

# Central Networks

A company of **e-on**

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Dear Martin,

## **Financing Networks Discussion paper**

I am writing on behalf of Central Networks in response to the joint Ofwat and Ofgem February 2006 discussion paper on "Financing Networks". We have commented in detail on each of the questions raised in the paper.

We are entering a challenging new era in our industry where we require significant investment in our electricity distribution network infrastructure over the coming years to replace aging assets and to support increasing renewable policies.

As such we believe the key aspect of ensuring that network companies can finance their long term activities efficiently whilst maintaining an investment grade credit rating is to ensure that the cost of capital is set correctly over the long term. Furthermore, this must be within a regulatory framework that can be flexed to respond to a variety of future conditions without restricting companies to assumed financing structures.

We also support the Electricity Networks Association response to this paper, and have included some of their key points where appropriate within our own detailed response.

Finally, I would like to take this opportunity to thank Ofwat and Ofgem for producing this paper. It has been useful in raising a number of important issues around the subject of financing large network investments, which has been important in generating significant interest from companies, investors and advisors alike.

Yours sincerely

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## **Key issue for discussion (1)**

**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?**

The ring fencing arrangements already existing in the license provisions of DNOs in the electricity sector are already sufficient in helping the DNOs maintain investment grade credit ratings.

However, a cash lock-up is only appropriate while businesses can finance investments. Cash lock-up provisions create a disincentive to inject equity into regulated businesses. While equity can be injected there are potential restrictions on getting it out of the regulated entity again which will therefore encourage higher levels of investment to be funded by debt rather than equity. We believe it is more efficient for the market to decide the gearing levels of businesses rather than through regulation. The appropriate gearing levels can then be determined on a case by case basis as opposed to imposing a “one size fits all” approach.

## **Key issue for discussion (2)**

**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 restriction of equity funding to operating costs and the delivery of new investment will effectively mean that debt would play a more significant role in the financial structure of most utility companies hence increasing gearing further.

Splitting past and future capital investment will force a business to separate asset ownership activities from asset management activities and split them into different independent business entities consisting of a separate debt financed asset owner and a separate equity financed asset management contractor. Such a business model would limit management discretion and flexibility and hence restrict the ability of managers to determine the model that allows them to run their businesses most effectively. Such restrictions would also reduce the Regulator’s ability to influence the asset operator and investment decision maker (the asset manager) assuming that it is the asset owner that would be directly regulated. As such, the regulatory review processes and models

would become more complex and time consuming which would add additional risk to the regulatory processes. Such complexity would also drive an increase in resources required within all parties to manage these regulatory reviews and returns effectively.

Furthermore, both asset ownership and asset management may not be optimized, and may result in the introduction of short term asset manager decisions with less incentive to take longer term considerations into account when building and investing in new assets or when maintaining and operating existing assets. The evidence from Eastern and London in the 2002 storms was of very different incentives to asset ownership and asset management.

The simple disaggregation of a business into two types of activity does not reduce its overall risk. It may obscure who carries what risk in the short term or it may increase costs as both parties attempt to offset opposing risks. Operating risk would be transferred to the asset management contractor for the operational work from the asset owners of the RAV. However it would (presumably) be the asset owners that are subject to direct regulation and not necessarily the asset management contractors. Operational risk would therefore be transferred to an unregulated business or the asset owner would need to incur costs to insure against such risks.

Even if it were possible to reduce the cost of debt by securing it against the RAV, it would merely transfer risk to equity which may actually result in a rise in the cost of the equity. Hence the approach would not necessarily result in a lower cost of capital but would force a far higher level of gearing. Such high levels of gearing with thin equity would transfer the residual risk onto customers should the equity fail.

It is also important to consider the investors who have already invested in the business on the basis that the company will earn the cost of capital of the day on all its assets. If a significantly lower cost of capital is applied to the RAV this will mean that existing providers of finance will earn lower returns than they would have expected when they committed the funds. Such a change in approach may have an adverse impact on the finance community's perception of regulatory risk.

For new capital expenditure a key practical issue is the point at which it would enter the RAV and begin to earn the lower rate of return. At the point of the investment decision it is the total expected return which the investor considers and not just the short term "equity type" return. Once the asset has been built and accepted onto the RAV the original investor would need to consider what he can "sell" the asset to the debt type asset owner for, and is therefore taking into account the whole weighted average cost of capital.

A key practical point that has not been explored is how this additional equity risk premium would be calculated. The difference in risk between past and new capital expenditure will be difficult to quantify and may vary over time. Its estimation will introduce further uncertainty into the process for determining the cost of capital, hence increasing regulatory risk. Introducing a split cost of capital model would therefore undermine the stability and credibility of an already built RAV.

The high gearing models that appeared in the water industry were a result of a very low allowed return given by Ofwat. It could be argued that regulation drove equity out of some companies and not the financial institutions looking to exploit a lucrative position.

We therefore believe that introducing a model that separates past and future capital investment would not improve the incentives for investment, lower the overall risk of regulated businesses or reduce the cost of finance.

### ***Key issue for discussion (3)***

#### **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?**

We have not seen any evidence of a lack of commitment to historic regulatory asset values. The key issue we believe is around the lack of clarity over the rules for which new expenditure is allowed to be added to the RAV and the inconsistency between price controls, both of which add uncertainty to long term investment decisions. This would become far more significant if different costs of capital were applied to past and future capital investment.

