19 FINANCEABILITY

Keith Mason

Introduction

The regulated utilities sector is typically characterised by being capital intensive. This has been the case since privatisation for the water companies, and is increasingly characteristic of other regulated sectors, such as energy. These capital programmes have significantly improved the quality of service and performance that companies achieve. Continuing large capital programmes can place a financing strain on the companies and is therefore an important consideration for regulators in determining price limits. For example, in the water sector it is clear that a consequence of requiring companies, even efficient ones, to undertake large capital programmes is persistent negative cash flow. This can lead to a deterioration in credit quality which could restrict the access of companies to capital markets, despite earning their cost of capital, or could significantly increase the cost of finance. This could jeopardise their ability to deliver services and the improvements required.

An important consideration for regulators, therefore, is whether companies are 'financeable' when determining price limits or in other words, whether efficient companies' revenues, profits and cash flows enable them to access the financial markets at reasonable cost.[1] In practice, financeability issues arise from a number of interrelated factors which are discussed in this chapter.

First, I want to go back to basics and explain the basic principles of the price setting process in the water industry, and what

[1] Ofwat (2004), Future Water and Sewerage Charges 2005-10, Final Determinations, December.

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factors may give rise to the financing strain referred to above. I will then summarise how regulators have dealt with the financeability issue at previous reviews (in particular Ofwat and Ofgem). This chapter then draws out some of the financial issues explored in a joint discussion paper, Financing Networks published by these regulators in February 2006, which regulators, companies and investors have usefully explored in the build up to the next price limit review for each sector.[2] This paper includes a discussion of proposals that have been put forward in relation to wider regulatory reform, including the concept of a 'split cost of capital' on new and past investment (put forward most notably by Dieter Helm).[3] I will touch on these related issues as well as the alternative approaches to the financeability that were set out in the financing networks paper. I will conclude this chapter by setting out Ofwat's next steps following the financing networks project.

The price setting process

Each company needs to collect sufficient revenue to cover its operating expenditure and to finance its capital investment programme. It also needs to be able to finance previous capital investment through the return the company earns on its regulatory capital value (this is the capital base used in setting price limits and represents the value of the regulated business that earns a return on investment) and to take account of its use through depreciation. In addition, the water industry pays tax. We also allow for any incentive allowance for out performance in the previous five-year period. The sum of these costs is called the revenue requirement. This is shown in **Figure 1** below:

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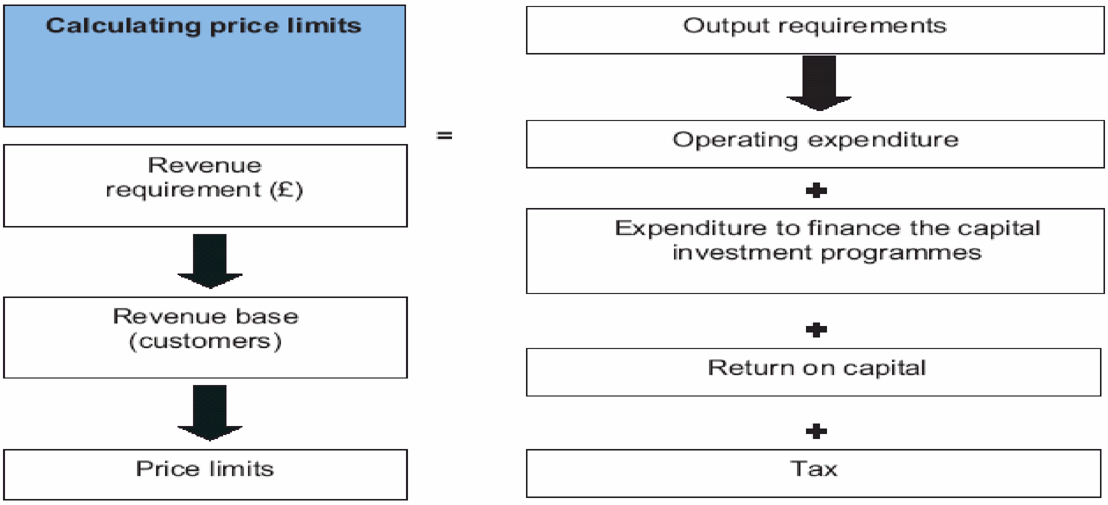
[2] Ofwat and Ofgem (2006), Financing Networks: A Discussion Paper, February.

[3] For example, Helm D (2003), Whither Water Regulation, in Helm D Water, Sustainability and Regulation, Oxera, May; Helm D (2006), Ownership, Utility Regulation and Financial Structures: An Emerging Model, 14 January 2006. Available at www.dieterhelm.co.uk.

