<u>Financing Networks discussion paper</u>

A response from Northumbrian Water Limited

<u>Introduction</u>

We welcome the opportunity to respond to the Financing Networks discussion paper, which provides a helpful and wide-ranging review of issues relating to the financeability of network industries. The seminar hosted jointly by Ofwat and Ofgem provided an excellent opportunity for a wide range of stakeholders to debate the issues raised in the discussion paper and helped to inform this respose. We consider the wider context and overarching principles before addressing the key issues for discussion identified in the paper.

<u>Context</u>

The genesis of this discussion paper was concern expressed by HMT and DTI in 2004 about the increased proportion of debt finance being used by regulated businesses. Much has happened since then including the completion of both the water and electricity distribution price reviews. The trend towards higher gearing appears to have continued, albeit at a slower pace, and capital markets appear increasingly comfortable with these relatively high levels of gearing.

The fact that no company appealed the price determinations suggests that the investment programme for at least the next five years can be financed. Following the review many water companies appear to be trading at above their regulatory capital value. Some commentators have suggested that the financeability uplifts for the water companies at the review look generous. We believe this is mistaken. Making adequate allowance for financeability was a major concern to investors in the run up to PR04. Investor confidence in the water sector was shaken at the 1999 review and the successful conclusion to PR04 was far from certain.

Companies may currently be able to borrow at below the costs assumed by the regulators. However, the current very low long term gilt rates are unlikely to prove sustainable. Regulated businesses are long term and require finance on a similarly long term basis. In the recent reviews regulators have been right to maintain a long term focus and not cherry-pick spot rates at historic lows. Moreover, it is the overall cost of capital (not just the cost of debt) which prescribes the appropriate financing ratios to ensure companies can finance their functions.

In fact, financeability is about more than the cost of capital. Already challenging efficiency targets look even tougher in the context of spiralling energy costs, which also have a direct impact on the cost of chemicals and transport. Financeability must encompass all aspects of the regulatory settlement including operating cost assumptions and efficiency targets as well as the assumed rate of return. One year into the review period is too soon to assess how tough the 2004 determination will prove to be.

Overarching principles

A key principle must be that decisions on financial structure should be left to the regulated businesses responding to developments in the capital markets. Regulators should not seek to prescribe or unduly influence decisions on financial structure. Regulators may wish to ensure that management is appropriately incentivised but management incentives are not governed solely by financial structure or gearing.

Capital markets are constantly evolving. A range of debt instruments along with both private and public equity will have a role to play in meeting the financing needs of the water industry. NWL believes there is an important role for quoted equity and was pleased to go against the trend of companies de-listing by floating on the stock market in 2003.

However, we believe that too much attention has been focused in a rather simplistic way on the gearing ratio. Several speakers at the seminar noted that the distinction between debt and equity, particularly in relation to management incentives, is not black and white. We believe there are legitimate choices for companies to make regarding the financial structure adopted. In each case appropriate management incentives are required but higher levels of equity do not necessarily imply greater management incentives.

Regulators have a duty to ensure that companies can finance their functions. It is therefore essential to test for financeability and to ensure that the price determination as a package is financeable. This test should focus on market realities rather than abstract economic theory.

Water UK commissioned a report by Oxera "Testing for Financeability: an assessment" which was published in late 2004. This report focused on a narrower range of issues than the discussion paper. It primarily considered whether financeability uplifts would continue to be required and the appropriate mechanism for any such adjustment. We broadly support the conclusions in this report, which we refer to at several points as "the Oxera paper".

Oxera concludes that, given the likelihood of high investment requirements continuing for the foreseeable future, financeability adjustments are likely to be required at future price reviews. Scope for NPV neutral approaches is limited because bringing revenue forward will tend to make the future financial position of companies worse and thereby require higher financability adjustments at subsequent reviews.

There are a number of alternative ways in which any required adjustments to ensure financeability can be presented. These alternatives have pros and cons but the most important issue is that financeability is achieved. On balance we agree with the Oxera report that Ofwat's approach at PR04, perhaps with modest evolution, remains appropriate. Financeability needs to address the realities of capital markets and therefore must recognise the generally accepted requirements to maintain a solid investment grade credit rating. We believe the request by Government for regulators to consider alternative ratios to those used by rating agencies is misguided since ratios have no validity unless they are recognised and used by the capital markets.

One specific proposal that has received considerable attention is the concept of a split cost of capital with lower returns on the regulatory asset value and higher on new investment. We believe such proposals are ill conceived and poorly specified. This would represent a fundamental change to the regulatory system and would significantly increase regulatory risk for no obvious benefit. For the reasons listed in our detailed response below we can see no practical or economic justification for adopting a split cost of capital

<u>Key Issues for Discussion:</u>

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 the case of water the ring fencing arrangements do cover all monopoly business activities. We believe that strong ring fencing provisions are appropriate and help to reduce investors' perception of risk. There is a case for making the core ring fencing conditions consistent for all water companies. Most companies have very similar licence conditions but a few have not amended the original licence to incorporate additional ring fencing provisions. The current ring fencing provisions are sufficient to allow the activities of the undertaker to be fully separated from other group entities.

