



## FINANCING NETWORKS

This response to Ofwat's and Ofgem's joint discussion paper, "Financing Networks", is on behalf of SP Transmission, SP Distribution and SP Manweb. These are, respectively, the electricity Transmission Owner (TO) and the Distribution Network Operator (DNO) for central and southern Scotland, and the DNO for Merseyside and North Wales.

Substantial investment will be required in the electricity networks over the coming years, to enable the government's renewable generation targets to be achieved, facilitate measures to meet wider climate change objectives, and to replace ageing assets, so as to ensure security of supply. The transmission and distribution licensees must be able to attract and retain equity funding, so as to be able to finance the increasing amounts of investment required. This challenge is already evident in the current Transmission Price Control Review, where new capital expenditure requirements are substantially above those of the recent past. Similar challenges will face other networks, at the next round of price control reviews.

Fundamentally, it is essential that sectoral regulators assume an adequate cost of capital when setting price controls. It is therefore disappointing that regulators appear to continue to be unable to agree on the components of the cost of capital and how the weighted average cost of capital should be calculated. Such differences, especially from one price review to the next, can only add to the perception of regulatory risk.

We set out on the following pages our detailed responses to each of the questions raised in the discussion paper. In summary, our key messages are:

- The current ring-fencing arrangements for DNOs in the electricity sector are sufficient;
- Simply disaggregating a business into two types of activity does not reduce its overall risk;
- Updating the RAV, on a more frequent basis, in a consistent and predictable manner, would help to reduce uncertainty;
- There is limited capacity for index-linked funding, especially for that in structured format with a credit wrap;
- The deferral of cash payment cannot be achieved by means of index-linked swaps, as the associated margining agreement would require amounts due to be settled in cash;
- Regulators should include an allowance for the costs of raising new equity in the allowed cost of capital;
- Attempting to change the nature of utility shares would be disruptive to investors, who would have to adjust their portfolios;
- Regulators should use financial ratios which are consistent with investment grade credit ratings by the major credit rating agencies;



- Accelerated depreciation has the advantages of being PV neutral and predictable.

In conclusion, we do not believe that the case has been made to justify a radical change to the way price controls are set. Instead, effort should focus on ensuring greater consistency between regulators and from one price review to the next.

## KEY ISSUES

***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.

***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?***

Simply disaggregating 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 RAB, 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. An overall reduction in risk would only arise were there to be a corresponding reduction in regulatory risk. However, the resulting delay in capital expenditure being consolidated into the RAB would increase the perception of regulatory risk.

In the electricity sector, network assets under construction typically form only a very small fraction of the total asset base. It is unlikely, therefore, that these will have a significant effect on the overall 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.

Investors have financed existing assets on the assumption that they would earn the cost of capital over their lives. If the existing RAB were to earn a lower rate of return in future, then they would not earn the cost of capital over the lives of the assets. Such a change would adversely impact investors and consequently increase their perception of regulatory risk and the cost of capital.

For new capital expenditure, a key practical issue is the point at which it would enter the RAB 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. If the return over the life of the asset is not to decline, new assets will have to earn the higher rate of return beyond the initial price control period.

Furthermore, implementing major changes to a company's capital structure would result in significant re-financing and associated transactions costs.

***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?***

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 regulatory asset base. In the electricity sector, concerns have been raised by Ofgem's review, at this late stage, of capital expenditure back to 1999/2000, as part of the current Transmission Price Control Review. The potentially long lag between incurring capital expenditure and confirmation of whether it will be included in the RAV increases uncertainty. Updating the RAV on a more frequent basis, in a consistent and predictable manner, would help to reduce this uncertainty. In particular, we would welcome early confirmation of:

- a) the process, timing and criteria for any efficiency test which may be applied to capital expenditure; and
- b) the process which would be for adopted if the RAV roll forward calculation were to be amended, at some point in the future.

There is a more general issue surrounding the lack of ability of a regulatory authority to limit its successor's discretion, in the future. This may be mitigated, to some extent, by issuing a statement of intent and drafting licence modifications in such a way that it is clear that, where appropriate, they are intended to continue beyond the end of the price control period.



