

Financing Networks: A discussion paper

Response by National Grid

- 1 In this paper, Ofgem and Ofwat raise a number of specific questions about financing networks. Somewhat paraphrased and shortened in some cases, these questions are:
 - (a) Should financial ring fence provisions be further extended and toughened?
 - (b) Should regulators adopt the suggestion by Dieter Helm of using a split cost of capital in setting price controls – split, that is, between existing assets and assets yet to be installed?
 - (c) Is there any evidence of a lack of regulatory commitment to regulatory asset values or equity funding and, if so, how might this best be rectified?
 - (d) Should regulators assume that a proportion of debt is index-linked when setting price controls?
 - (e) Does the regulatory regime need to change to facilitate equity injections? What would be the implications for highly geared companies?
 - (f) Should regulators be more flexible in how they model dividends in order to stabilise gearing and ease financial constraints?
 - (g) Should regulators be more flexible in their use of financial ratios in setting price controls?
 - (h) What are the relative merits of (i) revenue uplift (and should this be NPV neutral) (ii) accelerated depreciation and (iii) profiling returns on a nominal basis?
- 2 We address each of these questions in turn.

Ring fencing provisions

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 mechanisms 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?

- 3 In considering ring fencing provisions, it is important that regulators bear in mind that such provisions, and the associated special administration regime, are not free. Such restrictions raise the cost of equity and reduce the appropriate level of gearing because they remove the option of 'going junk' that is available to unregulated companies and bring a lot closer the point at which equity investments are likely to be wiped out.
- 4 Nevertheless, we recognise the importance of protecting consumers from the consequences of financial failure of a utility and believe that it is inappropriate for such critical public infrastructure to be funded on a junk basis. On balance, therefore, we support cash lock up mechanisms and have no objection to the existing gas

arrangements being extended into the electricity transmission licence. However, we do not believe that the existing gas arrangements need to be strengthened as they already have cash lock up mechanisms.

Split WACC

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?

- 5 The proposal for a 'split WACC' would seem to be based on the assumption that:
- (a) There is a substantial difference between the risks involved in funding new investment from those of funding the existing regulatory asset base.
 - (b) The existing asset base could be funded at debt rates close to the returns on index-linked debt.
- 6 We disagree with both of these assumptions. This is not least because a core risk facing regulated network businesses, and one of the reasons why network utility share valuations show investors requiring a return well in excess of gilt yields is that assets are remunerated over far longer periods than are covered by current regulatory decisions/commitments (notably commitments relating to price controls which typically last five years). This risk applies to existing assets as much as to new ones – and therefore explains, at least in part, both why the required rate of return on new assets is close to that required on existing assets and why both rates of return will be well above the returns required on index-linked gilts.
- 7 In other words, **the split WACC proposal assumes away one of the key problems with network regulation**, i.e. the problem of regulatory commitment beyond the duration of the price control period covered by existing regulatory decisions. For reasons given in response to the next question (on regulatory commitment), there is no obvious solution to the problems posed by the fact that regulatory asset lives are far longer than the period which will be covered by any credible regulatory commitment. As long as that remains the case, there is no obvious reason why the split WACC proposal would be in the public interest.

Regulatory commitment

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?

- 8 If this question is interpreted as "Is there any remaining doubt about how the basis for determining RAV values", then the answer would be that UK regulators, including Ofgem and Ofwat operate clear methodologies for rolling forward RAB values (to allow for depreciation and for new investment) and have moved on from the 'old' debates about how RAV values should be determined¹.
- 9 However, the current question is, in effect, about whether there is any evidence that there is a problem as a result of:

¹ This issue was effectively decided for water and for electricity networks in the mid 1990s and for gas as part of the last Transco price review which took place during 2001/02.

