

Emma Cochrane
Head of Corporate Finance
Ofwat
Centre City Tower
Birmingham
B5 4UA

Direct line 01925 463001
Direct fax 01925 463957
clive.elphick@uuplc.co.uk

Martin Crouch
Director – Electricity Distribution Regulation
Ofgem
9 Millbank
London
SW1 3GE

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FINANCING NETWORKS

1. INTRODUCTION

I am responding on behalf of United Utilities (UU) to the Ofwat/Ofgem discussion paper “Financing Networks”. UU is the only British company regulated by both Ofwat and Ofgem, so we have a particular interest in the issues raised in the paper.

Attached are our views on the eight issues for discussion set out in Section 8 of your paper.

This covering letter provides our views on the two over-arching issues addressed by the discussion paper, namely the public policy consequences of increased gearing and the role of financeability in price setting.

2. CONSEQUENCES OF INCREASED GEARING

2.1 Developments since Privatisation

The gearing of network companies has increased dramatically since privatisation as a result of both:

- debt financed investment to enhance the networks, which has been anticipated by regulators in price setting; and

- corporate transactions, special dividends and share buy-backs, which have not been anticipated in price setting.

The Government expressed concern about increased gearing, following the special administration of Railtrack. Their concern was that risks previously borne by shareholders could transfer to customers and/or taxpayers.

In paragraph 69 of “Financing Networks” you clarify that the risks of high gearing are borne by creditors and shareholders, rather than customer or taxpayers. We welcome this clarification and the signal it sends to creditors. It is, however, the case that if one utility gets into financial distress, this can be expected to increase the cost of capital for all utilities.

2.2 Risks Of Owning Networks

Dr Dieter Helm’s thesis is that once an asset enters the RAB it is low risk and so should be debt financed with rate of return regulation. This would result in very high levels of gearing as noted in Paragraph 107 of “Financing Networks”.

We dispute that assets in the RAB are low risk. The evidence for this comes most clearly from Railtrack, which was put into administration following the accident at Hatfield in October 2000 because of the cost of maintaining its existing assets. It was assets in its RAB, rather than planned new assets, which caused its downfall.

The reason why assets in the RAB are risky is as follows. The cost of repairing an asset is a function of its replacement cost, which is known technically as the modern equivalent asset (MEA) cost. According to Ofwat the MEA value of the industry’s tangible assets at March 2005 was £222bn. This compares with a RAB at the same date of £36bn. Companies therefore receive a return on the RAB but bear risks on the MEA value of assets, which is over six times larger. This makes ownership of network assets over six times riskier than it appears at first sight, and therefore appropriate for equity investors.

The significance of this distinction between MEA and RAB values is emphasised in a Moody’s report on the UK water sector which was published in March 2006, which tabulates RAB to MEA ratios for each company. The return of capital to shareholders through depreciation allowances is based on MEA values for the water companies, but the return on capital to shareholders is based on RAB values. This approach is sensible, but the consequence is that ownership of assets is significantly riskier than Dr Helm anticipates.

Investors have chosen to invest in utilities on the basis that the company will earn the weighted average cost of capital on its RAB. For the RAB to only earn the cost of debt would involve a retrospective change and jeopardise investor confidence in the regulatory regimes.

2.3 Long-Term Stewardship

Network assets have lives that are measured in decades and even centuries. As a result, network owners should take decisions about their assets from a long-term perspective, and avoid short-term ‘asset sweating’.

Professor Colin Mayer is of the view that owners need to demonstrate long-term “commitment” to their networks, which is more likely if they are conventionally geared. A highly geared company with an exit strategy, such as a private equity owner, could take short-term decisions that lead to poor customer service long after the owner has exited. The goal should be to align the long-term interests of shareholders and customers.

2.4 Incentives For Equity

Ofwat and Ofgem have sought to remove the tax incentive to gear-up by using a post-tax cost of capital. Nevertheless the current indications are that more utilities will become highly geared because of acquisitions by financial owners such as infrastructure funds and private equity firms.

Paragraph 91 of “Financing Networks” makes the case that incentives for equity were increased in the 2004 price reviews because the returns to equity were increased. We dispute this logic. Returns to equity were increased but using notional levels of gearing. This means that irrespective of actual gearing, a higher return is being earned on 45% of RAB for water companies and 42.5% of RAB for DNOs. The best way to increase share prices in this context is to spread the higher return on as small an equity base as possible. In other words, it can be argued that the approach taken in PR04 is encouraging companies to gear up!

