



Liberum Capital Limited
Ropemaker Place, Level 12
25 Ropemaker Street
London EC2Y 9LY

Tel: +44 (0)20 3100 2000
Fax: +44 (0)20 3100 2299
www.liberumcapital.com

To whom it may concern
Ofgem
9 Millbank
SW1P 3GE
London

31 January 2011

Dear Sir or Madam

Re: RIIO-T1 Overview Paper

I am writing a response to the RIIO-T1 Overview Paper published by Ofgem in December 2010.

I am writing in the capacity of both an investor and sector analyst in the UK utility industry. For 5 years until June last year I ran a Utility fund within Credit Suisse Securities Europe. I have been an industry analyst on the sell-side at Liberum Capital from October to present. I have been a major investor in equity in UK infrastructure (and believe I am an important stakeholder in regulatory reviews on UK utilities.) I would like to add my comments to the debate surrounding the next regulatory review.

There are 6 key points I would like to comment on.

1) Firstly I would like to show my appreciation for allowing consultation on this important change in regulation and the process that Ofgem is undertaking to encourage debate.

2) Cash-flows.

Changing the duration of cash-flows in theory should have little NPV impact if the allowed returns are in line with those required. In theory this is indeed correct, but we believe that this misses some very important real-world investment practicalities such as the fact that the required return will need to rise and that stakeholders do not always look at an RCV based NPV methodology.

UK utilities already receive a cash-flow return that puts a large degree of value on future growth rather than cash today. This is the nature of an RPI-linked return. However the long-duration for cash-flow return means that investors are aware that there remain significant risks associated with these investments and need compensating with adequate returns. To demonstrate this, the following chart (see overpage) shows the cash flow profile for a £100mn investment in a RCV (Regulated Capital Value) asset with 2.5% RPI and 5.1% plain vanilla real return. If the life of the asset is extended the cash-flows per annum are lowered – in this case from £9mn in the first year to £6.5mn, a 27% fall in revenues. However, the total amount of cash paid by the end consumer rises in nominal terms by 65% (from £240mn to £400mn). There are three things to note from this:

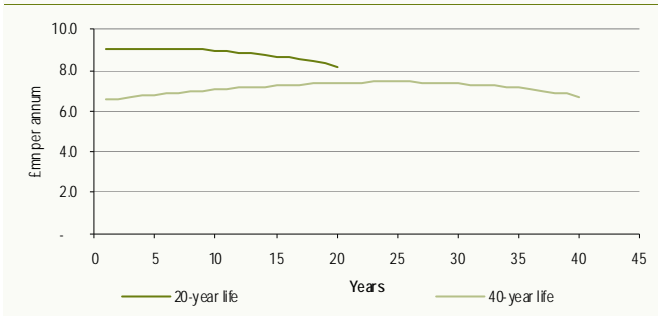
a) Firstly, the cash-flow duration increases. We calculated that under the cash-flow profiles in Figure 1, the duration for investors rises from 10.5 years to 21 years. To show the impact of this on returns, in Figure 2 we show the UK yield curve. It can be seen that as the time for redemption rises from 10 years to 20 years the required annual return rises by up to 40bps. We would expect a similar increase in credit margins and ERP (Equity Risk premium) as well. We present credit default swaps for UK utilities out to 10-years in Figure 3 and it can be seen that the CDS increases with increasing duration. If the regulator were to adopt a higher duration cash-flow, we believe that investors will need a higher allowed return of up to 80bps over the standard 10-year

CAPM model. We believe that the long duration associated with water stocks cash-flows is one of the reasons why water utilities receive higher returns than energy utilities.

b) Secondly I would like to make is that equity investors do not exclusively use an RCV based method to value utility companies. There are a number of other complimentary methods. We believe that the one of the main methods is the EV/EBITDA multiple. If a utility has a 20-year life and based on the assumption in Figure 1, we see that the EV/EBITDA of incremental investment (ie year 1) is at approximately 9.5x. However if a 40-year life was to be introduced then we see EV/EBITDA for an incremental investment rising to 12.5x EV/EBITDA. This is a high headline EV/EBITDA and it makes it more difficult in my view to find investors willing to finance a company where incremental investment should trade on such a high multiple.

c) Thirdly is that interest paid on these returns is in nominal terms. This means that as cash-flows are deferred, the portion that is used to pay interest costs increases leaving less cash to invest in the network or to compensate equity investors. In a steady-state asset, equity investors are relying evermore on growth rather than cash which yet further pushes risk onto equity investors and means that investors need to be found with an increased risk appetite. In our view these are not the current shareholders and it may take a significant level of time to find a new shareholder base.