Figure 1: The revenue requirements



The return on capital above represents each company's weighted average cost of capital multiplied by its regulatory capital value. The return on capital is particularly important. Ofwat has a primary duty to secure that the functions of each undertaker are properly carried out and that they are able to finance their functions, in particular by securing a reasonable rate of return on their capital. Very significant capital programmes have been a feature of the water industry – some £70bn will have been spent from privatisation to the end of the current price period (2010).

Customers' annual bills do not provide for the annual capital expenditure on a pound for pound basis. Rather, there is an element of customers' annual bills that allows for the investment over the economic life of the asset, once constructed. This is done by way of the depreciation charge. Therefore companies need to raise, via the capital markets, the difference between annual expenditure and revenue allowed to cover the annual depreciation charge. Providers of this capital expect to be rewarded for their investment ie, via interest payments or dividends. Therefore, Ofwat must allow a return on capital sufficient to attract investors.

Ofwat assumes that companies can earn a return equal to their weighted average cost of capital (WACC). The 'weighting' is by means of an assumption of how much debt and equity is invested in the business. At the price review in 2004 Ofwat assumed that 55% of investment was provided by debt and 45% by equity (ie, 55% gearing). Therefore, based on Ofwat's assumption of the cost of debt of 4.3%, and the cost of equity of 7.7%, this gave an overall real weighted average cost of capital (WACC) of 5.8% (or 5.1% on a fully post tax basis).

The cash flow gap

Where the level and treatment of capital expenditure (including the approach to depreciation) under a particular regulator's methodology is such that companies' capital bases are increasing quickly over time then significant new injections of debt or equity finance will be required in order to finance the purchase of fixed assets. In setting price controls Ofgem and Ofwat have assumed that when such circumstances arise most of the new finance comes from debt. Generally this reliance on the debt markets has been mirrored in companies' actual financing strategies. This tends to lead to pressure on key financial ratios (such as interest coverage) that are used by credit rating agencies to assess companies' credit quality.

But there is another factor to consider. And that is the mismatch in the timing between how the regulatory model calculates the amount that can be recovered from customers as an allowed return and companies' actual payments to investors in any one year. When we set price limits we model a real return. Because the value of the money investors lend upfront is eroded over time by inflation, investors need to be compensated. This is achieved in the regulatory model by increasing the capital base on which returns are allowed by RPI. This ensures that over the life of the asset the company has adequate revenues to make payments to investors. The absolute value of this return can be recovered from customers and therefore is part of the revenue allowance.

Providers of equity finance generally accept compensation for inflation via real dividend growth and the increase in equity provided by the inflation of the capital base, ie, the regulatory capital value. However, generally speaking debt providers – eg, large banks and the bond markets, traditionally expect immediate compensation for inflation via their interest payments. So, companies will pay a nominal interest rate that includes an expectation of the rate of inflation over the life of the loan they have taken out. The absolute value of this nominal interest payments are a cash outflow of the business.

The different approaches to compensation for inflation employed by the regulator and investors can produce a stark difference in the timing between payments to investors and revenue recovery from customers. We refer to this as the 'cashflow gap' in the financing networks paper. This cash flow gap unwinds over time but in the shorter term can put pressure on the companies' financial projections because the company has to borrow more to finance this cashflow gap. This extra borrowing is in addition to the capital required to finance the investment in the first place.

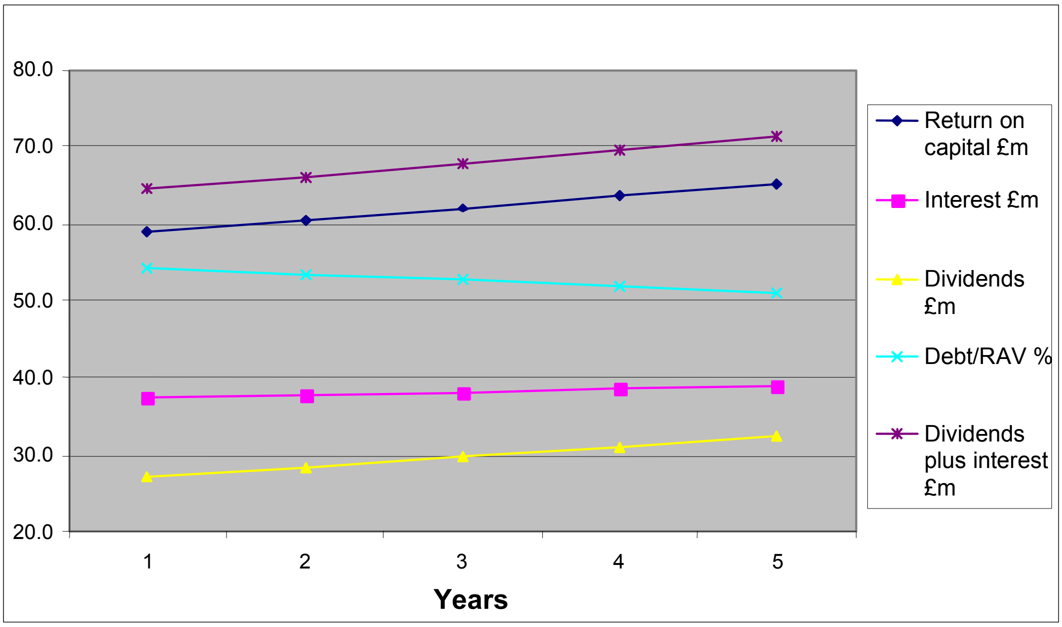
Figures 2 and **3** illustrate this point. They are based on generalised financial assumptions used by Ofwat at the price review in 2004 (see **Table 1** below).

