

REGULATORS AND CREDIT RATINGS

By John Reynolds

ELEVEN UK utilities with around £30 billion of debt have been allowed to finance their activities based on a credit rating process that is not designed for this purpose. These utilities supply vital services to most of the UK. UK utility regulators have trusted in credit ratings for more than a decade. This was always a mis-use of ratings, but now flies in the face of increasing evidence that ratings can be dangerously wrong (eg Northern Rock). Regulators have allowed increasing debt levels, at a time when the impact of extreme weather and global warming is causing severe financial shocks to utilities. The regulators' reliance on credit ratings now looks dangerous and out of date.

The UK's economic regulators have a legal duty to secure that licence holders are able to finance their activities. Regulators interpret this as ensuring that companies are not over-leveraged, which regulators have achieved by a combination of requiring "investment grade" credit ratings to be given, and a secure "ring-fence" around the regulated legal entity. In the mid-90s, when utilities were first subject to takeovers, there were no "securitisations". Now, there are at least 11 securitisations in the utilities sector: in electricity (eg Electricity North West), water (eg Thames) and gas (eg Wales & West), as well as BAA in the airports sector. The securitised utilities have nearly £30 billion of borrowings; BAA on its own has £13 billion.

Overseas regulators set their own debt benchmark figures. Two major problems have emerged with the UK regulators' approach: first, with the credibility of credit ratings; and second, with the stability that can be created by the ring-fence.

There has been a series of systematic errors in credit ratings, across many of the world's major industry groupings – not just individual companies but entire sectors have been affected. Looking just at events over this decade, the list is staggering: power and energy (the independent power producer sector in 2001-4, including Enron); telecoms and media (major telcos including Worldcom); financial institutions (Northern Rock); and property (the US subprime sector).

Christopher Dodd, chairman of the US Senate's Banking Committee has questioned why rating agencies had assigned "AAA ratings to securities that never deserved them."

President Sarkozy of France highlighted the problem, saying: "The warnings we are issuing to credit rating agencies have to be heeded. We want the sort of capitalism which encourages entrepreneurship, not speculation."

It is also at least arguable that the regulators are abusing credit ratings. The rating agency Fitch in its definition of a BBB rating states that these "indicate that there are currently expectations of low credit risk." Note the use of "currently": the rating agencies clearly use a probabilistic approach, and state that ratings are not immutable, whereas the leveraged financing structures allowed by regulators may need to stay in place for 25 years. The credit rating downgrade of some monoline insurers, who guarantee the higher risk "junior" debt in many securitisations, highlights the degree of systematic change possible over even relatively short timeframes.

There has been a strong and coherent argument supporting leveraged financing structures in utilities: high leverage focuses management attention on delivery to tight budgets, and reduces the

cost of capital thereby allowing lower tariffs. The corollary of this is that it may also reduce flexibility. Decision making by utilities dealing with a crisis should not involve seeking permission from creditors to spend money. Given typical restrictions in leveraged finance agreements, it is perfectly plausible to envisage circumstances when this is exactly what would be required.

Last summer saw widespread devastating floods across many parts of the UK. These affected all types of infrastructure, including utilities. Fortunately, the utilities affected such as Severn Trent Water, Central Networks in the Midlands and CE Electric in the North East are owned by well capitalised holding companies. Severn Trent alone reported costs of £25-35 million to respond to the floods. It is increasingly important that utility companies are able to withstand a financial shock: global warming is causing freak weather, and the financial flexibility required by utilities needs to increase if they are to be able to respond immediately and effectively to the type of incident seen in the summer.

Regulators have powers to impose cash lock-ups on licensed utilities, and to apply for special administration if a company cannot finance its activities. These are both problematic: a cash lock-up can be imposed, but if a company has no cash at the time, it will still not have immediate access to funds. Special administration is not straightforward: an administrator's duties in some areas conflict with those of a regulator. An administrator is appointed by a court and has a duty to a company's creditors, whereas regulators have duties regarding customers, such as the economic delivery of services and security of supply. The flaws and conflicts in the Special Administration process have been shown with both Railtrack and Metronet.

If a regulated utility cannot finance its activities, there are three unpalatable possible consequences: the utility can be bailed out by the Government (eg Northern Rock); the utility's creditors can take control (eg through administration), threatening service levels; or tariffs can be increased, the outcome that lenders and investors have bet on when financing buy-outs. This represents a transfer of risk and responsibility from the company to its customers.

Our regulators – Ofgem, Ofwat, the CAA and the ORR – all have access to significant investment banking and capital markets expertise (Alistair Buchanan, the Ofgem CEO, is a highly experienced investment banker himself). The increasingly prevalent model of financing infrastructure with very long-term structures using only a small proportion of equity finance – Electricity North West and Southern Water were both subject to leveraged acquisitions at the end of 2007 – covers a range of 11 water, electricity and gas companies totalling nearly £30 billion of debt, with at least one service in all parts of the UK except the Midlands affected. There is now sufficient evidence that credit ratings are not a suitable method for regulators to discharge their legal duty (to ensure that companies can finance their licensed activities) to require a move to a more bespoke approach. High debt levels have helped keep tariffs low. Are low tariffs more important than keeping the lights on and the water flowing?

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