

Emma Cochrane
Head of Corporate Finance
Ofwat
Centre City Tower
Birmingham
B5 4UA

Direct line 01925 463001
Direct fax 01925 463957
clive.elphick@uuplc.co.uk

Martin Crouch
Director – Electricity Distribution Regulation
Ofgem
9 Millbank
London
SW1 3GE

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FINANCING NETWORKS

1. INTRODUCTION

I am responding on behalf of United Utilities (UU) to the Ofwat/Ofgem discussion paper “Financing Networks”. UU is the only British company regulated by both Ofwat and Ofgem, so we have a particular interest in the issues raised in the paper.

Attached are our views on the eight issues for discussion set out in Section 8 of your paper.

This covering letter provides our views on the two over-arching issues addressed by the discussion paper, namely the public policy consequences of increased gearing and the role of financeability in price setting.

2. CONSEQUENCES OF INCREASED GEARING

2.1 Developments since Privatisation

The gearing of network companies has increased dramatically since privatisation as a result of both:

- debt financed investment to enhance the networks, which has been anticipated by regulators in price setting; and

- corporate transactions, special dividends and share buy-backs, which have not been anticipated in price setting.

The Government expressed concern about increased gearing, following the special administration of Railtrack. Their concern was that risks previously borne by shareholders could transfer to customers and/or taxpayers.

In paragraph 69 of “Financing Networks” you clarify that the risks of high gearing are borne by creditors and shareholders, rather than customer or taxpayers. We welcome this clarification and the signal it sends to creditors. It is, however, the case that if one utility gets into financial distress, this can be expected to increase the cost of capital for all utilities.

2.2 Risks Of Owning Networks

Dr Dieter Helm’s thesis is that once an asset enters the RAB it is low risk and so should be debt financed with rate of return regulation. This would result in very high levels of gearing as noted in Paragraph 107 of “Financing Networks”.

We dispute that assets in the RAB are low risk. The evidence for this comes most clearly from Railtrack, which was put into administration following the accident at Hatfield in October 2000 because of the cost of maintaining its existing assets. It was assets in its RAB, rather than planned new assets, which caused its downfall.

The reason why assets in the RAB are risky is as follows. The cost of repairing an asset is a function of its replacement cost, which is known technically as the modern equivalent asset (MEA) cost. According to Ofwat the MEA value of the industry’s tangible assets at March 2005 was £222bn. This compares with a RAB at the same date of £36bn. Companies therefore receive a return on the RAB but bear risks on the MEA value of assets, which is over six times larger. This makes ownership of network assets over six times riskier than it appears at first sight, and therefore appropriate for equity investors.

The significance of this distinction between MEA and RAB values is emphasised in a Moody’s report on the UK water sector which was published in March 2006, which tabulates RAB to MEA ratios for each company. The return of capital to shareholders through depreciation allowances is based on MEA values for the water companies, but the return on capital to shareholders is based on RAB values. This approach is sensible, but the consequence is that ownership of assets is significantly riskier than Dr Helm anticipates.

Investors have chosen to invest in utilities on the basis that the company will earn the weighted average cost of capital on its RAB. For the RAB to only earn the cost of debt would involve a retrospective change and jeopardise investor confidence in the regulatory regimes.

2.3 Long-Term Stewardship

Network assets have lives that are measured in decades and even centuries. As a result, network owners should take decisions about their assets from a long-term perspective, and avoid short-term ‘asset sweating’.

Professor Colin Mayer is of the view that owners need to demonstrate long-term “commitment” to their networks, which is more likely if they are conventionally geared. A highly geared company with an exit strategy, such as a private equity owner, could take short-term decisions that lead to poor customer service long after the owner has exited. The goal should be to align the long-term interests of shareholders and customers.

2.4 Incentives For Equity

Ofwat and Ofgem have sought to remove the tax incentive to gear-up by using a post-tax cost of capital. Nevertheless the current indications are that more utilities will become highly geared because of acquisitions by financial owners such as infrastructure funds and private equity firms.

Paragraph 91 of “Financing Networks” makes the case that incentives for equity were increased in the 2004 price reviews because the returns to equity were increased. We dispute this logic. Returns to equity were increased but using notional levels of gearing. This means that irrespective of actual gearing, a higher return is being earned on 45% of RAB for water companies and 42.5% of RAB for DNOs. The best way to increase share prices in this context is to spread the higher return on as small an equity base as possible. In other words, it can be argued that the approach taken in PR04 is encouraging companies to gear up!

2.5 A Possible Solution

The only way to address Government concerns about high gearing is to positively incentivise conventional levels of gearing or (equivalently) to negatively incentivise high levels of gearing. This requires that lower overall rates of return be provided to higher geared companies. This idea was first proposed in Colin Mayer’s 2004 paper entitled “Commitment and Control in Regulation”.

Regulators could achieve this goal by setting prices using actual rather than notional gearing, but Paragraph 66 of “Financing Networks” sensibly rules out this option.

Regulators could continue to use notional gearing of around 55%, but introduce increments/decrements to the cost of capital based on actual gearing, as illustrated below:

Actual Gearing	Increments to Cost of Capital
<60%	+0.5%
60 – 70%	+0.25%
70 – 80%	0%
80 – 90%	-0.25%
>90%	-0.5%

It would be sensible to use an average of the actual level of gearing over (say) the previous five years, to avoid a perverse incentive for a company to temporarily reduce gearing.

There is a precedent for such increments to the cost of capital in Ofwat’s treatment of the water-only companies.

3 **FINANCEABILITY**

The financeability payments made to water companies in PR04 increased bills by about 1% on average from 2005-10. The payments made to DNOs over this period increased bills by much less than 1%. Given this modest impact on customers, financeability has attracted a disproportionate amount of attention from regulatory commentators.

The primary cause of financeability payments is the mismatch between real returns on the RAB vs. nominal interest rates. This mismatch will, however, diminish in future price reviews, because the indexation of investment since 1990 by RPI will start to more than offset the difference between real and nominal returns. Financeability payments will also reduce if regulators assume a market based proportion of index-linked debt.

It has been proposed by some commentators that if financeability payments are needed, they should be NPV neutral. In this context statements by Professor Julian Franks at the Ofwat/Ofgem seminar on “Financing Networks” are relevant. He said that while a CAPM-based WACC is theoretically the right way to set prices, in practice the results of CAPM calculations are so imprecise that financeability is needed as a cross-check. This suggests that financeability payments are corrections to the imprecision of CAPM, not windfalls for companies.

It is clearly possible to avoid NPV positive financeability payments through use of accelerated depreciation and/or repex. To do so requires a departure from a fundamental principle of price setting used by Ofwat since privatisation, namely that:

- maintenance of networks is funded by customers on a “pay as you go” basis; but

- enhancement of networks is funded by the capital markets, because enhancement benefits current and future generations.

It would be undesirable to depart from this principle for an issue which is affecting water bills by only about 1% pa, and which can be expected to reduce in future years due to the indexation of past investment.

Furthermore the use of accelerated depreciation or repex can have unintended consequences. In particular accelerated depreciation reduces the RAB and therefore can exacerbate financeability problems at future price reviews. The use of repex can create a permanent mismatch between regulation and the requirements of accounting standards.

In overview, the use of NPV positive financeability payments provides a pragmatic method for enabling companies to access the capital markets efficiently without having a material impact on customers' bills.

If you would like to meet to discuss this response I would be pleased to do so.

Yours sincerely

Clive Elphick
Chief Operating Officer - Transformation
United Utilities North West