Figure 2 is for an illustrative company in steady state, where regulatory depreciation is equal to annual capital expenditure (ie, no real growth in the regulatory capital value). There is no requirement for the company to raise additional capital from the markets other than to finance the cash flow gap. But because the capital base is stable in real terms and the level of equity invested in the business is assumed to grow each year (in line with retained earnings and inflation of the RCV) then the proportion of debt finance or gearing declines over time. The level of revenues increases more quickly than interest payments and debt-based ratios improve over time. In these circumstances debt-based financial ratios should not act as a constraint on the regulator in determining price control revenue because they will not be indicative of a company whose credit quality is at risk of deterioration.

Table 1: Generalised financial assumptions

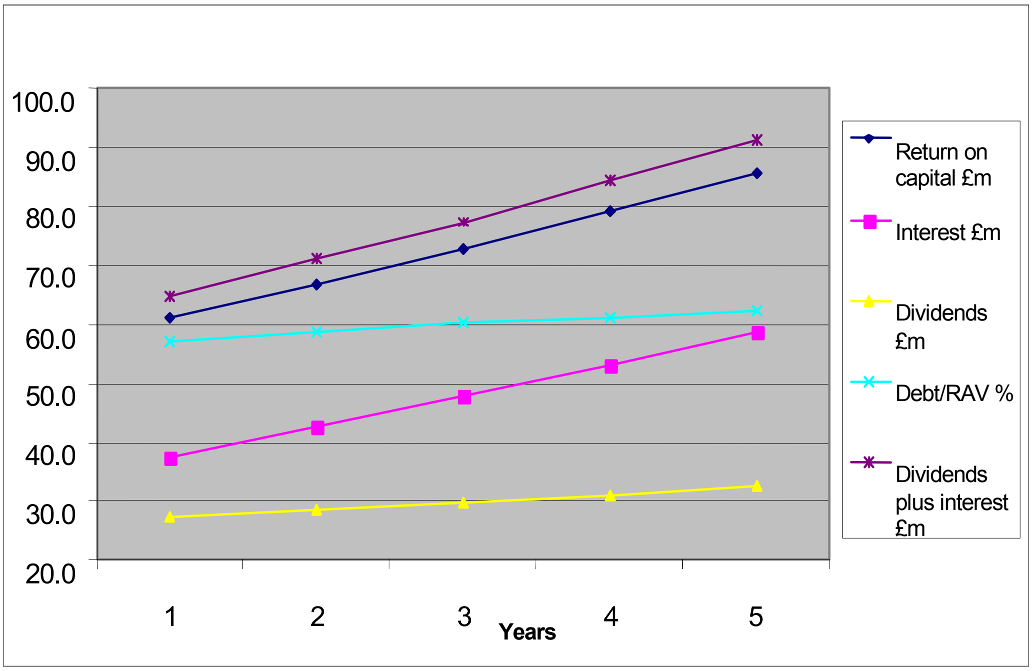
	Assumption
Real vanilla WACC (pre tax cost of debt and post tax cost of equity	5.8%
Real cost of debt	4.3%
Real cost of equity	7.7%
Dividend yield	5.8%
Dividend growth	1.9%
Initial gearing	55%
Annual Inflation	2.5%
Average asset life remaining for depreciation	25 years
Level of infrastructure renewals expenditure	1.25% of RAV

Figure 2: Real returns vs nominal interest and dividends - steady state



However, in the situation where a significant capital programme must be undertaken, annual capital expenditure will exceed regulatory depreciation. In this example the combination of the borrowing required to finance real growth in the capital base and to close the cash flow gap exceeds growth in equity arising from the assumption of retained earnings and the inflation of the capital base. Consequently, the proportion of debt finance, or gearing, increases each year as shown in Figure 3.