- (a) the fact that network assets may be remunerated over very long periods (currently 40 years for electricity transmission and 45 years for gas transportation);
 - (b) price controls typically last for five years; and
 - (c) current regulators cannot bind the decisions of future regulators.
- 10 In our view, this does constitute a problem in that:
- (a) There is clear evidence that the returns required by investors are well in excess of 'risk-free' interest rates. For example, the share prices of the water and sewerage companies (WASCs) in England and Wales (and, more particularly, the differential between the market valuation of these companies and their regulatory asset values) indicate that, over a number of years, investors have been post-tax real returns on regulatory value of between 5% and 6%, whereas index-linked gilt yields have averaged around 2% over the same period.
 - (b) A significant part of the reason for this differential is probably the lack of credible regulatory commitment beyond the period covered by existing price controls. For example, on the basis of our forecasts to Ofgem as part of the current Transmission Price Control Review, over 99% of the value of our transmission businesses is contained in the 'terminal value' of the price control calculation, i.e. that part of the value which will be remunerated beyond 2012.
- 11 As to what can be done about this, we do not think that there is any magic bullet. One option would be to embed regulatory asset values, and the methodology for rolling them forward, in primary legislation. (A version of this approach, at least in respect of the starting regulatory value, was used by the Victorian state government in Australia as part of the strategy for privatising electricity distribution businesses in the state.) However, even this would not preclude repeal by future governments.
- 12 The most obvious contribution to increased perceptions of commitment that UK regulators can make in the short term is to maintain the improvements in transparency and consistency that developed during PR04 and DPCR4 over a more sustained period of time. However, it needs to be recognised that there is a real asymmetry here. On the one hand, perceptions of increased regulatory commitment and stability may only build over quite long periods of time, whereas one action (like, arguably, PR03) can substantially damage that process.

Index-linked debt

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?

- 13 We believe that it is efficient for companies to take on index linked-debt and have been issuing index-linked instruments since 1999. As a result, we have no problem, in principle, with regulators assuming that index-linked debt forms a part of a utility's capital structure.

- 14 However, if regulators are to assume that a certain proportion of a utilities' capital structure is index linked, they need to take account of the following:
- (a) The index linked market is relatively small, it can be difficult for companies to issue index-linked debt and, historically, index-linked debt has been relatively expensive. As a result, for the foreseeable future, the majority of UK utilities' debt books are likely to be financed with nominal debt.
 - (b) A benefit of index-linked issuance is that it lowers immediate cash interest costs. This may improve the overall credit rating ratios that a company achieves but will depend upon the agency. Moody's use P&L interest as the denominator in its FFO/interest calculation and so there is no benefit to this ratio, or to FFO/Debt, from the use of index-linked debt. There is a slight benefit to the RCF/Debt calculation from the use of index-linked debt.
 - (c) Investors looking to buy index-linked debt are seeking to hedge their long run inflation exposure. Consequently, there is limited demand for short term index-linked debt. Issuing long dated index-linked debt (as with any other long dated debt) leaves utilities exposed to an embedded debt risk. If regulators are to encourage the issuance of index linked debt, then it needs to be made clear that future embedded debt costs above market rates will be recoverable if the relevant instruments were efficient in the light of information available when they were entered into.

Equity Injections and Dividends

Are there any changes that would be required to the regulatory regime in order to facilitate equity injections? What would be the implications for highly geared companies?

- 15 An important part of encouraging equity investment is in providing a sufficiently attractive return that equity investors remain properly remunerated and a sufficiently stable regime that equity investors feel confident that their investment is secure. Consequently, providing a longer track record of regulatory commitment will facilitate future equity injections.
- 16 We would, therefore, be concerned if regulators began to assume that equity injections were the solution to financeability issues and, as a result, set price controls which could not be financed on the cash flows allowed. This is not least because:
- (a) Over the last few water and energy price reviews, regulators have assumed fixed ('optimal') gearing when determining the cost of capital to be used for setting price controls. This approach assumes that revenue (including any 'financeability' adjustments) will vary to keep balance sheets within certain bounds. This approach started when most networks had reasonably conservative balance sheets and therefore allowed regulators to assume that companies could finance investment by issuing debt.
 - (b) Against the background of companies having adjusted their balance sheets more in line with regulatory assumptions, to now shift to an approach whereby higher capital expenditure is absorbed by balance sheets, rather than by revenue would have more than a whiff of regulatory opportunism. In other words, price controls **have** been set on the basis of an assumption which gave lower revenue in the past (than would have been the case on the basis of actual gearing and the assumption that balance sheets absorbed capex variability) and would now be set on the opposite basis in the future which would again give lower revenue than maintaining continuity of approach.

