



Investors and UK Infrastructure

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BEA - The effect of the credit crunch on UK energy investment

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Structure



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1. The energy investment challenge
 2. What are investors' views on investing in UK infrastructure? How have these changed?
 3. How do investors' view regulators' policy responses to the credit crunch?
 4. Final thoughts

1. Introducing the energy investment challenge



Energy sector investment to deliver govt objectives

- Estimates of £200bn by 2025
 - Generation and storage
 - Network enhancement and new connections
 - Smart meters, energy efficiency etc
- More than a doubling of investment levels to c£13bn/yr
 - from c£6bn/yr (10yr avge from Blue Book elec, gas, water)

Credit crunch will affect the cost of delivery

Raised questions over the attractiveness of investing in UK

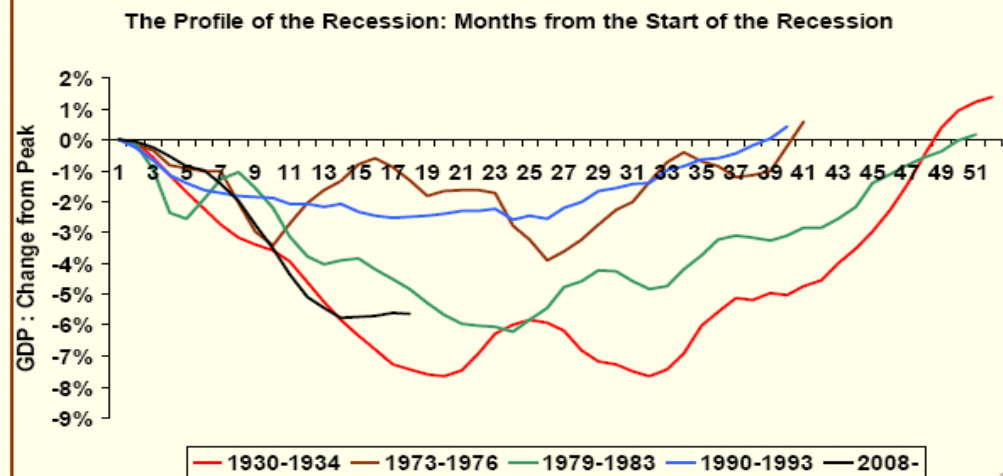
UK faces significant competition for infrastructure funding

Uncertain whether policy makers/regulators' responses will be sufficient

Changing economic and funding environment



UK monthly GDP estimates



niesr

The recession in context (NIESR)
What will be the effect of the govt's response?

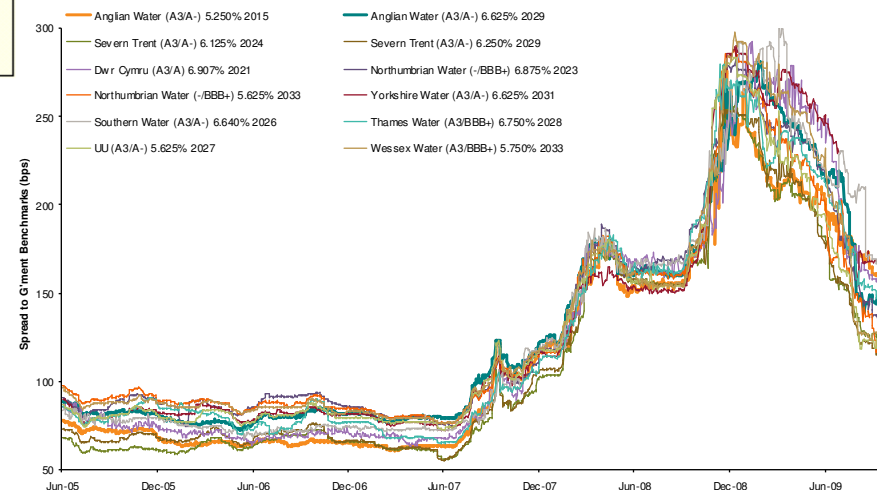
- QE and inflation
- Borrowing (RFR and £s strength)

We do know

- a permanent loss of income
- a higher cost of capital

2005-2009 debt spreads

Improvements in 2009 – where next?