When calculating the weighted average cost of capital (WACC), regulators have increased their assumed level of gearing over time, without allowing for a compensating increase in the cost of equity. As gearing increases, there is a consequential rise in the equity beta (i.e. the systematic risk factor in the Capital Asset Pricing Model). This may have had the undesirable effect of deterring equity funding.

In general, regulators have not allowed for the transaction costs of raising new equity. Furthermore, there are indirect costs associated with rights issues which regulators have not accounted for.

***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?***

#### **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. Indeed, it could be argued that there is material distortion at long maturities. However, most of the recent issues by utilities or other companies have been in structured format with a credit wrap or even two provided by AAA rated insurance companies and it is clear that there is a limit to the amount of capacity available for this purpose. The market in unstructured index-linked bonds is small although there is scope for it to develop further.

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.

#### **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 for 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 direct 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?***

In general, regulators have not allowed for the transaction costs of raising new equity. Furthermore, there are indirect costs associated with rights issues which regulators have not accounted for. A NERA report<sup>1</sup> for the Distribution Network Operators during DPCR4 estimated that equity issuance costs amounted to 0.3 percentage points. This is a significant cost of raising new finance and the allowed cost of equity should include an allowance for such costs. Failure to include such an allowance is inconsistent with the assumption of steady state gearing which is implicit in the calculation of the WACC.

***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?***

The majority of equity investors regard utilities as income shares and have chosen whether to invest in them, or not, on that basis. 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.

In the absence of a historical track record, it will be difficult to persuade investors that future dividend growth will be sustained.

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<sup>1</sup> "UK Electricity Distribution Cost of Capital", NERA, March 2004



***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 definitions of ratios by regulators would improve financeability. The views of the credit rating agencies carry substantial weight in the capital market and are a major determinant of the terms on which debt is available to a company. We are concerned that the introduction of more regulatory discretion into the assessment of financeability will increase the perception of regulatory risk and consequently increase the cost of capital.

Furthermore, it is clear that the rating agencies are now placing more emphasis on a broader range of financial ratios than Ofgem have traditionally used. For example, in a recent report<sup>2</sup> Moody's states:

“For regulated utilities in the UK, the two most important measures that we utilize in assessing the financial strength are the adjusted interest cover ratio (after deducting from post-tax cash flows the capex spend required to maintain the RAV) and the ratio of the debt to the RAV.”

Also, in a Special Report<sup>3</sup> following DPCR4, FitchRatings commented:

“Fitch analysis currently focuses on EBITDA rather than FFO.”

and

“Net debt/RAV is the key measure of gearing for regulated utilities and the best cross-DNO or cross-industry indicator of leverage. However, it is not a good early indicator of problems in a company or misalignment versus the regulatory template and EBITDA-based measures are much better for the early identification of a trend.”

Regulators should use financial ratios which are consistent with comfortable investment grade credit ratings by the major credit rating agencies. Furthermore, regulators should stress test the behaviour of financial ratios under adverse shocks.

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<sup>2</sup> UK Independent Gas Distribution Companies: Similar Fundamentals to Regulated Water at Slightly Lower Leverage, Moody's Investor Service, March 2004

<sup>3</sup> No Shocks – The UK Electricity Distribution 2005-2010 Price Review, Fitch Ratings Ltd, December 2004



The lower the level of a company's current credit rating then the higher the probability that it could be downgraded to below investment grade, at some future date. If the majority of 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 unlikely that reducing ratings to BBB would reduce the weighted average cost of capital (WACC).

In addition to debt related financial ratios, we believe that regulators should also consider equity related ones. In particular, the dividend cover ratio should be adequate and the prospective dividend yield and growth should be consistent with the return required by shareholders.

***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?***

Ad hoc revenue adjustments would not be predictable, may lack transparency, and may not be PV neutral. A need for their widespread use would suggest a more fundamental difficulty with the regulatory regime, which should be addressed in a more systematic and transparent manner. However, there may be occasions where, because of its unusual circumstances or characteristics, a particular licensee may require different treatment from the sector as a whole. Nevertheless, there remains uncertainty as to whether and, if so, when a revenue uplift may be clawed back.

In the electricity sector, DNOs already have a price control derived from accelerated depreciation. This has the advantages of being PV neutral and predictable.

Suddenly switching to returns set on a nominal basis would result in a step change in prices, which is unlikely to be acceptable to customers.