Figure 3: Real return vs nominal interest and dividends - capital programme



This increasing gearing puts pressure on the metrics used by the credit rating agencies to assess a company's financial position and could ultimately lead to a deterioration in credit quality. As long as companies are required to undertake significant capital programmes it would appear that the pressure on gearing and financial ratios is perpetuated.

How have regulators addressed financeability in the past?

At previous price control reviews, both Ofwat and Ofgem have emphasised the importance of strong credit quality for the companies they regulate in the context of the significant capital investment programmes they are required to deliver. Both regulators have taken steps to ensure that price limits are set to allow the companies to sustain credit quality well within investment grade ratings. The financial indicators used to assess companies' financeability are consistent with such ratings. In a number of cases Ofwat allowed extra revenue to ensure that the level and trend of these indicators would be consistent with these objectives (the financeability or revenue uplift). However, this solution leads to higher bills for customers because the additional revenue allowed feeds straight through, pound for pound, into customers' bills. Ofwat assumed a generic level of gearing and used the same package of indicators for all companies, regardless of their actual capital structure and associated debt covenants.

Ofgem made a similar adjustment for one electricity distribution business in its 2004 electricity distribution price control review, but the materiality of the adjustment was small. Financing constraints have been less acute in electricity distribution because Ofgem has adopted an approach that involves allowing accelerated depreciation in price limits, which also increases cash flow and improves financial ratios. This approach, whilst increasing customers' bills in the shorter term, will theoretically be net present value neutral in the longer term because depreciation charges will be correspondingly lower in the future.

Ofwat did not assume full distribution of the equity component of the cost of capital. An element was retained to mitigate the financeability issue. Ofwat has been clear in its statements to the City that amounts allowed for financeability are not a matter of simply providing higher returns for the companies to disburse in dividends. Ofwat does not intend to claw back the financeability uplift allowed in price limits determined in 2004. But the decision to increase companies' revenues in certain cases came with a warning that we would expect prudent companies to retain an appropriate proportion of earnings to alleviate the financial strain caused by heavy capital programmes, both in the current period and beyond 2010. In the context of continuing high levels of capital investment, the combination of revenue uplift and assumptions on dividend growth and yields were judged to be appropriate in order to continue to attract capital (both debt and equity) to the water sector, and to allow companies to maintain adequate credit quality based on projected ratios over the price limit period.

This approach, and in particular whether it is sustainable, has been the subject of considerable debate since price limits were finalised in 2004. One criticism of Ofwat's revenue uplift is that it was not been implemented in a net present value neutral way. Some commentators have argued that the impact of financeability revenues on returns is one factor that has led to a re-rating of the utilities and the current apparent willingness of acquirers to pay significant premiums to companies' regulatory asset values. Others have expressed concern that regulators have relied too heavily on the metrics used by credit rating agencies to assess financeability. Ofwat and Ofgem continue to think that their approaches were appropriate given the circumstances leading to the final determinations in 2004. Nevertheless, it has been appropriate to consider how best to address these matters in the future.

The financeability issue has had to be addressed by other regulators, although specific circumstances in particular sectors has meant that it has not necessarily been such a major area of debate compared to the water sector. For example, the CAA's approach in the latest airports review has been to put the onus on the new owner of the airports to introduce a financing structure that is designed to support future investment, and as such it has said that it did not expect to carry out an assessment of financeability as part of the review process. The Office of Rail Regulation has acknowledged that its approach to setting access charges must not make it unduly difficult for the company to finance its relevant activities. However, it notes that under current arrangements, whereby all of Network Rail's debt is supported by government, issues of financeability are less relevant because investors are largely protected from business risk.

The Financing Networks discussion paper

Back in 2004 the Treasury and the Department of Trade and Industry (DTI) expressed concern about the proportion of debt finance used by regulated businesses and whether there were any new ideas for encouraging equity to remain in the utility sector.[4] This was in the context of concerns about some very highly geared structures emerging in the utility sector in the years after the 1999 price reviews. There were also concerns about the 'flight from equity' from utilities to other opportunities, particularly the 'TMT' sectors but in retrospect the 'dot.com boom' was short lived and can be seen as a bubble. As a consequence of these concerns, Ofwat and Ofgem undertook a study on these issues and produced the financing networks discussion paper. Ofgem and Ofwat carried out this study after completing their respective price determinations in 2004 but widened the scope of the original remit to recognise that the markets have moved on since the report was initially commissioned.