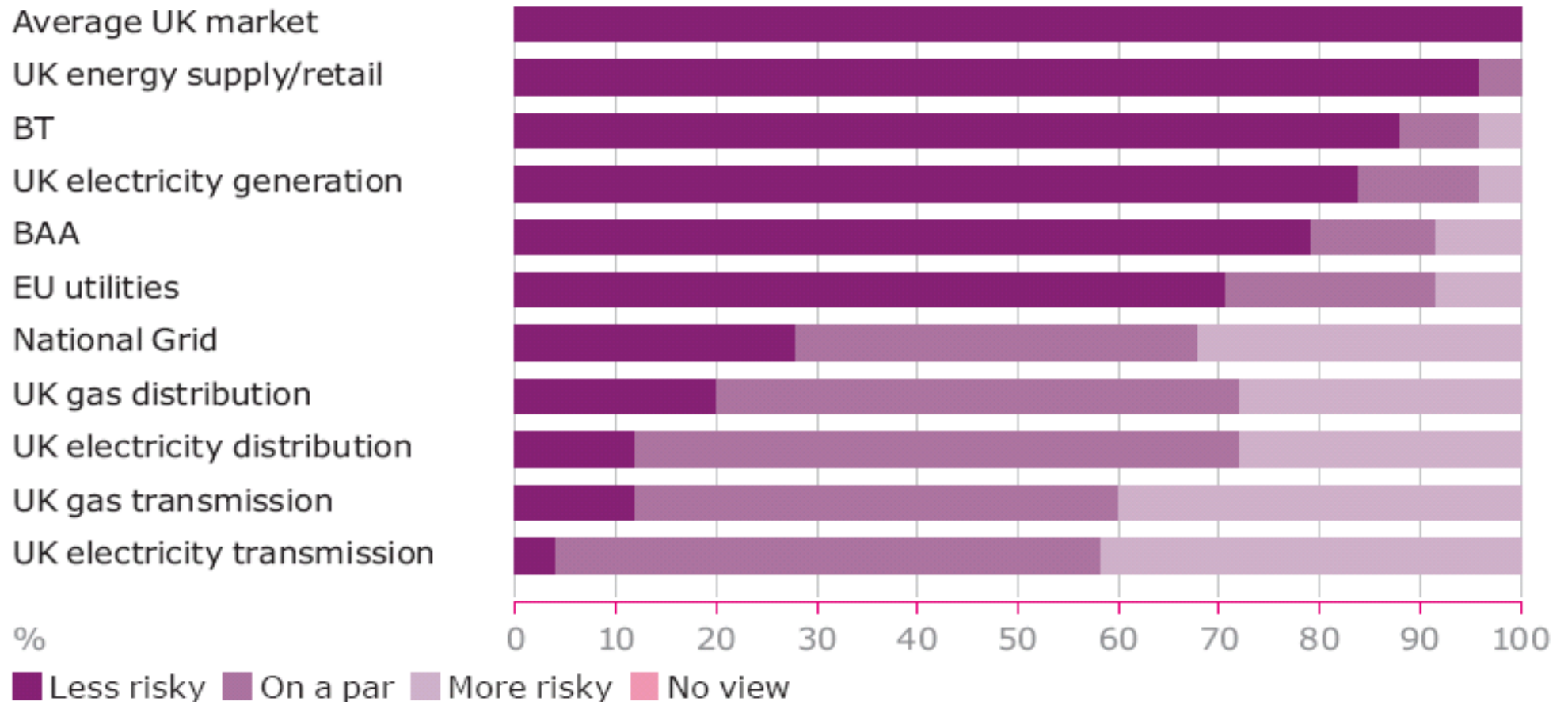


2. How do investors' view investing in UK infrastructure? Relative risk



A comparison of investors' views on relative risk

Respondents (max) 25



Typical (network) risks

– Political, regulatory, management, force majeure



UK infrastructure an attractive asset class

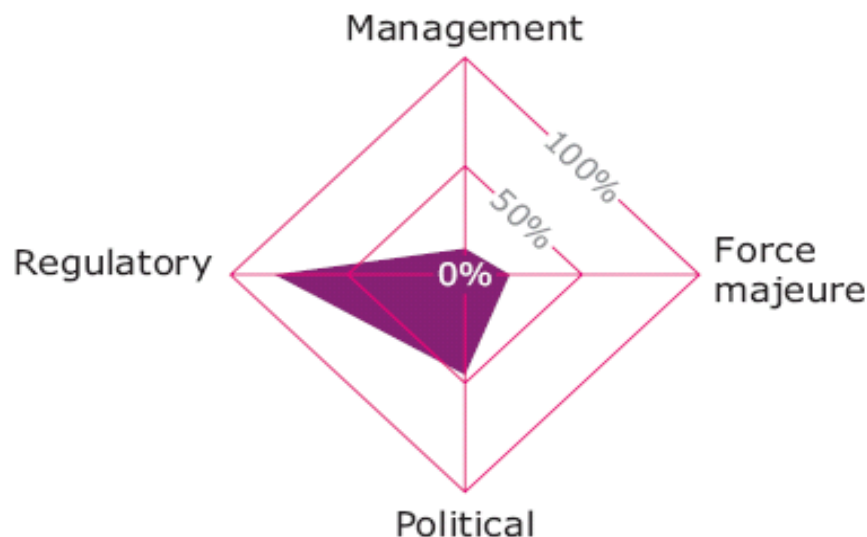
- Reasonably low political/regulatory risk
- Attractive fundamentals (RPI) - pension and infrastructure funds
- Good access to debt markets
- Enabled financial restructuring in a stable economic environment

Regulatory risk increasing

Financing and general economic risks appear for the first time

Increased risk since PR04

Respondents (max) 26



Could you rank the top five risks in order of most importance?

Respondents (max) 23

	Most important (%)	2 (%)	3 (%)	4 (%)
Regulatory	58	25	13	4
Financing	31	38	23	8
Other	22	11	0	11
Political	15	38	15	23
General economy	10	10	40	30
Force majeure	8	8	31	23
Management	0	31	38	31

Changing regulatory risks



The 'boiled egg dilemma' of ex ante regulation remains

Events can distort returns (credit boom)

Greater focus on legitimacy of profits (consumer vs producer)

- Energy supply market probe
- RoE calibration for networks
- Combination of ex ante and ex post

Uncertainty over regulatory reform (RPI-X@20 et al)

3. How do investors' view policy makers response to the credit crunch?



- i. Introducing the two surveys
- ii. Electricity survey - DPCR5 Initial Proposals
- iii. Water survey - PR09 Draft Determinations

i. Introducing the two surveys



Sixth water survey and first electricity distribution survey
Both sponsored by companies and supported by regulators

Water

- 25 face to face semi structured interviews
- 14 equity, 8 debt, 3 rating agencies

Electricity distribution

- 16 questionnaires
- 8 equity, 5 debt, 3 rating agencies

PR09 Ofwat's Draft Determinations (July 09)

- Firm proposals with 'flat' prices

DPCR5 Ofgem's Initial Proposals (August 09)

- Holding off a number of decisions; 5% pa increases

Final decisions due Nov/Dec 09

Future water and sewerage charges 2010-15:
Draft determinations
Protecting consumers, promoting value, safeguarding the future



ofgem Promoting choice and value
for all gas and electricity customers

**Electricity Distribution Price Control Review
Initial Proposals**

Document type: Consultation
Ref: 92/09

Date of publication: 3 August 2009

Deadline for responses: 14 September 2009

Target audiences: Consumers and their representatives, distribution network operators (DNOs), independent distribution network operators (IDNOs), licensees and operators of distributed energy systems, transmission owners, generators, electricity suppliers and any other interested parties.