The role of equity to finance increased investment is important in rewarding out-performance. It is a strong incentive in driving operational efficiency, and debt does not necessarily provide the same efficiency incentive.

We are concerned that Regulators are increasing their assumed level of gearing over time, without a compensating increase in the cost of equity, which would result from a higher equity beta (i.e. the systematic risk factor in the Capital Asset Pricing Model).

### ***Key issue for consideration (4)***

#### ***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?***

We believe that businesses should be able use their own discretion to decide for themselves whether to use index linked debt if they believe it is efficient to do so. Regulators should not assume certain levels are incorporated into a company's specific financial structure as this would force everyone to use it.

An important issue in relation to index-linked swaps is the inability to achieve hedge accounting under IAS39 due to the lack of certainty of long term index linked income to match the debt. Accountants (and auditors) do not view inflation as a legitimate, hedgeable, business risk, even in a utility that is regulated in relation to RPI. Their argument is that Regulators may set prices in relation to RPI at present but they cannot be assumed to do so in the next and subsequent price reviews. RPI swaps therefore have to be marked to market through the profit and loss account. Although this may not be of concern to regulators it is certainly of concern to shareholders who will see increased volatility in the accounts and reported results and thereby shy away from using index linked debt.

Furthermore, there is no evidence that index linked debt will reduce the cost of capital. Even if companies were able to restructure their existing debt portfolios to include a substantial proportion of index-linked debt, they would incur significant re-financing and associated transaction costs. Such costs are currently not allowed within price controls. If regulators make particular assumptions about company financing in price control reviews then the companies are likely to try and offset this by mirroring this in their actual finance structures, regulation driving what should be a market decision. If regulatory assumptions change on financing structures companies will need to change their actual financing structures with each and every price control, adding cost to the process.

## ***Key Issue for discussion (5)***

***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?***

The cost of capital needs to be set at a level that is sufficient to make equity investment attractive. Introducing regulatory models such as splitting past and future capital investment simply encourages higher gearing and does not provide incentives for equity injection.

An additional factor that inhibits equity injections is that in general in the UK, regulators have not allowed for the transaction costs of raising new equity. These costs can be substantial and may be a reason why there have been very few equity issuances in the UK utility sectors. Furthermore, there are indirect costs associated with rights issues which regulators have not accounted for. It would seem appropriate for the cost of equity to include an allowance for such costs.

Any regulatory regime which assumes high gearing in setting an allowed return will drive high gearing and discourage equity.

### ***Key Issue for discussion (6)***

**Would it be reasonable for regulators to be more flexible in their approach to modeling 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?**

We do not believe regulators should be flexible in their modeling of dividends. Equity investors fundamentally regard utilities as yield stock and existing equity investors have chosen whether to invest in them, or not, on that basis.

Furthermore, if the policy were to change to a growth stock then the risk of equity increases as the return is locked up in capital appreciation rather than yield. Consequently investors would require greater returns in the future which need to be financed. In addition, the absence of a historical track record may make it difficult to persuade investors that future dividend growth will be sustainable hence potentially having the detrimental effect of deterring investors.

In our view, attempting to change the nature of utility shares should be avoided, as it would be disruptive to investors who would have to adjust their portfolios.

### ***Key Issue for discussion (7)***

**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?**

It is unclear why the adoption of more pragmatic ratio definitions by Regulators will help the situation. It is the views of the credit ratings industry that are important with respect to companies accessing debt finance efficiently. We are concerned that the introduction of more regulatory discretion into the assessment of financeability will increase the market perception of regulatory risk and hence impact on the cost of capital. In practice the maintenance of an investment grade credit rating is dependent on companies satisfying the criteria that the credit rating agencies set down from time to time. Assuming that these ratios are different for regulatory purposes maybe convenient but it does not reflect reality and therefore negates the purpose of the financeability test.

We also believe there would be difficulties if the majority of companies had BBB ratings. The license conditions state that a license holder should maintain an investment grade rating and not a specific BBB rating.

The lower the level of a company's current credit rating the higher the probability that it could be downgraded to below investment grade, at some future date. It is difficult to predict what credit rating agencies will say in the future, hence if the majority of company ratings were BBB there would be a significant risk that several companies would fall below investment grade, in the event of future downgrades. Furthermore, in view of the higher yields which are required by investors on the debt of companies with lower ratings, reducing ratings to BBB would increase the cost of capital.

## ***Key Issue for discussion (8)***

**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?**

A price setting model is an artificial tool independent of the financial statements. The purpose of price setting models are:

- To ensure that a network business receives sufficient cash over the regulatory period to run an efficient operation that meets customer needs.
- Allows the company to maintain their investment grade rating.
- To provide a rate of return to encourage equity holders.

As it is an artificial model, it can therefore take any form and be flexed in any way appropriate to ensure the above conditions are met and does not leave a company in financial distress. Restricting regulation to specific measures will create an inflexible system that can not respond to a variety of future conditions. Accelerating regulatory depreciation only delays a financeability issue and does not address it and therefore may not be the most effective approach. A whole range of tools and approaches therefore needs to be considered to achieve the regulatory objectives.