We do not see any requirement to introduce cash lock-up provisions in the licence. We do not believe this would provide incentives for equity formation and the protection offered to debt holders might encourage higher gearing. It is important to maintain a clear distinction between the role of the capital markets and the role of the regulator. Investors may require cash-lock up covenants as a condition of supporting some highly geared structures. This will be a factor influencing the Board's decision about whether to adopt such structures. We do not believe that regulatory intervention in this process is helpful or necessary.

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?

It is not clear to us what problem the split cost of capital proposal is seeking to address. There is no evidence that incentives to invest are inadequate in the water industry. Investment has been extremely high since privatisation and is likely to remain so for many years to come. The existing regulatory framework has allowed this investment to be financed and there is no evidence that this will change so long as there is a commitment to continuation of broadly the same regulatory approach.

We do not believe that the “split cost of capital” is an appropriate mechanism for addressing financeability. Simply re-allocating returns between past and future investment does not address the issue of financeability. The ratio of past to future investment is such that simply to retain the same overall revenue, the marginal cost of capital for new investment would have to be implausibly high to compensate for a lower return on past investment (see Oxera report). Investors do not invest in particular categories of asset (new or old) and will want to understand the overall financial position of the business. In our view the split cost of capital approach would not improve incentives to invest or reduce the cost of finance. Indeed by increasing risk it may actually raise the cost of finance.

Initially we understood that the split cost of capital was intended to address the "dash for debt" and promote equity formation although we doubt that it would be an effective way of meeting this objective. Proponents of the split cost of capital now appear to accept that it would be more likely to encourage higher gearing with most, if not all, of the historical regulatory asset value being debt financed. It is not clear if this would be a desirable outcome.

We are concerned that little thought appears to have been given to the practical application of this approach, which would be a fundamental change to the regulatory system. The question of precisely when and how new investment enters the asset base would need very careful consideration. The mere fact that this is a fundamental change is likely to increase perceptions of regulatory risk. Furthermore, this approach may be perceived as reducing regulatory commitment to the regulated asset base and may restrict options for future financing. The fact that the devil will be in the detail, and proponents of the approach do not appear to have considered the detailed application in any depth, only serves to heighten concern.

The underlying premise of the split cost of capital is that regulated businesses carry out two distinct activities with quite different risk profiles - the low risk management of routine operations and the high-risk activity of new investment. This is a fundamental misconception. The risks applying to managing the regulatory asset base (operations) are underestimated and the risks associated with new investment overestimated. The two activities are in any case less distinct than this simplistic characterisation would suggest as we explain below.

Water companies are now very experienced at managing large scale investment programmes. The main risk associated with investment is not cost over-runs on the agreed capital programme but unforeseen additional or changed requirements arising between price reviews and whether these will be dealt with appropriately by the regulator. This can result in disputes about logging up, service capping or potential IDoK's. The split cost of capital does nothing to address this risk.

It is wrong to think of new investment as a totally distinct activity from operations. Most water industry investment is incremental with relatively few projects involving construction of totally new assets. The majority of projects involve upgrading and refurbishing existing sites or networks. Investment responds to operational need with serviceability and growth being major drivers alongside rising quality standards. In most cases a combination of drivers applies to a single scheme. One of the biggest risk factors is carrying out an investment project in a live environment whilst maintaining uninterrupted supply. The investment and operational activity are closely interwoven with correlated risks rather than being separate and distinct.

There appears to be very little appetite for fundamental regulatory change from investors. The split cost of capital appears to have few supporters other than a small group of academics. Few details are available as to how the approach would work in practice. The supposed benefits ascribed by proponents do not always appear to be consistent giving the impression that this is a solution in search of a problem. Consistency of regulatory approach is a critical issue and fundamental change requires a clear and unequivocal justification. We can see no practical or economic justification for adopting the split cost of capital.

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?

There is inevitably a timing mismatch between long term financing and regulatory review periods. It has been suggested that a lack of regulatory commitment is one reason why financeability adjustments above the cost of capital are required since investors are not sufficiently confident that future cash flows will materialise and are therefore not prepared to wait for the long term to earn the appropriate return on investment.

We are not convinced that it will ever be possible to commit future regulatory decisions - perhaps many years into the future – to totally remove the requirement for financeability adjustments. However, regulatory asset values do play a key role in the valuation of water companies and greater commitment to maintaining these would help to reduce regulatory risk. Whilst regulators have largely committed to maintaining these values in practice there is no explicit requirement for them to do so. It would reduce regulatory risk if a clear and credible commitment to regulatory asset values could be provided perhaps by including the regulatory asset value in the operating licence.

It is clear that regulators have a preference for the retention of a meaningful proportion of equity finance. However, it is not for regulators to determine company financial structure. Regulators may wish to ensure that inappropriate incentives are avoided, for instance by removing tax incentives to gear up, but should not seek to prescribe particular forms of finance.