- 17 Thus, we believe that the best way of facilitating equity injections is to have a stable regulatory regime which is attractive to equity investors. To make the assumption, in setting future price controls, that balance sheets can be maintained in the face of higher capex requirements by equity injections would be likely to undermine expectations of stability and discourage equity injections.

Modelling of dividends

Would it be reasonable for regulators to be more flexible in their approach to modelling dividends as a method for stabilising gearing and easing 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 appropriate?

- 18 We do not believe that it is appropriate to resolve financeability constraints through assuming greater retention of dividends. To the wider equity market, a sustainable and predictably growing dividend is the most tangible evidence of certainty of cash flows. Introducing arbitrary dividend cuts, however justifiable the long term growth prospects, is likely to substantially undermine the confidence of equity providers and, if the goal is greater equity investment in utilities, prove counterproductive.
- 19 Our answer to the previous question is also relevant to this one. Ofgem and Ofwat have, in recent reviews, followed an approach which assumed fixed gearing and revenue bearing the strain of increased capex. To break with this approach now would, for the reasons given above, imply regulatory opportunism and run directly counter to the objective of fostering a climate of regulatory stability and commitment with industries where, because of their long life assets, the need for such stability and commitment is at a particular premium.

Credit Ratings and Ratios

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?

- 20 Irrespective of companies' actual ratings, regulators should continue to target a Single A credit rating when setting price controls. Targeting a BBB credit rating, with the threat of a cash lock up and special administration if the utility slips just two notches, leaves insufficient headroom to cope with shocks and would inevitably significantly raise the cost of equity to reflect the increased probability of equity being wiped out. We believe that, over the long run, this would lead to higher prices for consumers.
- 21 On the issue of how regulators should apply financial ratios, we believe that the current approach of targeting credit rating financial ratios is appropriate. This is for two reasons:
- (a) Credit rating agencies are a fact of life in the financial markets and, for better or worse, their opinions cannot be ignored.
 - (b) The existing approach aids transparency and consistency. A more 'flexible' approach to financial ratios is likely to be interpreted as a reduced commitment to ensuring financeability and reduce perceptions of regulatory commitment to the assets.
- 22 However, credit rating agencies also use qualitative assessments and evaluate trends. Consequently, regulators should bear in mind that simply hitting a financial ratio at a point in time may not ensure a certain credit rating if, for example, the

financial ratios over the price control period get continually weaker over time. Furthermore, other aspects of the regulatory regime, including the form of control, incentive regimes and mechanisms to compensate for unforeseen cost increases are very important to the credit rating agencies' view of the business risk. A package that hits target ratios but increases business risk would not be consistent with the rating indicated by those ratios – and, therefore, not an appropriate outcome.

Methods of ensuring financeability

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?

- 23 The regulatory objective of minimising prices for consumers means that any method chosen to correct financeability issues should, in principle, be NPV neutral. Of the NPV neutral options, we favour tilted depreciation for electricity transmission on the grounds that it would:
- (a) provide greater certainty over long run cash flows (when compared with an ad hoc revenue uplift); and
 - (b) maintain the inflation hedge of the current regime (unlike profiling of returns on a nominal basis).
- 24 In addition, Ofgem have suggested an alternative method for resolving financeability based on expensing replacement expenditure, as was used for gas distribution at the last Transco review. This method is, however, a less efficient solution as the increased revenue is offset by increased operating costs in many credit rating calculations.

National Grid
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