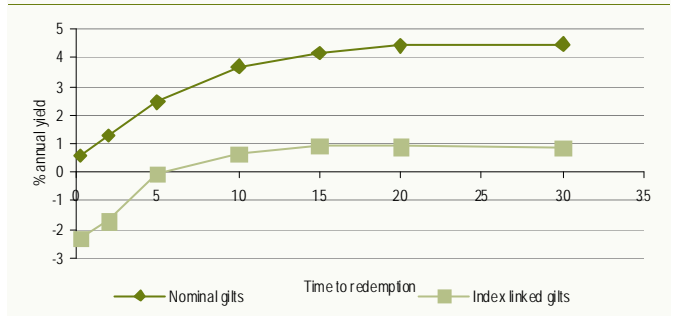
Figure 1: Nominal post-tax cash flows with 20 and 40 year asset life



Source: Liberum Capital Estimates

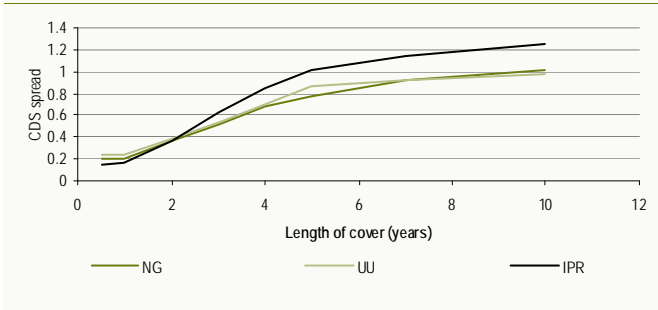
Assumes £100m investment 2.5% inflation and 5.1% plain vanilla real returns

Figure 2: UK Gilt Yield Curve



Source: Bloomberg

Figure 3: CDS spreads increase with increasing tenure



Source: Bloomberg

3) Cost of debt

In section 8.16 you state your preferred cost of debt methodology as a 10-year trailing average of BBB and A rated bonds. As the investment burden of these networks increases significantly, the weighted average capital requirement will be significantly closer to the current time period than 10 years ago. We see a mechanical process with a simple arithmetic average as increasing the potential mismatch between the actual cost of debt and the recovery. This calculation could therefore have the opposite impact to its intention in trying to encourage regulatory stability for both equity and debt providers.

4) Allowed returns

Equity holders add equity to investment in UK infrastructure through retained earnings and potential new equity raises. We see the allowed returns quoted in section 8.19 as unhelpful. The range quoted (4.0 – 7.2% post-tax real) has an outcome at the bottom end wholly inadequate for equity investors and even at the top end returns are not sufficient given the scale of future investment required in some of these networks and potential reduced cash-flows. The 5-year and 10-year inflation expectations from the bond markets are currently 2.7% and 3.2% respectively. An equity return at the bottom of the range, 4.0% post-tax real is between 6.7%-7.2% nominal (and even at the top of Ofgem's range is only around 10% which is not excessive for these assets in our view). 10-year risk free yields are currently 3.7% and with a 200bp credit spread we would expect a credit investor should be receiving 5.7% returns. A 100bp income pick-up from credit to equity is too low in our view, in reality investors would be far better to invest in credit at 5.7% rather than equity at 6.7%.

5) Global utility returns are more attractive except at higher end of quoted range

When I was running the global utility fund within Credit Suisse, we had an option to invest in any utility globally. The other two main global RCV-based compensation markets are the US and Italy. We invested in US utilities providing returns no less than 9% on equity in new investments, and we invested in Italy where returns were a basic 6.4% pre-tax real (with a further 3% 12-year kicker for new investments). The underlying returns on a like-for-like basis in Italy were 4.3% post-tax real before the 3% new-investment incentive. We see equity returns in Italy for new investment in double-digits.

