4 February 2011

Bank of America Merrill Lynch Response to Ofgem Consultation on RIIO-T1 and GD1 Financial Issues

Responses Focused on Chapter 3 – Allowed Return

Q. 5 Is our proposed mechanism for indexing the cost of debt assumption appropriate?

Q.6 How should we account for the costs of issuing debt?

We have set out our comments split by question below.

Question 5:

The attraction of the current method for setting the cost of debt for companies is its ultimate simplicity – a single fixed rate off which all companies are benchmarked. With the downward trend in underlying Gilt yields in recent years it appears that Ofgem feel it may have missed out on an opportunity to extract value for consumers. The implementation of a backwards-looking debt indexation mechanism has in itself led to suspicions that Ofgem is looking to "claw back" excess revenues just at a time when underlying Gilt yields look likely to be on an upward trend.

There are a number of aspects of the proposed indexation structure that we fear may result in issues for utility borrowers in any implementation. We summarise as follows:

(a) The trailing 10-year average presupposes an even and level capital expenditure plan, and it would seem to have the potential to penalise companies in a high capex (and high borrowing) phase;
(b) By rightly considering the practical methodology for imposing cost of debt indexation, Ofgem is embedding such inflexibility in its future cost of capital decisions that its methodology will not survive the first serious test to its integrity;
(c) The choice of index constituents appears to present practical issues that may manifest themselves in financial penalties and volatility in the future; and
(d) The calculation of a real cost of debt for the index from nominal yields using implied inflation expectations could create significant distortions

Evidence suggests the profile of capital expenditure for the electricity and gas transmission and distribution sectors is not even when considered over periods of 5, 7 or 10 years. A trailing 10-year index gives no allowance for any requirement to raise debt substantially above an average level to reflect significant medium-term investment requirements. An index would seem to increase the potential to penalise even the most efficient companies in situations where capex and funding exceeds an average level. Of course this effect could work in reverse, but there seems little prospect at present of declining capital spending requirements. Given the proposal more broadly for the deferral of cash flows to utilities through extended asset depreciation lives, in turn increasing the upfront financing burden, this could be exacerbated under RIIO. Over

time the actual cost of debt versus the implied index cost of debt could diverge materially, creating a drag on returns irrespective of performance. The rationale for not using some weighting based on RAV additions is having regard to simplicity. The impact of simplicity is that there may be some margin for error that penalises efficient companies, and this may remove the incentive to outperform on financing costs.

Ofgem is rightly concerned with proposing not just a microeconomic theory, but more importantly a practical and workable implementation thereof. Nevertheless, the broad range of implementation options considered only highlights the added complexity of introducing a workable cost of debt indexation. There are significant difficulties in designing a practical solution that would produce a financeable and "fair" outcome in a wide variety of future scenarios. Ofgem is proposing to embed such inflexibility in its future cost of capital decisions that its methodology risks not surviving the first serious test to its integrity.

In the evidence presented by Ofgem it is argued that there is little differentiation between the cost of debt for 10-year bonds and longer issues. We have misgivings regarding the use of corporate indices with constituent bonds with average maturities of 5-8 years, versus the natural funding profile for utilities being at maturities closer to 20-30 years, if not longer. Examining the profile of the Merrill Lynch Sterling Corporate Single A and Triple B indices, which are used as performance benchmarks by many investors in the UK market, and which we would expect to have a comparable profile to those used by Bloomberg or iBoxx, we find that the Single A index had an effective duration over the last three years ranging from 7-8 years, while the Triple B index had an effective duration over the same period ranging from 6-7 years. Shorter-dated bonds can expect to have lower volatility and smaller shifts in yields versus longer-dated instruments. This would seem to penalise borrowers from considering longer-dated issuance.