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?

Financing policy is a matter for individual companies and regulators should be careful to avoid imposing particular policies. Index-linked debt is attractive in terms of the cash flow profile for a water company whose revenues are linked to RPI. We consider that a proportion of index-linked debt is appropriate as part of a balanced overall debt profile and NWL has recently taken advantage of the index-linked debt market.

However, the market for corporate index-linked debt is immature and relatively small. It would therefore be unwise to assume that the industry could raise a substantial proportion of finance in the form of index-linked debt on reasonable terms. Index-linked debt is currently available at attractive rates, with a healthy demand from pension funds. However, these conditions may not always apply and will be subject to the forces of supply and demand.

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?

Markets are better placed than regulators to assess risk and market sentiment is becoming more comfortable with higher gearing for water utilities. The choice of financing structure should be left to the regulated companies and the capital markets rather than the regulator. So long as debt continues to be available at a cost substantially lower than the cost of equity it is likely that in most cases debt will be companies' preferred method of finance.

We have argued that regulators should not seek to impose particular capital structures. In any case the tools available to the regulator are limited. The regulator could try to encourage equity formation by using pro forma assumptions reflecting a higher proportion of equity or assuming equity injections in future years to address financial ratios. However, companies may choose not to follow these assumptions if they consider that finance can be raised more efficiently by other means. Indeed raising the assumed cost of equity may actually increase the incentive to increase gearing. Furthermore, if reduced gearing were to mean companies adopting less efficient balance sheets it is not clear that this objective would be in the best interests of customers as it would result in higher bills.

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?

A persistent cut in the level of dividends in order to address financeability could affect market sentiment and reduce share prices. To the extent that companies are unable to sustain dividend levels in line with market expectations this may provide an additional incentive to increase gearing.

The Oxera report concludes that a substantial change in the assumed dividend payout ratio "would create risks in relation to the longer-term funding of the industry". Certainly such an approach would not be consistent with encouraging increased equity formation.

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?

Regulators must have regard to the ratios used by credit rating agencies and the way in which these are interpreted by the markets. Whilst regulators could derive alternative ratios, which may have theoretical merit, these will have no practical value in relation to financeability if they are not recognised and used by the capital markets.

The trend of ratios is important but there are critical thresholds, which must be maintained in order to achieve a satisfactory rating. It is not clear how the term "pragmatic" should be interpreted in this context. Regulators must follow the accepted norms for solid investment grade ratings in line with the policies of the major credit rating agencies.

We agree with statements previously made by Ofwat that companies should aim to be comfortably within investment grade. It would not be appropriate for the regulator to set prices such that an efficient company was rated BBB. This is the bare minimum investment grade and leaves insufficient scope to deal with business risks. If the majority of water companies were rated BBB this would result in a significant loss of confidence in the sector and would jeopardise the ability to finance required investment programmes. It would be inappropriate for the regulator to encourage a reduction in credit quality across the sector.

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 Oxera paper commissioned by Water UK considers this issue in considerable detail. There are likely to be substantial differences between water and electricity distribution in terms of the likelihood and extent to which financeability adjustments will be a necessary feature of future price reviews. Given the real sectoral differences in financial profile and investment requirements highlighted at the Financing Networks seminar it is unlikely that a common approach for water and electricity distribution will be appropriate.

Given the likelihood of high investment requirements continuing for the foreseeable future there appears to be limited scope for NPV neutral approaches in the water sector. Bringing revenue forward will tend to make the future financial position of companies worse and thereby require higher financeability adjustments at future reviews. Oxera conclude that there is limited scope for accelerated depreciation in the water sector as the depreciation allowance is already relatively high since it is based on replacement values.

Profiling returns on a nominal basis would remove the requirement for a financeability uplift but would actually increase customer’s bills in the short run by significantly more than the financeability uplift. To the extent that the concern about financeability adjustments relates to the impact on bills this change would make matters worse. This would also represent a major change to the regulatory regime requiring the recalculation of asset values and significant changes to cash flows over time. Such a change would cause unnecessary disruption and uncertainty that may have implications for both equity and debt markets. Many investors are attracted by the index-linked nature of the water company assets and switching to nominal returns could reduce investor appetite for water company securities. Holders of water company index-linked debt might have particular concerns.

Regulators have a duty to ensure that companies can finance their functions. It is therefore essential to test for financeability and to ensure that the price determination as a package is financeable. This test must focus on market realities rather than abstract economic theory. There are a number of alternative ways in which required adjustments to ensure financeability can be presented. These alternatives have pros and cons but the most important issue is that financeability is achieved. On balance we think the approach adopted by Ofwat at PR04, perhaps with modest evolution taking into account the conclusions of the Oxera report, remains appropriate. It is important that the approach adopted is consistent and transparent. Ofwat was more transparent at PR04 than in previous reviews, but it would appear that investors would like to see a more detailed explanation of the approach to testing for financeability for PR09.

Northumbrian Water Limited
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