The range quoted for UK equity returns, prompts a real concern that there is therefore not a large enough incentive in our view to have remained an investor in UK utilities. We would only consider investing in the UK when the stocks traded at a sufficient discount to RCV to provide an adequate return. There are two follow-on impacts in taking shareholders for granted. 1) They provide investment capital through retained earnings (which are significantly higher than the headline accounting treatment due to the RPI component of the allowed returns) and this will become harder to justify and 2) as these stocks lose shareholder support the equity buffer for credit providers will diminish and credit will become harder to find at an economical rate.

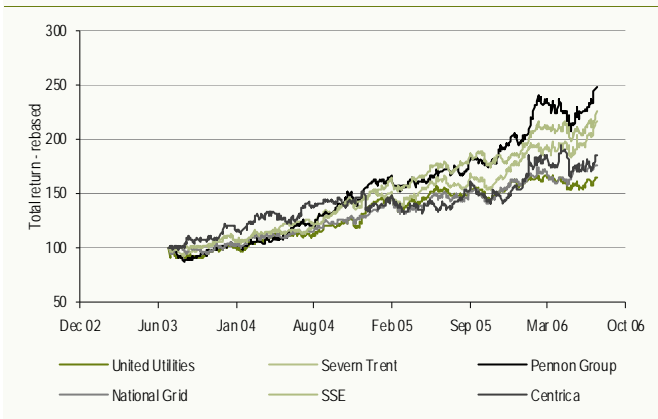
With the UK needed up to £300bn in infrastructure investment over the coming decade, a further £3,000bn needed in Europe over the same period and the US likely to need a similar amount starting in 5-years time, we do not think reducing returns to this low level will incentivise investment into the UK.

6) Equity capital raises only happen with a gun to investors' heads

Equity capital providers do contribute to the ongoing success of an investment programme through retained earnings and potentially providing equity in capital raises. These capital raises are always going to be successful if a gun is held at their heads with significant dilution if existing investors do not subscribe. The only two sizeable capital raises in the previous 8 years are United Utilities and National Grid. The following charts show the performance of these stocks following a rights issue (in both cases to provide capital for an investment programme). United Utilities underperformed the other UK water stocks over the next 5-years considerably and sentiment towards the company never fully recovered. In the case of National Grid, where the majority of the rights issue was to essentially underpin the UK investment programme, the stock has since been the UK's worst performer and valuing the US business at a blended average of their peer group (Consolidated Edison and NU/NStar, 40% premium to US earnings base) the market is valuing the UK at a 5% discount to RCV. This is not

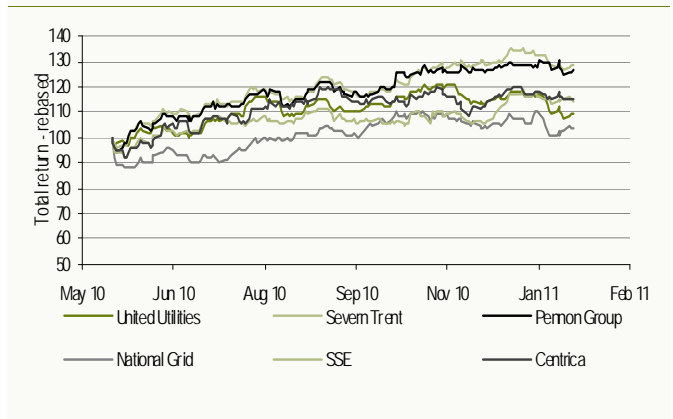
a good starting point before an investment programme of the size now facing the UK and we believe that with the right regulation and incentives, equity holders can provide the equity capital to ensure the new investment in infrastructure can happen whilst not forcing existing shareholders to slowly exit the sector.

Figure 3: UK utility total returns following UU rights



Source: Datastream

Figure 4: UK utility total returns following NG rights



Source: Datastream

In summary my belief is that Ofgem is at risk of taking shareholders for granted with an increased risk profile and inadequate returns. In the current global investment market where capital supply should not be assumed there is a serious danger that the needed investment in this important infrastructure may not be possible.

Yours sincerely,

Dominic Nash
Analyst