2.5 A Possible Solution

The only way to address Government concerns about high gearing is to positively incentivise conventional levels of gearing or (equivalently) to negatively incentivise high levels of gearing. This requires that lower overall rates of return be provided to higher geared companies. This idea was first proposed in Colin Mayer’s 2004 paper entitled “Commitment and Control in Regulation”.

Regulators could achieve this goal by setting prices using actual rather than notional gearing, but Paragraph 66 of “Financing Networks” sensibly rules out this option.

Regulators could continue to use notional gearing of around 55%, but introduce increments/decrements to the cost of capital based on actual gearing, as illustrated below:

Actual Gearing	Increments to Cost of Capital
<60%	+0.5%
60 – 70%	+0.25%
70 – 80%	0%
80 – 90%	-0.25%
>90%	-0.5%

It would be sensible to use an average of the actual level of gearing over (say) the previous five years, to avoid a perverse incentive for a company to temporarily reduce gearing.

There is a precedent for such increments to the cost of capital in Ofwat’s treatment of the water-only companies.

3 **FINANCEABILITY**

The financeability payments made to water companies in PR04 increased bills by about 1% on average from 2005-10. The payments made to DNOs over this period increased bills by much less than 1%. Given this modest impact on customers, financeability has attracted a disproportionate amount of attention from regulatory commentators.

The primary cause of financeability payments is the mismatch between real returns on the RAB vs. nominal interest rates. This mismatch will, however, diminish in future price reviews, because the indexation of investment since 1990 by RPI will start to more than offset the difference between real and nominal returns. Financeability payments will also reduce if regulators assume a market based proportion of index-linked debt.

It has been proposed by some commentators that if financeability payments are needed, they should be NPV neutral. In this context statements by Professor Julian Franks at the Ofwat/Ofgem seminar on “Financing Networks” are relevant. He said that while a CAPM-based WACC is theoretically the right way to set prices, in practice the results of CAPM calculations are so imprecise that financeability is needed as a cross-check. This suggests that financeability payments are corrections to the imprecision of CAPM, not windfalls for companies.

It is clearly possible to avoid NPV positive financeability payments through use of accelerated depreciation and/or repex. To do so requires a departure from a fundamental principle of price setting used by Ofwat since privatisation, namely that:

- maintenance of networks is funded by customers on a “pay as you go” basis; but

- enhancement of networks is funded by the capital markets, because enhancement benefits current and future generations.

It would be undesirable to depart from this principle for an issue which is affecting water bills by only about 1% pa, and which can be expected to reduce in future years due to the indexation of past investment.

Furthermore the use of accelerated depreciation or repex can have unintended consequences. In particular accelerated depreciation reduces the RAB and therefore can exacerbate financeability problems at future price reviews. The use of repex can create a permanent mismatch between regulation and the requirements of accounting standards.

In overview, the use of NPV positive financeability payments provides a pragmatic method for enabling companies to access the capital markets efficiently without having a material impact on customers' bills.

If you would like to meet to discuss this response I would be pleased to do so.

Yours sincerely

Clive Elphick
Chief Operating Officer - Transformation
United Utilities North West

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?

UU RESPONSE

Ring-fencing

- 1.1 It is reasonable for highly geared water companies to have a tighter financial ring-fence than conventionally geared companies. It would be perverse to impose a tighter ring-fence on all companies, since this would remove a deterrent for companies gearing-up.
- 1.2 Cash lock-up provisions are not required for water companies since they are typically included in debt covenants for highly geared companies. Investors will be more comfortable with market mechanisms such as covenants rather than regulatory mechanisms such as licences.
- 1.3 The introduction of cash lock-up provisions would deepen the quasi-regulatory role of rating agencies, which is already a matter of concern for Government. It would also act as a disincentive for equity, since dividends could be adversely affected. This is the exact opposite of what the Government is seeking to achieve.

Holding Company Debt

- 1.4 Debt at the holding company level is serviced only after debt in the utility has been serviced and dividends distributed to the parent. Consequently, a credit investor at the holding company level is *structurally subordinated* to a credit investor at the utility level.
- 1.5 The credit rating agencies currently attribute a credit differential equivalent to one notch for this structural subordination. Bonds at the parent company level trade only a few basis points worse than equivalent bonds in the utility. However, Moody's has made clear that as a utility goes down the credit spectrum, it will widen this notching because of the risk of regulatory intervention in the distribution of dividends.
- 1.6 Moody's presently rates the debt of National Grid holdco two notches back. It is possible that if there were further cash lockup provisions, weaker utility groups could see a credit differential of more than two notches.