Overview: Ofgem regulates the 14 monopoly regional DNOs to protect the interests of current and future consumers. We set a price control every five years that sets the maximum revenues that each DNO can collect from customers as it leads them along an efficient business to finance its activities. We also place incentives on DNOs to improve and put more efficient ways to provide an appropriate level of network capacity, security, reliability and quality of service.

The current price control expires on 31 March 2010. This document sets out our Initial Proposals for the revenues the companies should be allowed to earn in the next five years. We set out the new obligations and incentives we propose, the one consulting on our proposed approach to setting the cost of capital and the overall balance of risk, and invited the regulators. We will make responses to this document over the autumn and set out our final proposals for the next price control in the winter.

If the companies accept our proposals they will come into force in April 2010.

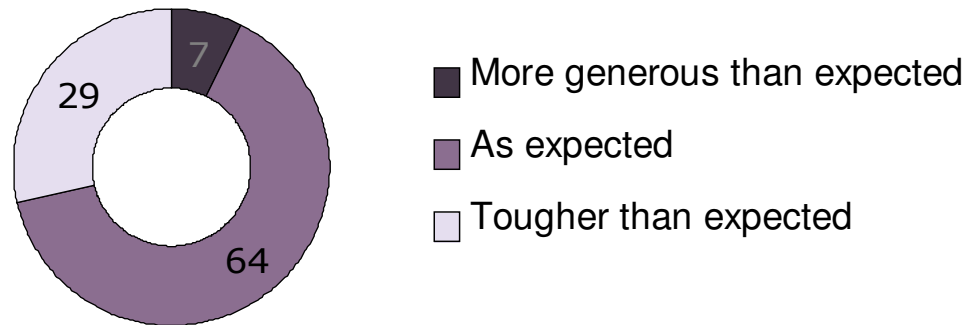
Contact name and details: Rachel Fletcher - Director, Distribution
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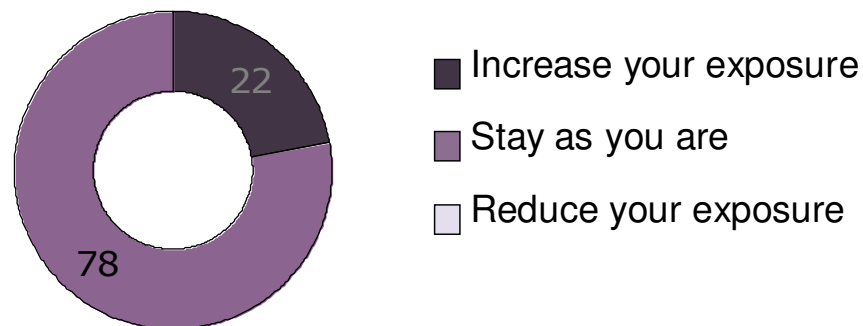
ii. Electricity findings - Overall view



How do the Initial Proposals compare with your expectations?



Relative to your current position, are you likely to increase your exposure, stay as you are, reduce your exposure or not applicable?



Reasonable but incomplete (WACC (3.5-5.6%), pensions, tax)

