift in sentiment on the part of a particular rating agency.

31. The target level of credit rating will have a significant influence in the cost of borrowing so weaker ratings will be reflected in higher prices to customers if the true cost of debt finance is included in the cost of capital.

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?

32. As set out above, we feel that the guiding principle from the regulator's perspective has to be that the allowed income must be set at a level that is sufficient to finance the licensed business on the basis of:

- appropriate costs, both capital and operating;
- appropriate gearing; and
- a true cost of capital.

33. Where companies accept the price control proposals, they aim to match or to outperform the underlying assumptions in terms of operating and capital efficiency. The level of gearing that a company sets itself will then dictate the level of equity return that it earns.

34. If regulators do not use the right assumptions, financeability issues are very likely to arise. Any assistance necessary in these circumstances should be NPV-positive. Any other solution would result in the company being forced to use its own money to solve a problem which is not of its own making and is more fundamental. This does not seem to give the regulator the right incentive to determine the correct answer in the first place.

35. Provided that the regulators have used the right assumptions the licensee should not experience any difficulties with financeability. Any issues that do arise in these circumstances will then be the responsibility of the management and the risks will be appropriately borne by the providers of capital.

36. If there are short term considerations that would preclude a real (as opposed to the regulator's hypothetical) business from raising additional debt or equity the regulator may wish to provide some assistance through additional short term measures. In these circumstances it would be appropriate for the adjustment to be NPV-neutral.