



Martin Crouch  
Director Distribution  
Ofgem  
9 Millbank  
London  
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19 May 2006

Dear Martin,

### **Financing Networks**

I am writing on behalf of the Energy Networks Association (ENA) in response to the joint Ofwat and Ofgem February 2006 discussion paper on 'Financing Networks'. The ENA is funded by UK gas and electricity transmission and distribution licence holders and therefore this discussion paper raises issues of considerable importance to our members.

We provide detailed responses on each of the questions raised in the paper in the attachment to this letter. There are, however, a number of overarching principles that we believe must be established.

Firstly, the key aspect to ensuring that network companies can finance their activities efficiently is to ensure that the cost of capital is set correctly. We firmly believe that as long as the cost of capital is set at the right level, and the regulatory environment is both transparent and stable, then 'financeability' ought not be a significant issue.

Secondly, significant investment will be required in energy infrastructures over the coming years, as we address the important challenges of both replacing ageing energy networks and supporting the achievement of the government's renewable generation targets. Therefore, in order to attract the necessary investment it is vital that investors, both debt and equity, have confidence that the financing framework for network companies is consistent with such long-term commitments. In order for this to be achieved, the regulator's approach to financing must be:

***well connected***

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- Clear – ensure clarity over key aspects of the regulatory process and thus reduce uncertainty and consequently the perception of regulatory risk;
- Transparent – the greater the level of transparency in the process, the more confidence both companies and investors can have; and
- Stable over time – increased regulatory discretion over key components of the financing structure will increase uncertainty and hence add to regulatory risk.

We acknowledge that Ofgem has asked for both academic and empirical evidence as part of its cost of capital review for the transmission price control, and we have recently sent you a set of issues papers prepared initially for EDF Energy by NERA Economic Consulting to help inform that debate.

Lastly, can I take this opportunity to thank both Ofwat and Ofgem for their 27 April public workshop on financing networks. It was clear from this that there is significant interest in this subject from companies, investors and advisors and that directly consulting in this way is an important part of the regulatory process.

I am copying this letter to Emma Cochrane at Ofwat

Yours sincerely,

A handwritten signature in black ink that reads 'Andy' followed by a horizontal line.

Andy Phelps  
Head of Regulation



## Key Issues for Discussion

### ***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?**

In our view, the current ring fencing arrangements for DNOs in the electricity sector are sufficient. DNOs already have a provision within their licences which prevents a licensee, with the lowest credit rating consistent with investment grade, from making a dividend distribution should its rating be placed on review for possible downgrade. The introduction of similar financial ring fencing arrangements in the DN gas transporter licences, upon their sale, provides the same assurance in the gas sector. However, before seeking to extend such arrangements to other sectors, regulators should consider whether market based arrangements (such as covenants) can achieve the same protections without the need for licence provisions.

### ***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?**

There is no evidence to support the premise that applying a different cost of capital to past and future investment will improve the incentives for investment. In the electricity sector, network assets under construction typically form only a very small fraction of the total asset base. Indeed, the risks faced by companies stem from the full physical asset base, the modern equivalent value (MEA) of which is typically many times larger than the RAV.

It is unlikely, therefore, that these will have a significant effect on the cost of capital, especially as the most likely risks (cost over-runs and/or delays of projects) are unlikely to be correlated with movements in the stock market. In addition, 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. This raises the issue that the consequent level of gearing may be sub optimal and hence increase the required cost of capital.

The simple disaggregation of a business into two types of activity does not reduce its overall risk. 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 would then cost more, as the riskiness of the aggregate cashflows of the business have not changed.

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.

Investors have invested in utility companies 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 would undoubtedly 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 be included in the RAV and begin to earn the lower rate of return. This will have a substantial impact on the return over the life of the asset, which is what matters to investors.

### ***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 acknowledge that there has generally been strong regulatory commitment to both regulatory values and equity funding." Regulators have re-affirmed their commitment to RAV and are taking a longer-term view of the capital investment needs across the network industries.

Nevertheless, there are some issues within each sector that need to be addressed. The key issue in the electricity sector is the lack of clarity over the circumstances in which the regulator will disallow capital expenditure, which has already been incurred, from being added to the RAV. In this sector, concerns have been raised by the apparent treatment by Ofgem of NGET's capital expenditure overspend, which has still not been resolved satisfactorily. The potentially long lag between a company incurring capital expenditure and



it receiving regulatory confirmation as to whether it will be included in the RAV increases uncertainty. To minimise this, the rules for defining the RAV should be set out. These should include:

- Prudence tests for determining whether expenditure is added to the RAV;
- Dates for adding new capital expenditure and deducting depreciation; and
- Principles for accommodating changes to the rules.