Four main topics were covered in the financing networks paper:

- Issues relating to capital structure, and specifically the impact of relatively highly leveraged structures on management incentives and the ability of management to deliver efficient levels of investment. It also deals with questions around the robustness of debt markets and the implications for regulated businesses (including highly leveraged companies) of possible disruption to these markets.

- Issues relating to how levels of gearing impact on the regulatory framework. The financial ring-fencing arrangements are explained and the importance of them in ensuring that regulated businesses continue to have access to debt finance on reasonable

[4] Department of Trade and Industry and HM Treasury (2004), The Drivers and Public Policy, Consequences of Increased Gearing: A Report by the DTI, October.

terms. In this context there is a discussion about whether highly leveraged structures will restrict a regulator's ability to require companies to fund capital expenditure programmes. The paper also explains the 'special administration' regime and discusses the impact of financial distress, on capital expenditure programmes, the costs of financial distress, and where these might fall.

- As context for the debate on proposals for encouraging equity investment, the paper set out recent developments in the approach to setting price controls and the likely effect of these on the incentives for the equity financing of regulated businesses. It then discusses the ideas that have been advanced for reducing the uncertainty around the risk of allowed revenues for capital investment, including the ideas of Dr Dieter Helm and Professor Colin Mayer.

- Whether aspects of the present approach to setting price controls make it unduly difficult for utilities to finance their activities. Subsequently it discussed a number of options for dealing with these financeability constraints and asked whether regulators should change their approaches, which at present tends to take the metrics used by the credit rating agencies to assess financial robustness.

In the remaining part of this chapter I draw out some of the debate on two important ongoing regulatory issues that run through the financing networks discussion paper – the concept of 'regulatory commitment' and, secondly, how regulators should approach financeability issues in the future. I provide background on each – drawing heavily from the financing networks paper – then set out respondents' views. I finish by explaining the regulators' next steps.

Regulatory commitment

The financing networks paper summarised a number of proposals for regulatory reform. A common theme is how regulators deal with the issue of regulatory commitment. This issue arises because there is an inherent timing mismatch between the current five-yearly price setting cycle and the much longer timeframe for financing regulated businesses. Uncertainty in the financial markets about future price control reviews and the allowed cost of capital tends to increase the regulatory risk premium in the cost of capital. Given that the capital expenditure programmes of regulated businesses can extend out over many years (and more than one price period) it is important to consider whether regulation should adapt to deal with these timing issues. This is exactly what the proponents of reform have done by challenging regulators to consider ways of reducing regulatory risk to allow for the efficient funding of capital investment. This could benefit customers if it resulted in a lower cost of capital.

Dr Dieter Helm has been at the forefront in challenging regulators' current approaches. Central to his proposals for improving regulators' commitment to allowed financing costs is the so-called 'split cost of capital'. The details of his proposals are set out elsewhere, but his basic argument is that once investment has been added to the capital base (and there needs to be clear rules for this) it is relatively low risk and is suitable for debt finance (Helm 2003 and 2006). He suggests that managing the day to day operations of the business and project managing new investment is higher risk (as there are added uncertainties around procurement, project management and whether outturn expenditure is fully reflected in the capital base) and so should attract a higher return consistent with the provision of equity capital. Helm's package of reforms also includes the idea of indexing the cost of capital using appropriate market indicators eg, for debt financing using current bond yields. This would differ from the existing approach where regulators set the cost of capital every five years. He suggests that this would reduce the regulatory risk created by the interaction of the current five-year price control cycle and regulated businesses needing to finance investment over a longer time scale.

Helm believes that overall his package of reforms would result in a lower cost of capital for regulated businesses because a very significant proportion of the business would be funded by debt finance and any 'regulatory risk premium' in the cost of capital would be reduced. In his analysis he recognises that the cost of equity, for the risks involved in operating the business, would need to be higher than currently allowed by Ofwat and Ofgem and more akin to those required by service providers.

Other suggestions for improving regulatory commitment include setting price limits or some elements of the price limit package (eg, the cost of capital) for longer than the current five year period. For example, Keith Palmer in his foreword to the financing networks paper suggested that the need for regulatory commitment might be addressed by setting allowed revenues in respect of depreciation and the cost of capital – for sunk capital and capital expected to be incurred over the forthcoming review period – for the full life of those assets (or at least for a considerably longer period than five years). In his view this approach would reduce regulatory uncertainty and should therefore lower the cost of capital and strengthen companies' credit quality as assessed by ratings agencies. He recognises that a downside of this approach is that it would lock-in the allowed cost of capital and preclude consumers from benefiting in the event that companies refinance their debt at a lower cost in the future.