- Sensible evolution but package difficult to access

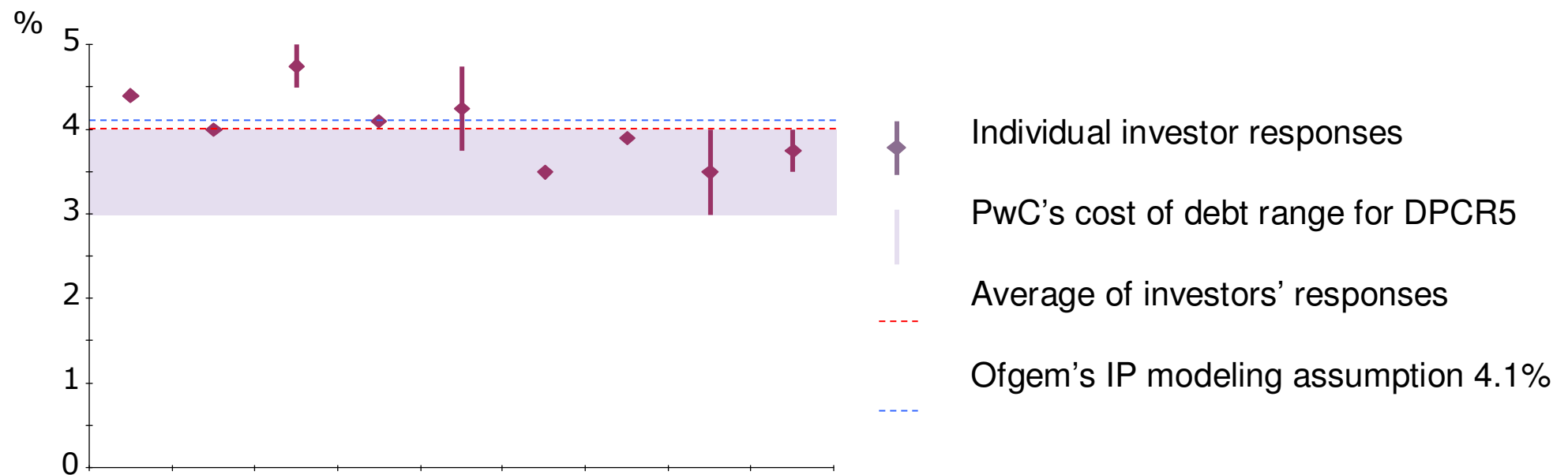
The cost of debt – a range of outcomes



What do you think of PwC's range for the cost of debt (3.1% - 4.0%)?

- 78% top end of PwC's range

What is your current estimate for the cost of debt in the sector?



Policy challenge - What should Ofgem assume in setting prices?

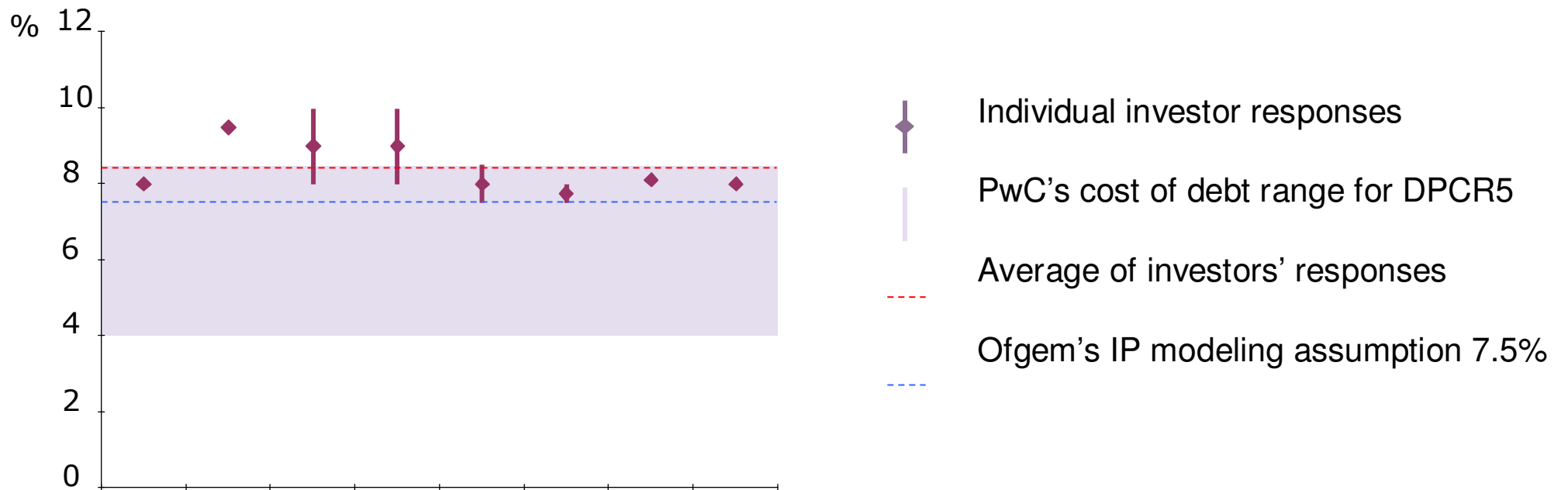
- Yesterday's CoD vs today's vs tomorrow's?
- Investors were unwilling to forecast a CoD for 2015