A further concern is that regulators have increased 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). This may also have had the undesirable effect of deterring equity funding.

#### ***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?***

The choice of capital structure is one for the companies and not for the regulator. However, we recognize that regulators need to make notional balance sheet assumptions in order to calculate the WACC and to conduct various financeability tests when setting price controls.

#### **Issues in relation to index-linked funding**

There is no doubt that there is substantial demand for index linked debt from UK pension funds as they seek to match the nature and profile of their liabilities and, given the nature of utility regulation, index-linked debt will be attractive to the network businesses.

However, index-linked debt is only one of a number of market-based options available to such businesses and is not as readily available as other forms of debt financing. As such, we do not believe that regulators should assume a portion of debt is index linked when setting price controls.



Furthermore, 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

#### Issues in relation to the use of index-linked swaps

The index-linked swaps market has also developed in response to demand from pension funds, as they move closer to liability-driven investment. However, this market is based upon banking intermediaries (who stand between the payer and the receiver). Although pension funds may be prepared to accept growth in asset values in compensation for inflation, banks will not be, and they view index-linked swaps as higher risk than similar conventional swaps (because of the increase in value over time). Index-linked swaps, therefore, use much more credit capacity than conventional swaps and banks will be very reluctant to enter into long-term transactions without some form of credit support. This will usually take the form of a margining agreement that would require the company which is paying index-linked flows under the swap to settle amounts due in cash. In other words, the deferral of cash payment, sought by regulators and inherent in an index-linked transaction, cannot be achieved by means of index-linked swaps.

A second issue in relation to index-linked swaps is the inability to achieve hedge accounting under IAS39. Accountants 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 reported results.

#### ***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?***

Unlike the US, there have been relatively few new equity issuances by UK utilities. One possible reason is that, in general in the UK, regulators have not allowed for the transaction costs of raising new equity. These costs can be substantial. Furthermore, there are indirect costs associated with rights issues which regulators have not accounted for. In work carried out for the DNOs in



2004, by NERA, issuance costs were estimated to require an uplift of the cost of equity of 0.3%. This is substantial and it would seem appropriate for the cost of equity to include an allowance for such costs.

If equity issuances are to become a more frequent occurrence, as companies expand and develop their networks, then there is a need to condition investors to this. There is a risk that some investors may initially perceive the issuance of new equity as a sign of distress rather than a product of the business cycle. Nevertheless, in our view, a rights issue will be successful if the company is successful. If the cost of capital is set correctly, an efficient network business should be able to attract equity.

An additional means of incentivising equity would be for regulators to set notional gearing assumed in the WACC to reflect companies adopting lower geared structures.

### ***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 it would be reasonable or appropriate for regulators to be more flexible in their modelling of dividends. Network businesses should set their dividend policy not regulators. The majority of equity investors regard utilities as income shares and have chosen whether to invest in them, or not, on that basis. In our view, attempting to change the nature of utility shares would be disruptive to investors, who would have to adjust their portfolios. Furthermore, investors may well misinterpret an initial dividend cut as a signal that there will be a reduction in future overall returns, resulting in falls in utilities' share prices, further deterring investment.

### ***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. This is inappropriate.

Additionally, it is now clear that the ratings agencies are placing more emphasis on a broader range of financial ratios than Ofgem has traditionally utilised. For example, Moody's places significant emphasis on adjusted interest cover ratios to assess the creditworthiness of highly leveraged companies. We believe that regulators should use the financial ratios which are consistent with the achievement of comfortable investment grade credit ratings, as assessed by the major credit rating agencies.

We believe there would be difficulties if the majority of companies had BBB ratings. 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. 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, it is unclear that reducing ratings to BBB would reduce the weighted average cost of capital (WACC).

### ***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?**

The cost of capital is the most appropriate tool to address the financeability issue because it is equitable and avoids potentially arbitrary adjustments. The use of ad hoc revenue uplifts raises a number of issues. If revenue uplifts have to be applied generically across an industry, this would seem to imply that the cost of capital is incorrect, and, as discussed earlier, getting the cost of capital right will generally minimise any financing issues of network businesses.

In the electricity sector, Ofgem has already recognized the need to advance revenues to ensure companies can finance their activities, particularly their respective capital expenditure plans. As a result, DNOs already have a price control partly derived from accelerated depreciation. This has the advantages of being PV neutral and predictable. However, there is a concern that accelerating depreciation may only defer a problem to future periods. If



financeability constraints do not ease in the future then the use of accelerated depreciation now may result in further and more severe financeability adjustments in future periods.