

**Financeability: What Happens Next?
A Discussion Note Prepared by First Economics****12 April 2006****1. Introduction**

This short note provides comments on the discussion of financeability in the joint Ofgem/Ofwat consultation paper Financing Networks.¹

With responses due in to the regulators by 5 May 2006, the purpose of the note is to identify how the debate about the need for and form of financeability adjustments might develop, and to highlight some of the issues that companies ought to take account of as they write their submissions.

2. Context

Like many other organisations, we found the Ofgem/Ofwat paper to be an extremely helpful (if somewhat overdue) explanation of the basis for adjustments to allowed revenues in the 2004 electricity distribution and water periodic reviews. Financeability is an issue that regulators have in the past found difficult to debate openly and the detailed discussion in Financing Networks fills a gap in what is normally a very transparent UK regulatory system. The debate that the paper has started is something that we think all parts of the privatised utility sector ought to welcome as it should ultimately lead to greater understanding and more predictability at the outcome of future reviews.

Perhaps because the consultation document is the first real occasion on which the regulators have explained the full logic behind their approach to financeability it deliberately stops short of giving a firm steer on the way in which Ofgem and Ofwat might deal with financeability at future reviews. Instead, the paper invites consultees to give their views on what looks to be a fairly comprehensive list of the options that regulators might wish to consider (each presented in an objective and dispassionate manner).

In responding to this invitation, it is essential that companies appreciate fully the nature of the 'problem' that the options are intended to solve. This is not something that the paper goes out of its way to make 100% clear, but it is a point that we think is worth highlighting again. As we explained in our original paper on this issue,² the origins of previous financeability adjustments lie ultimately in:

- the trend increase in levels of gearing among companies across regulated sectors; and
- the growing mismatch that this leads to between the real (index-linked) returns earned by companies on regulatory asset bases ('RABs') and the nominal interest rates payable on most debt.

Ofgem and Ofwat (in common with most regulators) have to date chosen to inflate the RAB in line with the retail prices index and have set allowed returns equal to companies'

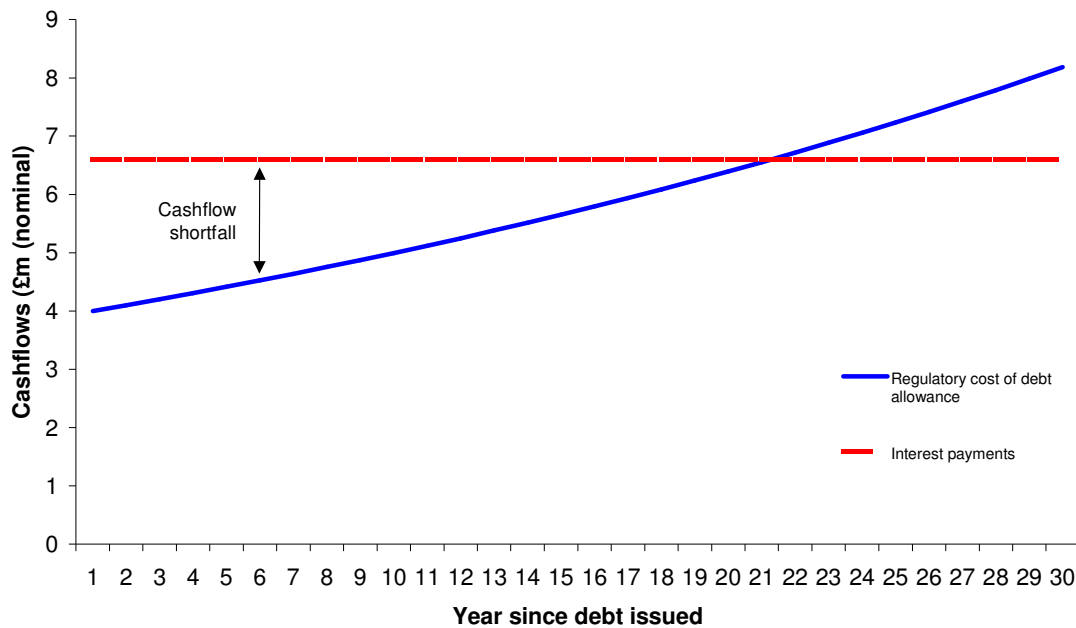
¹ Ofgem/Ofwat (2006), 'Financing Networks: A Discussion Paper', available at www.ofgem.gov.uk.

