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Dear Mr Crouch and Ms Cochrane

Re: Financing Networks discussion paper

Macquarie Bank Limited ("Macquarie") is pleased to provide you with our comments in respect of the Financing Networks discussion paper (the "Paper") issued by Ofwat and Ofgem. Macquarie was also represented at the seminar on the same matter held on 27th April 2006 (the "Seminar") and the attached is Macquarie's response to issues raised and discussed in both the Paper and the Seminar.

A Macquarie subsidiary, Macquarie Investment Management (UK) Limited, is the investment manager of the Macquarie European Infrastructure Fund which owns material interests in South East Water and the Wales and the West gas distribution network. Consequently, Macquarie has a significant interest in the UK water and energy industries. We are keen to participate in the discussions and contribute our views to assist in your assessment of the regulated sector.

Macquarie generally believes that the market should be left to determine the most efficient source of financing for a particular asset. Macquarie refers to Helm¹ (2006) who points out that equity risk never goes away regardless of the ownership structure. Whether an all-debt model or an all-equity model is used, the "equity risk" is still the same and the market will apply the most efficient source of financing over time. Macquarie believes that increasing the certainty surrounding these assets benefits all stakeholders, including regulators and customers as it provides a strong incentive for investment and reduces the cost of funding. This is particularly relevant in the current capital-intensive period.

Our thoughts on the eight key issues for discussion as raised in the Paper are provided below:

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 purpose of financial ring-fencing is to provide additional 'protection' to the regulated business. Macquarie believes companies should be given the flexibility to implement the most suitable ring-fencing

¹ Dieter Helm (2006), Ownership, Utility Regulation and Financial Structure: An Emerging Model, 14 January 2006.

arrangements. Therefore, ring-fencing provisions should not be systematically applied to cover all monopoly businesses nor modified to include cash lock-up provisions.

Macquarie believes that the current ring fencing provisions are sufficient to allow the activities of the licensed undertakers to be fully separated from other group entities. In highly geared companies, the capital markets will apply additional ring fencing provisions, as it considers appropriate (and hence efficient), to further insulate the regulated business from non-regulated activities.

The introduction of cash lock-up provisions provides no additional value and unnecessarily constrains the holding company from sourcing the most efficient form of capital.

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?

Macquarie does not believe that the separation of past and future capital investment will lower the overall risk of the regulated businesses, nor will it reduce the cost of finance. Macquarie agrees with the concerns raised in paragraph 107 of the Paper that this would be a risk 'transfer' rather than a risk 'reduction'. In assessing regulated businesses the capital markets implicitly make an assessment of a company's existing split of past and future capital investment and price the business accordingly. If a company as a whole has the same responsibilities and the same level of risks, the cost of capital should not change because the risks have only been re-allocated within the company rather than reduced.

Notwithstanding these points, a further practical implication for the separation of future and past investments that also needs to be considered is how such a change could be implemented given the long term financing's that currently exist across existing assets in the sector.

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?

Macquarie believes that there is no evidence that suggests a lack of regulatory commitment to the regulatory asset values or equity funding. Clearly the regulator must maintain its commitment to the regulatory regime to give companies confidence in planning sustainability and capital expenditure programs that will span through numerous regulatory review periods.

There are suggestions that longer regulatory periods with respect to setting the WACC will increase regulatory commitment to RAV. Macquarie believes that regulatory commitment is a function of certainty, consistency, and transparency rather than the length of the regulatory period.

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?

Macquarie believes it is reasonable for the regulators to assume that a proportion of debt is index-linked when setting price controls. The use of index-linked bonds and derivatives has become increasingly common in the water sector because the profile of index-linked bonds is more consistent with the RAV profile than nominal bonds.

Innovations in the financial markets should allow the majority of companies, regardless of their specific financial/corporate structure, to either directly issue index-linked debt or utilise a derivative product. Macquarie believes there is sufficient demand for long-dated corporate index-linked debt and that the market is capable of supporting innovative structures to accommodate borrower's preferences and constraints. With respect to cost, there may be a slight credit margin premium for index-linked debt relative to nominal debt, but the overall cost of debt including market inflation expectations does not materially differ.

Adopting a significant portion of index-linked debt does not result in any long-term implications for the companies. Companies must manage their capital structure such that the debt covenants are satisfied (e.g. gearing is within pre-agreed limits). It is also efficient for a company to maintain a constant capital structure. The use of index-linked debt facilitates this and reduces the frequency for having to access the debt markets.

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?

Macquarie believes management and shareholders should be encouraged to operate as well as finance the regulated businesses in the most efficient manner. The regulator should encourage and allow the market to select the most efficient form of financing to maximise benefits to stakeholders. Equity is always available, as discussed by participants at the Seminar and the decision to inject equity should remain with shareholders.

The higher gearing in the water market reflects the market's view that the water sector has a relatively low risk profile. Macquarie agrees with Helm (2006)² who states "it is economically inefficient to use equity finance where there is no equity risk – debt is cheaper; and it is inefficient to get debt holders to bear equity risk". Companies have primarily used debt to finance their obligations in part because debt is the more efficient form of financing for the particular funding requirement. Equity injections will take place as and when required to optimise the capital structure.

This is not to say that equity investors should not be incentivised to invest or to optimise the performance of the company. Macquarie would not be adverse to the regulator making stronger use of appropriate 'penalties and bonuses' in this respect. Macquarie also strongly disagrees with the premise that high levels of gearing reduce the commitment of licence holders. Investors seek a profitable return on their investment regardless of the level of gearing and Macquarie believes that an efficient capital structure is one of the best means by which to incentivise and discipline any investor.

Key Issue for discussion (6). 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?

It is reasonable for regulators to use some degree of flexibility in modelling dividends to mitigate financing constraints, and this should not require material changes to the regulatory regime. The capital markets provide companies with several financing alternatives to fund growth capital expenditures. However, a significant capital expenditure program that cause financial ratios to deteriorate materially will have a higher marginal financing cost and requires some form of financeability compensation.

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

² Dieter Helm (2006), Ownership, Utility Regulation and Financial Structure: An Emerging Model, 14 January 2006.

trend of ratios that is important? Would there be significant difficulties for companies if the majority of ratings were BBB?

The regulator should adopt a pragmatic approach to the application of financial ratios because no one ratio in isolation can provide an accurate assessment of a company's financial health. Macquarie believes that the regulator should apply this pragmatism whilst continuing to apply a consistent approach to financeability by maintaining a test based around a 'solid/comfortable' investment grade credit rating.

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?

Consistent with a view expressed at the Seminar, Macquarie believes that implementing a significant capital expenditure program that causes financial ratios to deteriorate will have higher marginal financing costs. Macquarie considers that a PV-positive revenue uplift (financeability payment) is appropriate to offset this cost.

Macquarie does not support the use of an accelerated depreciation methodology or nominal return profiling to mitigate financeability constraints. Financeability issues should be addressed by specific financeability solutions. Accelerating depreciation or changing to a nominal return calculation has far broader implications for regulated businesses. Macquarie believes that the implications on short term customer pricing, costs of potential financial restructuring or more importantly the implications of deviating from an established and consistent regulatory approach far outweigh the benefits of any such approach.

Conclusion

Macquarie appreciates the regulators' transparent approach to investigating these issues. Regulatory certainty, consistency and transparency are essential to continue to attract the most efficient and competitive capital to the sector and this benefits all stakeholders. Macquarie believes that companies should be free to optimise their capital structures and the regulator should not seek to limit market efficiencies.

We appreciate the opportunity to provide our comments and please don't hesitate to contact us to clarify any points discussed.

Yours sincerely



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