The length of the period between price reviews has an impact on the strength of regulatory commitment. Ofwat has recently consulted on the length of the price control to be set in 2009. The overwhelming response was that Ofwat should set price limits for five years in 2009 and this is what it recently concluded.[5] The five-year cycle represents an appropriate balance between stability and incentives, and the need to be flexible to changing circumstances. The five year cycle also has the advantage of being well understood and established. In our view major change

[5] Ofwat (2006), A Sustainable Water Industry – To PR09 and Beyond, October.

could potentially add to (as oppose to reduce) perceptions of regulatory risk or uncertainty and potentially increase the cost of capital to these businesses. However there has been considerable debate recently about the need to provide a longer term planning horizon – beyond the traditional five year price setting cycle – to allow and encourage companies to take a more strategic approach to planning their investment and service provision. Ultimately such an approach should benefit customers by improving long term efficiency.

In particular, we intend to set price limits within a longer-term context and to do this we will ask each company to publish a strategic direction statement before it prepares its draft business plan. The strategic direction statement will set out for consultation with consumers, other stakeholders and Ofwat, the priorities the company sets itself for the next five years and beyond, with an early indication of what that will mean for consumers. Each statement should cover at least the following areas: resources; drinking water quality issues; environmental priorities and obligations; capital maintenance; consumer service; scope for efficiencies; and financing issues.

We will be asking companies to highlight any large projects and when they might be needed, and any other significant investment needs. Companies can choose their own format for the draft statements. We expect them to be presented in a consumer-friendly way. We have proposed that companies publish their statements, and consult consumers and stakeholders on their strategies as they formulate their business plans. Each company should send us its strategic direction statement when it is ready, and at the latest by December 2007. We have also suggested that the companies may also wish to discuss their strategies earlier with us as they are developing them. We will discuss each company's statement with them.

For the 2004 review companies provided longer-term views on capital maintenance and 25-year water resource plans. When companies submit draft and final business plans for the period

2010-15, we will expect these to include a 25-year forward look. We will expect each company to review the costs and benefits of its proposals and to set these out clearly.

Financeability

The work that Ofwat has been doing on scenario modelling has reinforced the view that a large capital programme beyond 2010 is likely.[6] The financial markets continue to place considerable weight on financial ratios, particularly debt to RCV, so the issue of maintaining access to the capital markets is not going to go away. Given the earlier analysis set out in this paper you might think this would give rise to even more significant financeability problems.

But in some respects the markets themselves have moved on since the price limits were set. The financing networks discussion paper points up the potential of the increased appetite for, and capacity of, the index-linked debt market, improved conditions for equity injections and rights issues, or a more flexible interpretation of financial indicators as ways of mitigating, or removing completely, financeability issues. For example, index-linked debt more closely aligns the interest payments a company must make on its debt with the revenue it receives under the price limits we set. This would have the effect of improving a company’s short term financial cash interest coverage profiles. At its 2004 price review, Ofwat did not make an assumption of the proportion of index-linked debt in companies’ balance sheet. The discussion paper explained that regulators could also deal with issues of financeability in setting price controls by accelerating depreciation or using a nominal cost of capital to reduce pressure on cash flow.

All of the options discussed in the financing networks Paper would have different impacts on consumers' bills and the timing

[6] Ofwat (2003), Water Industry Forward Look 2010-30: Some Possible Views of the Future, March.

of investors' returns. All need to be considered in relation to the objectives of not unnecessarily increasing perceptions of regulatory risk and ensuring that risks are allocated to the parties best able to manage the risk in a cost effective manner. Respondents' views on these alternative approaches are set out in the next section.

Summary of responses to the Financing Networks paper

The overall thrust of the responses from the regulated companies and investors is opposition to radical change, general support for the regulatory framework and recent developments, and calls for more consistency and stability. The overall tone of the responses was that there was no need for radical reform.

Regulatory reform

There was quite strong opposition to the concept of a 'split cost of capital' on new and past investment because it was felt that this would increase regulatory risk, and changing the regulatory regime in such a fundamental way would undermine investor expectations of the returns they receive on their investment. Other problems cited with this proposal include an unhelpful diminution of the role of equity, and the difficulties of separating the risks associated with asset growth from asset maintenance. Two conclusions reached by the majority of respondents were:

- that it will lead to an increase in the proportion of debt finance in companies' financial structure (in the electricity and water sectors assets under construction typically form only a small proportion of the overall asset base. Therefore, respondents argued, if equity was used to fund only operating costs and the delivery of new investment, then it would play only a limited role in the financial structure of companies within these sectors);

- that of itself it will not lead to a reduction in risk and therefore the overall cost of capital will remain the same and that risk can only be reduced if it is transferred elsewhere.