² First Economics (2005), 'Financeability: The Key Issue In Regulation Today?', available at www.first-economics.com.

real cost of capital, so that compensation for the effects of inflation comes mainly³ as the RAB is depreciated over time. Since depreciation in most industries is profiled over periods of 20 years or more, this means that regulators have, in effect, been spreading compensation for inflation over multiple control periods rather than ask customers to pay upfront when the erosion of companies' financial investment is first felt.

This contrasts with the way in which companies typically remunerate lenders for the financing that they make available to a business. Most⁴ debt is structured so that companies pay an annual interest rate set in nominal terms and pay back the original (uninflated) principal after a fixed period of time. This produces a stark difference in the timing with which interest payments go out to lenders and the equivalent revenue comes in from customers, significantly lowering cashflow for companies that rely heavily on debt finance. Figure 1, by way of an example, shows the cashflow implications for a company paying interest at 6.6% per annum (a real cost of debt, in regulatory terms, of 4.0% per annum) on debts of £100m.

Figure 1: The mismatch in cashflow



In purely economic terms, the profile of a company's revenues should have little bearing on its attractiveness to investors; all that ought to matter is the net present value of future revenues less future costs. However, in practice, lenders and rating agencies typically want to be sure that there is a sufficient buffer in a company's annual revenues and look to measures of cashflow relative to interest payments when assessing default risk. At a certain level of gearing, the timing difference becomes too much for rating agencies to accept and it becomes necessary for regulators to provide companies with additional

³ Some compensation is also provided as the (real) cost of capital is earned on that element of the RAB that reflects past indexation, but these amounts tend to be small in the years immediately after an investment is included in the RAB.

⁴ Although index-linked bonds and inflation swaps have become more widely used in recent years, across regulated sectors as a whole only a small proportion of debt is currently raised on this basis.

revenue in order for companies to maintain the sort of credit rating they require in order to finance what in most sectors is a substantial investment programme.

For so long as this is the case – and there is a worthwhile debate to be had about whether rating agencies are placing too much emphasis on cashflow-based cover ratios – the financeability ‘problem’ cannot be analysed sensibly without looking at the mismatch between the conventional approach to setting returns and the requirements of lenders. For an increasingly large number of companies, the way in which regulators compensate for the effects of inflation has become disconnected to the way that companies compensate investors.

3. Evaluating the alternative options

When taking forward their work on financeability, we think that regulators will eventually have to address head on the justification for compensating companies for the effects of inflation through the indexation of the RAB. There are two possibilities. Either:

- the existing regulatory approach is sound and the profile of (cash) interest payments that companies make to lenders should have no direct bearing on the calculation of allowed revenues; or
- in economic terms, prices should, in fact, be set at a level that provides compensation for the eroding effect of inflation on past investment upfront (i.e. at the point when inflation is first felt).

In all of the recent discussion about financeability, we have not seen any attempt to analyse the way in which efficient prices in a capital intensive industry should, as a basic matter of principle, be set. This need not be just a theoretical question; in a whole range of other industries, companies set prices at a level that allows them to recoup investment from customers over time. How do they deal with inflation? Are other capital-intensive companies satisfied earning their real cost of capital each year or do they expect to be compensated for inflation on a profile that better matches their interest bill? We think that the absence to date of any work on this subject is a significant omission. Is it just an historical accident that regulators allow companies to earn a profit equal to their real cost of capital or can they put forward a sound economic basis for this policy?

It is an important question because, in our view, the evaluation of the different options set out in the Ofgem/Ofwat paper has to be founded on some assessment of whether the mismatch between the real return on the RAB and nominal interest payments to lenders ought to continue. If it should, options which focus on companies developing solutions that enable them to finance the resulting profile of cashflows are likely to become the focus of attention. If the mismatch is inappropriate and should be eliminated, it is the regulatory solutions that need to be explored.

3.1 Financing

One of the interesting features of recent determinations is that companies which appear to have more vulnerable financial profiles than those apparent in regulators’ notional balance sheets appear to have been able to obtain and maintain credit ratings comfortably within investment grade. To some this implies that regulators have taken too cautious a line on the ratios that companies would need to maintain over the next five

years. Perhaps, for example, Ofwat ought to have considered the minimum level of adjusted interest cover to be 1.5x rather than 1.6x. Maybe Ofgem should have set the threshold level of FFO interest cover nearer 2.5x than 3.0x.