The cost of equity – a wide range of outcomes



PwC CoE range 4%-8.5% and ERP 4.0-5.5%

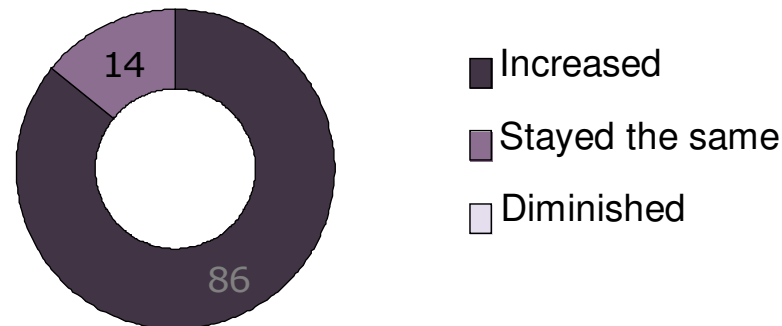
- Unprompted c50% said the range was too broad
- Unprompted 50% that the low end of the range was inappropriate



Risk and mitigation mechanisms



What do you think has happened to the risks facing the DNOs



Risk mitigations – uncertain economic conditions and financing risk

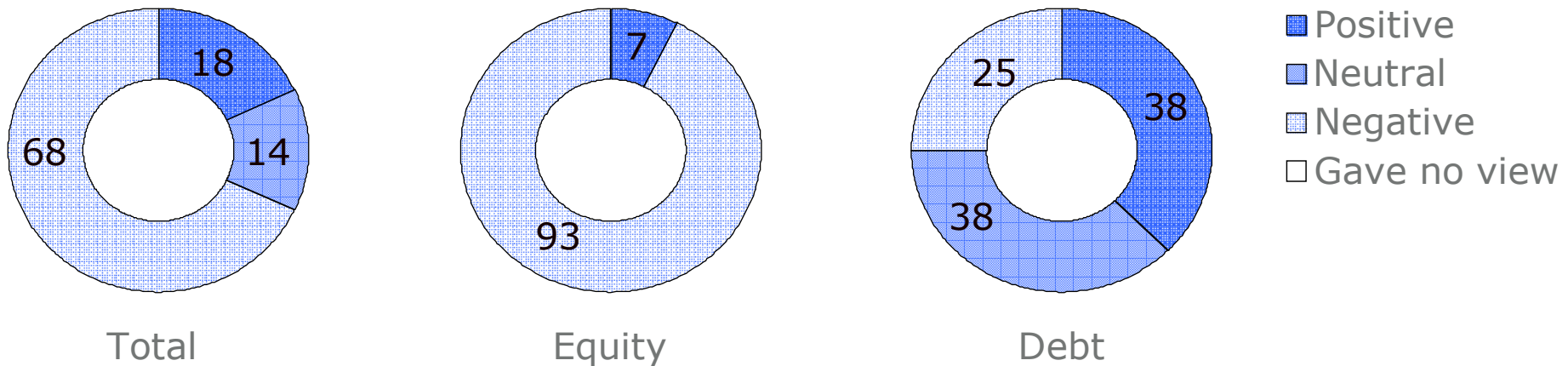
Economic conditions / demand

- Reopener for TMA and tax trigger
- Removal of general volume drivers
- Demand side risks managed through targeted reopeners or volume adjustments for certain activities

Cost of debt - options

- Automatic re-openers / pass through difficult to design - clarity
- More general re-openers (SAEC) - concern over discretion
- Preference for inclusion in WACC

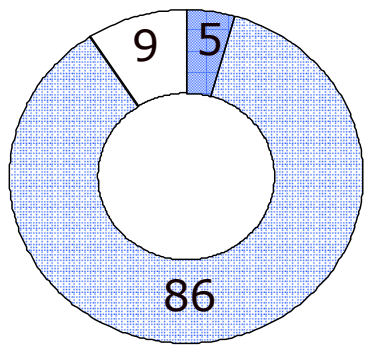
iii. Water findings - In overall terms, what do you think about the draft determinations?