We are concerned about the practical aspects of deriving an indexed real cost of debt from nominal yields in corporate indices. Taking the trailing nominal yield of the index and then subtracting a market implied inflation rate based upon the index-linked Gilt market introduces new risk and variability to the cost of debt. If a utility were to borrow index-linked debt, it would pay a credit spread over the real yield quoted on an index-linked Gilt. A comparatively small proportion of utility debt is issued in this manner, and certainly none is issued at ten-year maturities. The great majority of fixed rate debt is issued as nominal debt instruments. The implied break-even inflation rate between nominal Gilts and index-linked Gilts is subject to a number of factors beyond simply market expectations of inflation outcomes. The actions of pension schemes and insurance companies pursuing liability-driven hedging activities can create distortions between nominal and index-linked Gilts. These may persist for some period of time. Why should utilities face the risk of a punitively low cost of debt assumption solely because the implied market inflation was unexpectedly high? The indexation approach proposed by Ofgem forces a mismatch between observed (for RAV) and predicted (for the cost of debt) inflation, which must introduce distortions and additional uncertainty.

We believe this introduces an additional level of risk in the cost of debt which is beyond the control of an efficient company.

We prefer the method where a cost of credit, including the costs of debt issuance, is derived for an efficient company. If there is a need to introduce indexation of cost, then we would argue the great majority of volatility in fixed rates for borrowing is derived from moves in the underlying Gilt yields. Instead of the proposed corporate indices, we would argue Ofgem define a cost of credit and apply it to an index of Gilt yields. This could be an average of 10-year and 30-year Gilts, or some appropriate liquid Gilt benchmarks. We would recommend using nominal Gilts as the reference benchmarks. In order to derive some real cost of debt, Ofgem may use some appropriate long-term inflation assumption rather than a market derived measure. This combination of yield indexation and fixed credit cost would provide some clarity and stability over the cost of credit – allowing for a clear efficiency target – while at the same time allowing some measure of changing yield environment to be reflected in the cost of debt.

We retain our concerns regarding the timeframe for any index yield calculation measured against the scale and timing for capex and borrowing at the individual utility level – short-term spikes in borrowing to fund a step-up in investment could result in a punitive impact on returns.

Question 6:

Capital markets endure periods of volatility and flux, which to some degree is reflected in an index, albeit on a far smaller scale given the trailing average nature of that index. This volatility is reflected in the secondary trading levels of bonds and would, therefore, be captured by the proposed indexation. However, secondary trading prices and yields reflect comparatively small trading volumes. For borrowers seeking larger amounts of capital, as with all new bond issues, then investors tend to demand a premium to the cost of funds implied in secondary trading. This is a well established formula in the debt capital markets. The range of new issue premium varies with market conditions. In strong market conditions this may be as small as 5-15 basis points. In poor market conditions this could be as much as 50 basis points or more. These costs should be incorporated into an assessment of the likely cost of credit for an efficient borrower, but they would not be automatically included into an index. In late 2007, some double A rated borrowers were paying a premium to their Credit Default Swap ("CDS") of 40-50 basis points to issue bonds. Continuing into 2008 some European utilities rated in the single A category were paying premia as high as 150 basis points to CDS for the same maturity debt.

At the same time, it is not possible for companies to issue bonds in small sizes, say £5-10 million, each day or as investment needs arise and to achieve an efficient cost of funding. There is not enough investor appetite for securities issued in this manner, and there are comparatively higher administrative costs to such a route. Consequently borrowers need to have short-term borrowing arrangements (e.g. medium-term bank

facilities, commercial paper, backstop facilities). These facilities have commitment and arrangement fees that, we would argue, need to be factored into an efficient company's financing costs. As a practical example, UK regulated utilities that are not part of much larger groups tend to arrange for revolving credit facilities from banks to cover 12-24 months of their annual capex, typically 10-15% of RAV. The undrawn portion of these facilities include an annual commitment fee of c.50bps running even before arrangement and administration fees are taken into account.

As Ofgem notes from Europe Economics' analysis, utility borrowers are typically more than two-thirds funded with fixed rate debt. But this does mean at least one-third of that financing would not be appropriately benchmarked against a fixed rate index. We would argue that providing a fixed cost of credit for utility borrowers would allow for the companies to choose and manage their cost of debt efficiently according to their preferences. Separately, each company could manage its fixed rate or floating rate cost of debt against a clear and transparent Gilt benchmark – a fixed rate or an index.