In future reviews, companies can be certain that regulators will want to examine in some detail the point at which an efficient company would begin to find it difficult to raise new finance. If regulators have concluded that allowed returns should continue to be set on a real basis, this exercise may become one in which a key question is whether the financial structures that companies are adopting are properly suited to financing the profile of long-term cashflows produced by the regulators' methodology for compensating for inflation. They may well feel that adjustments to allowed revenues are only appropriate if companies have first entered into financing arrangements that maximise their capacity to deal with index-linked returns.

Expecting companies to use greater quantities of index-linked debt is one possibility. Rather than just characterise a notional balance sheet as one in which there is a certain mix of debt and equity, regulators might go further and assume that this notional balance sheet contains a given balance between index-linked and nominal debt. Another possibility is that regulators might begin to look at the assessment of financeability in the same way as the assessment of comparative efficiency. In setting opex allowances, regulators assume that there is an efficiency frontier; perhaps there is also an efficiency frontier for financing? Maybe the calculation of allowed revenues should be based on the balance sheet of the company that is best equipped to deal with the provision of a real cost of capital and the relatively low annual cashflow that this produces?

At the very least, we think a useful exercise in the next stage of the Ofgem/Ofwat consultation process would be to examine whether some types of financing arrangement are better suited than others to deal with the mismatch in real returns and nominal interest payments. One place to start could be the covenants in recently issued debt. By how much do interest cover covenants differ from company to company? Why do these differences exist? We think that this sort of analysis would help to reveal how regulated companies ought to finance themselves in a world in which it is accepted that price limits should only provide a return in line with the real cost of capital. Financeability adjustments would then only be made if even the most efficiently financed companies found cashflow too weak to sustain an appropriate credit rating.

3.2 Regulatory reform

The other path that the Ofgem/Ofwat work might take is one in which the regulators come to recognise that it is simply inappropriate for them to go on compensating for the effects of inflation through the indexation of the RAB. In such circumstances, there are two main mechanisms through which compensation for inflation can be brought forward:

- a straight switch to setting returns in line with the nominal cost of capital; and
- a twin-track approach in which some of the compensation for inflation continues to be provided through the RAB but some is brought forward into annual returns.

In most regulated industries, the first option causes quite severe difficulties. Although the switch does not affect the net present value (NPV) of future revenues, the one-off change in prices that the change produces is so great as to present a significant burden to

customers. It is essentially a binary option in which there are only two extreme outcomes, neither of which appear to represent an appropriate balance between the interests of investors and the interests of users.

By contrast, the second option is much more flexible and would allow regulators to tailor allowed revenues to circumstances in much the same way as the financeability adjustments that have been seen in the past. It is sometimes crudely characterised as 'advancing depreciation', but could in fact be presented in a number of different ways (for example, an entirely separate component of allowed revenues labelled 'inflation compensation').

The obvious difference to the financeability adjustments seen in Ofgem's and Ofwat's previous reviews is that a change in the timing of the compensation of inflation is NPV neutral in nature. If companies consider that financeability can only be secured through the payment of a long-term premium on the cost of capital, our advice would be that they have yet to demonstrate this convincingly to policy makers. That said, we would expect the work that the regulators undertake after the close of the consultation period to examine in detail whether there are undesirable implications of a change in the profile of inflation compensation which more than outweigh the benefits of a NPV neutral solution to the financeability problem.

4. Conclusion

Further insights into the way in which regulators are currently thinking will be provided at the joint Ofgem/Ofwat seminar on 27 April 2006. We suggest that companies look carefully for insights into whether the regulators see the 'problem' as one of financing, which companies should solve, or a regulatory one, which they must themselves deal with.

Looking further ahead, we expect Ofgem and Ofwat to put out a follow up document later in the year. It is not clear at present what that document might say and how far it will seek to settle the approach that the two regulators will take in future reviews. One constraint that they face is that developments in other sectors may well overtake the joint Ofgem/Ofwat work and begin to define regulatory 'best practice' in a way that the two regulators will have no choice but to take account of. Here we are thinking particularly of a report from the Competition Commission next year on price caps at BAA's Heathrow, Gatwick and Stansted airports, where the continuation of a large-scale investment programme in new capacity in the south east of England is likely to expose the mismatch between the real cost of capital and nominal interest payments to an even greater extent than the 2004 electricity distribution and water periodic reviews. The Commission may well feel in its inquiry that it has to deal with financeability from first principles, in which case the choices that we have highlighted in relation to compensation for inflation become highly relevant. Other industries might therefore wish to keep a careful eye on BAA's review as it develops over the course of the next 18 months.