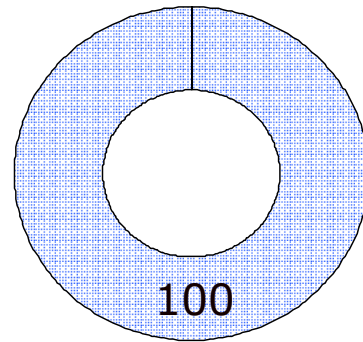
"Individual parts tough but not unreasonable - together though it is unexpectedly harsh"

taken

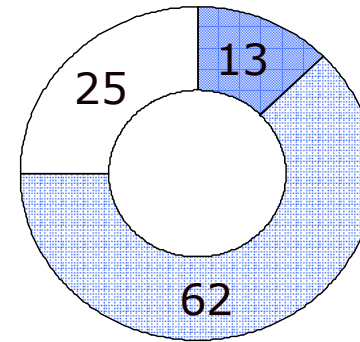
Was it as you expected?



Total



Equity



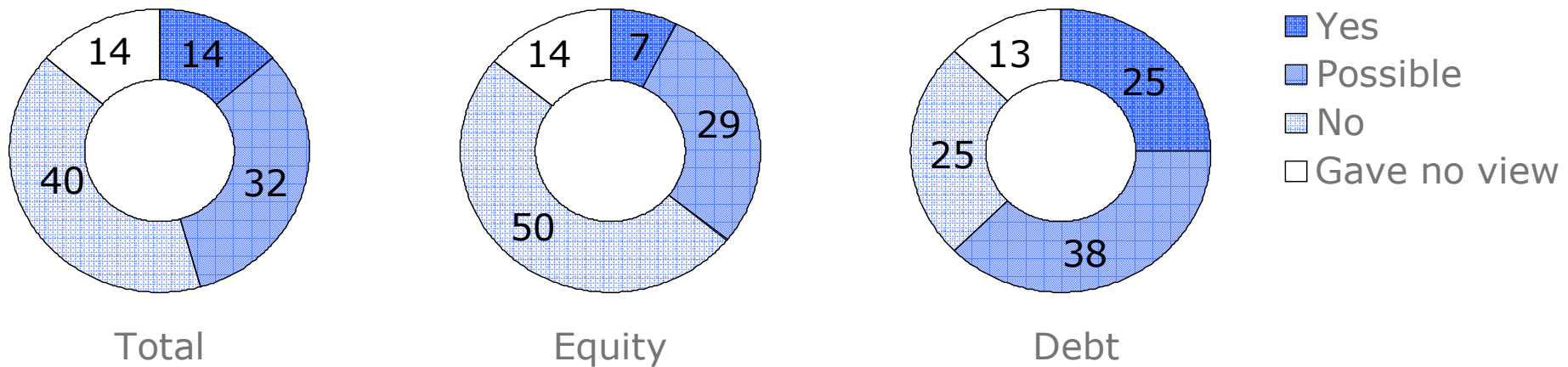
Debt

- As expected
- Tougher than expected
- Gave no view

"Nothing left to deal with shocks in a time of greater volatility"