Respondents felt that the proposals by Helm understate the nature of the risk of the capital base (RCV). They consider the RCV to carry significant risk not least because a large proportion of a regulated businesses capital expenditure relates to the maintenance of assets contained in it. At the seminar the example of Railtrack and the Hatfield rail crash was cited as an example of the risk associated with existing assets in the RCV.

There was some support however for the idea that a differential cost of capital could be applied to large investment projects. Heathrow's Terminal Five construction project is cited as an example where such a regulatory approach has been applied. However, respondents note that the vast majority of investment projects undertaken in the water, electricity and gas sectors are relatively small and limited in duration, although it is recognised that this may not remain the case in the future. That said, it is widely recognised that Helm's proposals have brought focus to the debate of how risk is allocated in utility businesses, and also how important regulatory commitment can be in reducing the overall risk of these businesses. A constant theme emerging from the seminar was the principle that greater regulatory commitment and transparency would lead to improved investor confidence, and was cited in relation to the appetite for issues of new equity.

Alternative approaches to financeability

There were a variety of views on the alternative approaches to financeability but most felt that because of the scale of investment required, regulators were right to test for it, and that there may be a need for regulatory intervention under some conditions.

There is a mixed view about whether regulators should assume that companies' debt portfolios comprise a proportion of index-linked debt. Some water sector respondents were of the view that this would be a reasonable regulatory assumption, subject to certain caveats, for example:

- that it would be reasonable only if it is apparent that this is what the sector is doing in practice;

- that any assumed proportion should be limited to the weighted average for the sector.

However, energy sector respondents were generally of the view that decisions on the overall mix of debt instruments in a company's portfolio should be taken by companies and not the regulator, and this is consistent with a view that decisions on capital structure lie with companies. It was generally recognised that whilst index-linked debt may help cash flow in the short term, it does not fundamentally alter the debt position of the company going forward.

On the role of equity, a number of respondents make the point that equity funding is already available, particularly to well run companies. Evidence cited for this is the rights issue by United Utilities and the fact that equity funding has been available to facilitate the acquisition of the gas distribution networks in 2005, and more recently the sale of network businesses at premiums to RCV suggests considerable appetite amongst the investment community for these assets.

The allowed return on equity is highlighted as a key determinant of the ability of companies to raise equity finance. Some respondents believed that the costs of issuing equity are potentially prohibitive and suggest the regulator should specifically allow for these costs in price determinations. However, some respondents argue an assumed higher cost of equity might not necessarily lead to companies adopting a financial structure that contains an increased proportion of equity, and that it might actually increase the incentives for companies to adopt higher gearing. Some conventionally structured companies argue that if concerns persist about higher gearing then this can only be addressed by positively incentivising conventional gearing by allowing higher returns for lower geared companies.

The vast majority of respondents believe that when conducting financeability tests the regulator should adopt definitions of ratios that are consistent with those used by credit rating agencies, accepting that there are different approaches between various agencies. The consensus is that the adoption of different ratios would not only have little effect on the capital markets' assessment of companies' financial strength, but could increase perceptions of regulatory risk. Most consider that it is the overall level and trend of the ratios that is important to credit quality. This is the approach taken by credit rating agencies, and the regulators should mirror this approach.

There would be widespread concern if there were a majority of utilities companies with a BBB/Baa2 credit rating. A BBB/Baa2 credit rating would leave little headroom against cost shocks, and as a result there is a danger that a number of firms could fall below investment grade credit rating. The implication for the utilities sector of firms falling below investment grade credit rating could be a significant increase in the cost of debt finance.

Respondents felt that different solutions to financeability may be appropriate in different sectors but with clear explanation as to why this is the case. There is an element of past experience colouring these views. The option of accelerated depreciation was favoured by most of the electricity companies, and revenue uplift was the preference of most of the water company respondents. Some respondents felt that to implement the revenue uplift in an NPV neutral manner would be fairer to customers, although there may be practical issues with this approach. The use of a nominal weighted average cost of capital, to overcome the cash flow timing problems associated with a real return and nominal financing costs was generally rejected because of its significant implications for customers. It would result in a large incremental increase to prices, and may ultimately not resolve financeability issues over the longer term.

Next steps

So, in the light of all this, what are Ofwat's next steps with regard to these important financing issues?

Introducing a cash lock up provision

The financing networks paper includes a discussion on the licence conditions that have been put in place to ring fence the regulated business from the activities of the wider group. For many regulated businesses this includes a requirement that they should retain an investment grade issuer credit rating. These arrangements have been designed to reduce the risk of financial distress by constraining the conduct of the company, ensuring its resources are not diverted, and that it is not exposed to undue risk. Their presence helps to reassure the regulator that companies remain in a position to finance their functions, and consumers' interests are not adversely affected by a company's capital structure.