- 1.7 Stronger utility groups such as United Utilities, would probably see a credit reduction of a further one notch at the parent company level. While this may not appear to some observers as significant, account should be taken of the adverse affect on sentiment of investors.
- 1.8 The holding company investors in United Utilities are largely drawn from the United States via its SEC listed Yankee bond program. These US investors would suffer immediate mark to market (MTM) losses on their holdings in United Utilities paper. These losses could be substantial as the MTM impact takes account of both the change in credit spread and the maturity of the bonds, which in the case of United Utilities extends to 2028. By way of contrast, Ofwat went out of its way during the 2004 price review to reassure credit investors that they should expect solid and stable credit ratings resulting from the regulator's actions in the price review.
- 1.9 A one notch downgrade of holdco debt as a result of a cash lock-up provision would make it more expensive and more difficult for United Utilities to access the US market in the future. This at best should be described as unfortunate because it is one of only two major bond markets where ultra long term debt can be financed. The other one is the UK, but the depth of the US market is significantly greater.
- 1.10 A significant portion of current and previous bond issues by United Utilities in the US market has been used to downstream both debt and equity capital into the water utility. Loss of this market is likely to make funding for the utility more difficult and more expensive.

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?

UU RESPONSE

- 2.1 The separation of past and future investment would not, of itself, reduce business risk and therefore would not reduce the cost of finance. Were it to do so it would be a “free lunch”.
- 2.2 The only way such separation could reduce risk would be if RABs were underwritten by a Government guarantee. In these circumstances some risk would be transferred to taxpayers, so the cost of capital would reduce accordingly. It seems unlikely that the Government would be willing to provide such guarantees.
- 2.3 The practical implication of a split cost of capital would be to increase gearing to over 90% for most companies. This would remove the current diversity of capital structures, make systemic failure more likely and be the precise opposite of what the Government is seeking to achieve.
- 2.4 Dieter Helm’s thesis is that once an asset enters the RAB it is low risk and so should be debt financed with rate of return regulation. This would result in very high levels of gearing as noted in Paragraph 107 of “Financing Networks”.
- 2.5 We dispute that assets in the RAB are low risk. The evidence for this comes most clearly from Railtrack, which was put into administration following the accident at Hatfield in October 2000 because of the condition and cost of maintaining its existing assets. It was assets in its RAB, rather than planned new assets, which caused its downfall.
- 2.6 The reason why assets in the RAB are risky is as follows. The cost of repairing an asset is a function of its replacement cost, which is known technically as the modern equivalent asset (MEA) cost. According to Ofwat the MEA value of the industry’s tangible assets at March 2005 was £222bn. This compares with a RAB at the same date of £36bn. Companies therefore receive a return on the RAB but bear risks on the MEA value of assets, which is over six times larger. This makes ownership of network assets over six times riskier than it appears at first sight, and therefore appropriate for equity investors.
- 2.7 The significance of this distinction between MEA and RAB values is emphasised in a Moody’s report on the UK water sector which was published in March 2006, which tabulates RAB to MEA ratios for each company. The return of capital to shareholders through depreciation allowances is based on MEA values for the water companies, but the return on capital to shareholders is based on RAB values. This approach is sensible, but the consequence is that ownership of assets is significantly riskier than Dr Helm anticipates.

2.8 Whenever an efficient company exceeds its maintenance expenditure allowance, this is caused by risks associated with past investment. The large overspend by Thames Water in AMP3 provides an example of this risk in practice.

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?

UU RESPONSE

Commitment to RABs

- 3.1 There have been several examples of a lack of commitment to RABs by Ofgem, most notably in the revised price review for 1995 – 2000 which took place in 1995. Lesser examples of a lack of commitment include:
- the removal of a value for metering assets from DNO RABs in the 2004 price review; and
 - changes in regulatory rules between price reviews that affects RABs, such as the apportionment of indirect costs and assumed asset lives.

The RAB is widely recognised as the core component of the value of a regulated utility. It is therefore important for investors that historic values are stable and that there is a clear understanding of how and why they will change in the future.

- 3.2 There are two aspects of regulators' commitment to the RAB to consider. The first is where RAB values have been adjusted, so that future income streams have been modified. The most serious example of this was Ofgem's decision to recalculate RAB values in 1995 when it revised the price control review outcome from the previous year. More generally, the issue can be defined in terms of the risk of asset stranding. Ofgem's decision in 2004 to create a separate metering price control for DNOs included the removal of some meter asset value from the Distribution RAB. Transco suffered a similar change in 2002. Removing asset values from the RAB to be exposed to competitive challenges not previously foreseen will inevitably reduce investors' confidence in the stability of the RAB and increase the cost of capital.
- 3.3 The second issue is a lack of consistency in the way that future RAB additions are made. Ofgem have been less consistent than Ofwat in defining the cost categories to be included in RAB additions. For example, non-operational capex is not added directly to the RAB and in the last distribution price control review, a proportion of fault related capex was also omitted from the RAB, while artificial limits were put on the proportion of indirect costs that could be included in RAB additions. Even if these regulatory rules are specified in advance, the frequent changes make it harder for investors to understand the likely track of future RAB values, which also makes it more difficult or more expensive to raise new finance.
- 3.4 Another area of uncertainty is the mechanism by which investment expenditure may be added to the RAB. Ofwat have generally excluded any expenditure that exceeded the values assumed at the time of price setting (so called 'RAB capping'), which means that investments legitimately incurred to meet customers' needs may not be

accepted as part of the future RAB. This creates an asymmetric incentive for investment and discourages discretionary investment. Ofgem have set out criteria to determine whether additional expenditure should be added to the RAB and if so what should be the short-term financial impact. We have yet to see these 'efficiency tests' used in earnest, but hope that they will represent an improvement on RAB capping.

3.5 We believe it would be helpful for regulators to confirm certain principles:

- past decisions about the RAB should not be reopened unless there is clear evidence of error or deception. Changes in market conditions, especially ones initiated by a regulator, should not be used to justify RAB reductions; and
- the definition of 'regulatory capex' should be as stable as possible.

Commitment to Equity

3.6 Turning now to the regulators' commitment to equity, Ofwat was publicly supportive of United Utilities' £1bn rights issue and Ofgem has made more general public statements supportive of conventional equity structures. Recent price control reviews have aimed to address the tax advantages that could be achieved from increased gearing. This is a welcome step, but only represents a partial removal of an incentive to gear up and is not an explicit encouragement for equity funding.

3.7 With investment demands likely to continue to grow in the future, new equity funding will become increasingly important. Investors in utility stocks expect to see good yields and modest dividend growth. Indicators of importance to equity markets (such as dividend cover and dividend growth) will need to be given greater attention and more attractive rewards be offered to companies with a higher proportion of equity finance.

3.8 We welcome the importance that regulators now place on discussions with investors and rating agencies. Such dialogue should help to inform regulators' views on capital market expectations. This is a more appropriate way of incorporating market sentiment than giving rating agencies power over company prospects through licence conditions linked to ratings.

KEY ISSUE FOR DISCUSSION (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?

UU RESPONSE

- 4.1 It is reasonable for regulators to assume a proportion of index-linked debt, but this proportion should be at most the weighted average for the sector as a whole rather than being company specific. Caution is needed because index-linked debt (on reasonable terms) for utilities requires at present that the credit risk is taken by a monoline credit insurance company. The capacity of the monoline market is limited, which needs to be taken into account when assuming index-linked debt across the water and energy sectors.
- 4.2 There are at present only about half a dozen monoline companies active. We do not fully understand why index-linked bonds wrapped by monoline insurers and placed into structures by investment bankers where the index-linked cash flows are passed through the banks' swap books are creating funding opportunities for utilities at present. It is therefore very difficult to say whether these structures are available to both highly levered and conventionally financed utilities. These structures are best described as unreliable over the medium term. Due to the dependence on a limited number of monoline insurers to take the credit risk in respect of utility index-linked debt, this market cannot be relied upon to source the large amounts of financing which may be required by the UK utility sector over the next 10 years.
- 4.3 Index-linked debt does enhance the cash flows and key ratios that are important to rating agencies and providers of debt finance. However, these cash flows should not be considered as available to fund returns to providers of equity since the acquisition of index-linked debt will not enhance distributable reserves.

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?

UU RESPONSE

- 5.1 The only way to address Government concerns about high gearing is to positively incentivise conventional levels of gearing or (equivalently) to negatively incentivise high levels of gearing. This requires that lower overall rates of return be provided to higher geared companies. This idea was first proposed in Colin Mayer's 2004 paper "Commitment and Control in Regulation".
- 5.2 Regulators could achieve this goal by setting prices using actual rather than notional gearing, but Paragraph 66 of "Financing Networks" sensibly rules out this option.
- 5.3 Regulators could continue to use notional gearing of around 55%, but introduce increments/decrements to the cost of capital based on actual gearing, as illustrated below:

Actual Gearing	Increments to Cost of Capital
<60%	+0.5%
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- 5.4 It would be sensible to use an average of the actual level of gearing over (say) the previous five years, to avoid a perverse incentive for a company to temporarily reduce gearing.
- 5.5 There is a precedent for such increments to the cost of capital in Ofwat's treatment of the water-only companies.

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?

UU RESPONSE

- 6.1 We assume this question is referring to the balance between allowed dividend yield and dividend growth for a given cost of equity. Shareholders choose to own utility shares because they are yield rather than growth stocks. It would therefore be unreasonable for regulators to assume high levels of dividend growth, in order to reduce dividend payments in the short-term. To do so would reduce the attractiveness of utilities to equity investors, which would have the opposite effect of that desired by Government.

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?

UU RESPONSE

Indicators

- 7.1 Moody's has just published a very clear paper on how it approaches the rating of water utilities. The market is likely to agree with the agency's approach. It is very unlikely that Ofwat or Ofgem could issue any different metric for evaluating the credit worthiness of utilities that would gain acceptance or have credence with credit investors.
- 7.2 Moody's has pronounced that debt to RAV and adjusted interest cover are the two key credit ratios. It is likely that this will be a self fulfilling prophecy amongst credit investors.
- 7.3 Since credit ratings now feature in many utility licences, it would be perverse for the regulators to seek to circumvent the indicators used by the credit rating agencies to assess these ratings.

Ratings

- 7.4 There would be significant difficulties for companies if the majority of ratings were BBB. Ofwat has stated in connection with the Northumbrian restructuring that BBB flat is an unacceptable credit rating for the UK water sector. It is likely that the credit market would consider it a significant change by regulators if they move the goalposts away from their current location after the game has started. Regulators must recognise that credit investors have already lent. As referred to above, sentiment is extremely important in being able to sell bonds to credit investors whose continuing support for the sector is crucial to financing huge initiatives such as the water framework directive.
- 7.5 In order to finance the enormous amount of funding needed in the UK water sector, it is important that issuers can diversify their sources of funds away from the UK market the size of which is extremely small for long dated issuers carrying a relatively weak credit rating. For some UK utilities to have continuing access to overseas markets is therefore essential. While it may be possible to obtain credit investor support for some long dated BBB rated issues in markets such as the United States, utilities will also need to have access to currency swap facilities with bankers in order to hedge their currency risk on such longer dated issues.
- 7.6 In addition water utilities have very significant interest-rate exposures to manage. Obtaining essential interest rate swap dealing facilities with bankers is much more difficult as a BBB credit.

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?

UU RESPONSE

- 8.1 To profile returns on a nominal basis would involve a step change in bills, which would be undesirable for customers and likely to increase bad debts. It would also sit uncomfortably with the universal expectation that dividends (all other things being equal) will at least grow with inflation.
- 8.2 The conclusion of a comprehensive recent report by Oxera on this issue, was that revenue uplift is the best available option. The question of whether financeability should be NPV positive or NPV neutral has exercised some commentators, but it is worth noting that AMP4 financeability payments for the water industry amount to only 1% of AMP4 revenue and XD4 financeability payments for DNOs are even smaller.
- 8.3 The primary cause of financeability payments is the mismatch between real returns on the RAB vs. nominal interest rates. This mismatch will, however, diminish in future price reviews, because the indexation of investment since 1990 by RPI will start to more than offset the difference between real and nominal returns. Financeability payments will also reduce if regulators assume a market based proportion of index-linked debt.
- 8.4 It has been proposed by some commentators that if financeability payments are needed, they should be NPV neutral. In this context statements by Professor Julian Franks are relevant. He has said that while a CAPM-based WACC is theoretically the right way to set prices, in practice the results of CAPM calculations are so imprecise that financeability is needed as a cross-check. This suggests that financeability payments are corrections to the imprecision of CAPM, not windfalls for companies.
- 8.5 It is clearly possible to avoid NPV positive financeability payments through use of accelerated depreciation and/or repex. To do so requires a departure from a fundamental principle of price setting used by Ofwat since privatisation, namely that:
- maintenance of networks is funded by customers on a “pay as you go” basis; but
 - enhancement of networks is funded by the capital markets, because enhancement benefits current and future generations.

It would be undesirable to depart from this principle for an issue which is affecting water bills by only about 1% pa, and which can be expected to reduce in future years due to the indexation of past investment.

- 8.6 Furthermore the use of accelerated depreciation or repex can have unintended consequences. In particular accelerated depreciation reduces the RAB and therefore can exacerbate financeability problems at future price reviews. The use of repex can create a permanent mismatch between regulation and the requirements of accounting standards.
- 8.7 In overview, the use of NPV positive financeability payments provides a pragmatic method for enabling companies to access the capital markets efficiently without having a material impact on customers' bills.