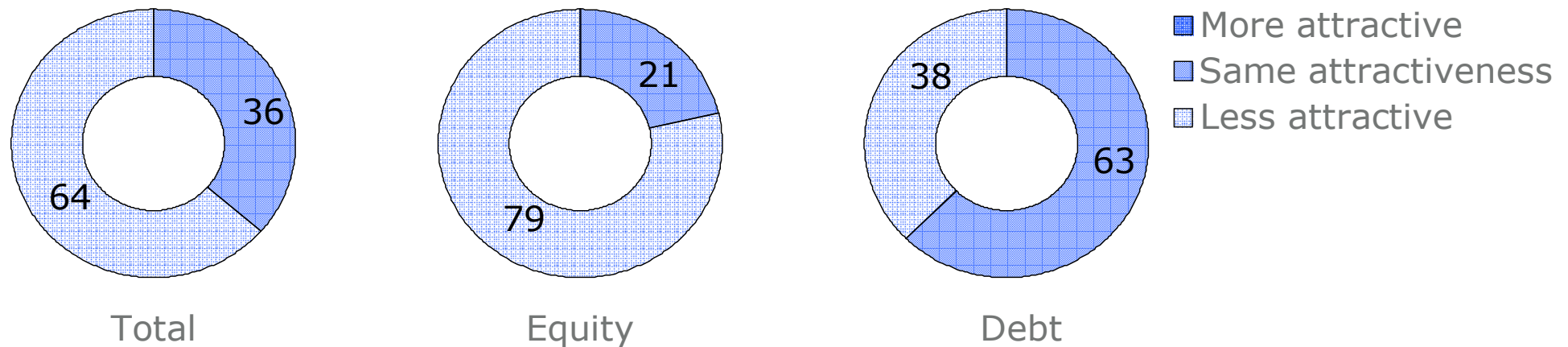
"Harsh at any time but very harsh in the circumstances"

Will companies will be able to earn a return equal to or greater than the sector (actual) cost of capital?



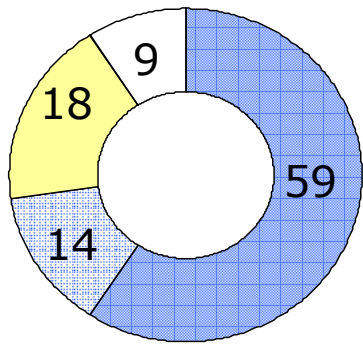
"There is more equity risk. Certainty in bills is not free. Equity happy to bear risk to create certainty in bills but this should mean higher returns and bills."

How has the draft determination affected the attractiveness of the sector?

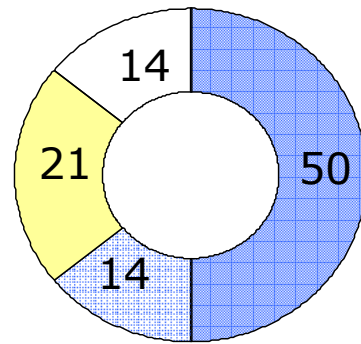


'The regulator should be clear about the change in policy – selling the future for short term benefits - so it can be held accountable'

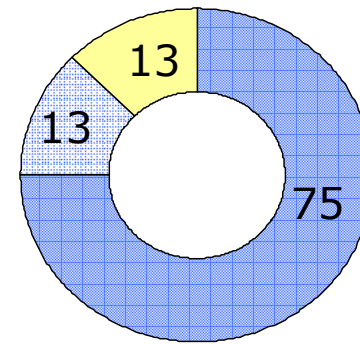
Relative to current holdings, are you likely to increase/decrease exposure, stay unchanged, or wait for FD?



Total



Equity



Debt

- Increase your exposure
- Stay unchanged
- Reduce your exposure
- Wait for FD before deciding
- Gave no view

Implications - two different regulatory approaches to current uncertainties



Ofgem '**wait and see**' Initial Proposals

- No certainty yet
 - Investors - sensible evolution but heavily caveated; no package
 - PwC WACC range unhelpful
- Confidence – wavering where discretion exists; desire for certainty or WACC adjustments
- Complexity - more transparency and information required

Ofwat '**here it is**' Draft Determinations

- Certainty provided to customers at a cost (initially) to investors
 - Not the centre of the dart board
 - Sector will be challenged to attract new equity
- Confidence has been hit
 - New mechanisms (CIS); discretion for existing mechanisms
- Complexity/justification - more transparency and information required

4. Final thoughts



In an environment where capital is more constrained and demand from infrastructure is rising

How should UK infrastructure position itself to compete for capital?

- Stable, transparent and predictable (commitment)
- Clarity on regulatory objectives and trade-offs
- Recognition that even monopolies compete for capital

Early warning signs from water that UK infrastructure is losing its appeal

- