

RAV premia and implications for the price control

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Introduction

- Long-term businesses, but subject to regular short-interval economic regulation.
- We understand that this is an important issue as it is all too easy to erroneously explain the existence of a RAV premium as the result of generally slack regulation, particularly in respect of the cost of capital.
- Important that we don't force a thin-equity model on the whole sector.

Components of RAV premium

- Cost of capital.
- Expectation of regulatory out-performance.
- Economic conditions.
- Synergies with other businesses.
- Value of other assets or liabilities being acquired.
- Balancing risks as part of a portfolio.
- Market entry.
- A “must-have” trophy for the collection.

Expect that something is left for the buyer

Issues with RAV premium

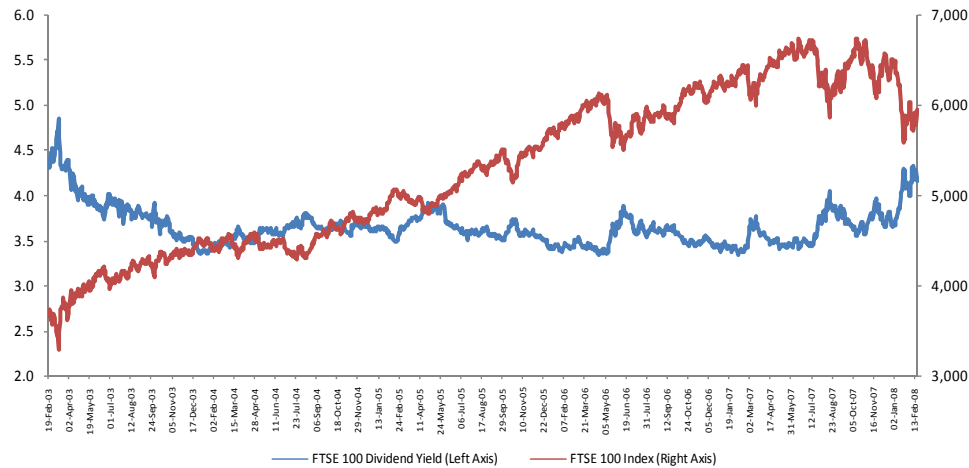
- Represents a snap-shot of a negotiated price of one transaction which brings together all of the specifics of the time and place. As such it is not an indicator of the “right” answer for a whole sector.
- Quoted premium often varies between buyer and seller.
- Often problematic as they rely on estimates to disaggregate the worth of a quoted company.

RAV premium and implied WACC

based on DPCR4 data



Investor returns haven't fallen



Dividend Yield and Index Performance Last 5 Years

P/E ratios

FTSE 100 US + S&P 500 Europe + DJ Euro Stoxx



Source: DATASTREAM

Investor expectations haven't fallen

- Public information we have seen does not indicate that the ultimate equity investors in the thin-equity model expect lower equity returns.
- In a competitive auction for assets, judgments made in modelling are subject to significant uncertainty - making the assumptions deliver a forecast value that wins an auction is easier than making those assumptions come true.
- The most likely outcome is that the investment ultimately fails to yield the forecast benefits. Danger that impetus will be to achieve cost savings *"at all costs"* irrespective of long-term impacts on the asset base or customers.
- Holding company problems have to be isolated. The cost of capital has to relate to the investment grade operating company.

Other factors

- Have some acquisitions been based on flawed and optimistic assumptions?
 - Use of high leverage and index-linked debt to bring down WACC and enhance equity returns.
 - Expectations of long-term out-performance against regulatory targets.
 - Rising RAV to protect against refinancing risk.
 - Belief in an implicit government guarantee.
- Interesting that existing asset owners don't seem to be participating in these transactions.

Are we storing trouble for the years ahead?

Rating agencies

- Ofgem has consistently taken the view that an investment grade credit rating provides sufficient evidence of an appropriate financing structure and that its concern is with the ring-fenced entity only.
- Ratings are a snapshot and are subject to change. They measure the probability of a short to medium term default on debt, not an assessment of whether a company can finance its activities. They are not perfect as a long-term predictor of financial stability.
- Need to look at different ratios to capture the profile issues relating to index-linked debt. Cash based ratios may not be the most appropriate.
- Limitations on their effectiveness in measuring stress requires other monitoring.

Failure is a possibility (1)

- There are some striking similarities to some of the important features of the sub-prime scenario.
 - Financial engineering is being brought to bear to introduce margins to asset-backed securities that are unlikely to be sustainable in the long-term.
 - Assumptions are effectively made that the future will take care of itself - but the valuations either accept, or worse ignore, very credible risks that, if realised, can lead to extremely damaging situations.
 - Ultimately, the customers will have to be served and protected - and that will inevitably fall to the government in the absence of a promptly available, viable solution.

Failure is a possibility (2)

- In the case of sub-prime and its impact, the concerns were recognised but action was not taken because it was assumed that the existing arrangements would work out and that the market would deal with the fall-out.
- Within the regulated sector we might think that as long as regulated assets have a worth there will be a range of willing buyers. Therefore the *"lights will stay on"* and any financial turmoil will be experienced elsewhere.
- But at what price and over what time?
- The UK example shows that the market, or a regulator, does not necessarily deal with all of the results of such inactivity.

Are we entering a period of more intrusive regulation?

Conclusions

Conclusions (1)

- One-size does not fit all.
- A high premium is likely to be an indication of over-optimistic assumptions, and the upfront cash flow of index-linked bonds, rather than evidencing a decline in required equity returns.
- We believe that companies with a more traditional equity structure are essential to the long-term sustainability of the sector. It is critical that Ofgem avoids an approach that places an incentive on such companies to dilute their equity holding or to exit the sector.
- Underlying risks have only increased.
- Recent operational experiences, e.g. floods, and changing obligations, demonstrate the need for immediately available cash reserves.
- Cost of equity hasn't changed - it certainly hasn't reduced.

Conclusions (2)

- Leveraged financial structures in regulated networks have much in common with the sub-prime and financial sectors.
 - Rapidly increasing leverage.
 - Reliance on tranching debt and credit ratings.
 - Underestimation of refinancing risks.
 - Optimistic assumptions on efficiency - out-performance assumed in perpetuity.
 - Scope for imprudent or abusive treatment of some financing.
 - Inherently less resilient to financial shocks.
- The most likely outcome is a sequence of events in which:
 - The fund managers take their fees.
 - The incentives created put significant pressure on management to talk up and underspend.
 - The investment never realises the expected returns.
 - The asset is eventually sold at a mark down, if sold to a rational investor, otherwise the obligation has to be assumed by the government.

CE Electric

- Whatever other investors assume, in the real world CE Electric is experiencing:
 - Sustained rises in commodity/raw material costs driven by an expanded global market place and supplier consolidation.
 - Increased lead times and inability to fix prices.
 - Increases in contract rates due to a more competitive market place for service provision.
 - Marked increase in faults and site security costs (copper theft).
 - Volatility in weather patterns leading to increased fault costs from storms and negative impact on income.
- CE Electric needs to work with Ofgem to ensure that the price control settlement:
 - Gives proper incentives to long-term investors and operators.
 - Allows the appropriate funding for the long-term investment needs of the company.
 - Doesn't encourage properly capitalised organisations to adopt higher risk structures.

Impact on DPCR5

Ofgem must:

- Consider the usual key components of cost of equity, cost of debt and gearing.
- In addition, consider the robustness of the financing arrangements in the context of:
 - *the credit crunch;*
 - *the application of index-linked bonds;*
 - *high gearing; and*
 - *credit ratings.*
- Discourage further thin-capitalisation.
- Balance the scope of regulation between:
 - *A focus on the regulated business; and*
 - *An overview of holding company structures.*