The first 'outcome' from the financing networks paper was the announcement by Ofwat that it will be modifying companies' licences when the opportunity arises to introduce cash lock-up provisions. It is considering the precise legal drafting of the cash lock-up provision. It intends to roll out the cash lock-up provision into other water companies' licences as suitable opportunities arise. There is precedent for such a licence condition contained in the energy distribution companies' condition of appointment.

The cash lock up would be triggered should the regulated company be assessed by the rating agencies as at the bottom of the investment grade on negative watch. Consequently, the appointee would be prohibited from making, without Ofwat's prior consent, any transfer of cash or other asset to an affiliate in circumstances where the regulated business no longer holds an investment grade credit rating or holds a rating at the minimum investment grade level, and that rating has been put under review for possible downgrade or is assigned a negative outlook. The prohibition continues in effect until the regulated business's credit rating has been restored to a level above the trigger level.

This should not undermine those companies that do not yet have this condition because the majority have a licence condition that requires them to maintain investment grade credit quality. If a water company's credit rating were downgraded to the brink of non-investment grade, Ofwat might reasonably consider this as evidence of the likelihood of the company ultimately breaching the licence condition requiring it to maintain an investment grade rating. In those circumstances, under the existing ring fencing conditions, Ofwat would be very likely to take enforcement action to prevent cash and assets from leaving the regulated company. There are benefits from a cash lock-up provision in the licence. It provides a transparent, instantaneous response to a breach or a likely breach of the requirement to maintain an investment grade issuer credit rating.

Improving regulatory commitment

Ofwat believes that it has focused on regulatory commitment for some time, as evidenced through its consistent and transparent approach to regulation. Ofgem has published a letter setting out its conclusions on some of the issues raised in the financing networks paper. Ofgem has said that it intends to focus on regulatory commitment as a key plank of its framework for delivering investment.[7] This framework includes moving to rolling incentives, instituting annual cost reporting based on detailed rules and templates, annual publication of an indicative RCV figure, setting the cost of capital based on longer term trends, and regular city briefings. Ofwat already has these

[7] Ofgem, Financing Networks: Conclusions letter, 27 October 2006.

principles well established to a large degree within its current regulatory regime. It has said that it will continue to consider how to improve regulatory commitment further within the longer term framework set out above.

Ofgem sets out two areas of further work in its letter. Together with regulatory commitment, these follow up on some aspects of Dr Dieter Helm's proposals, although Ofgem and Ofwat reject the full split cost of capital approach. Ofwat is also going to be working with Ofgem on these workstreams.

The first is the idea that revenues recovered annually from customers could be linked to a market index of debt costs. This would transfer interest rate risk from companies to customers by allowing bills to fall or rise in relation to movements in this index. Consultancy work commissioned by British Airways suggested that the Civil Aviation Authority (CAA) should consider a similar mechanism for BAA allowing, in the consultant's view, the regulator to make a very low assumption on the cost of debt initially. The CAA, in its December 2006 document setting out initial proposals for Heathrow, Gatwick and Stansted Airports, has not adopted this approach but has specifically said that it intends to raise this issue with the Competition Commission as part of its own wider considerations of the risk-free rate.

The second area of work is an analysis of the variability of returns across the regulated sectors aimed at delivering a better understanding of the differences in risk across the sectors.

Financeability

On allowed returns it does appear that equity and other city analysts are advising investors not to expect Ofwat to come to the same conclusions at its next price review in 2009, either on the cost of capital or on its approach to financeability. Those acquiring water companies at significant premiums to RCV are doing so against this background.

Improving regulatory commitment may reduce concerns about short term financial ratios, and there is evidence that regardless of capital structure companies are raising a significant proportion of index-linked debt, which also benefits shorter term cash interest cover ratios (though not gearing). And there is no evidence of a lack of equity funding to the industry as demonstrated by the premiums being paid at present. In its recent conclusions for the electricity transmission review (December 2006) Ofgem has concluded that the baseline positions for the companies can be funded without any requirement for equity or any other financeability adjustment beyond the 'depreciation tilting' adopted for its final proposals. It has said, however, that in certain higher capital expenditure scenarios, two transmission companies may need to inject equity to stay financeable, and it has set price controls on that basis making an allowance for the cost of raising the new equity required.

Ofwat's approach to financeability at its next price review will be developed after consultation with stakeholders. It has not yet shut down any options but it has said that if there needs to be an allowance for financeability (through whatever mechanism) it should be implemented in a NPV neutral manner in the future. The financing networks consultation has meant we have a wealth of views and information available for us to develop our approach. Expect a methodology paper later this year.

References

(bold numbers refer to the footnote in which first cited)

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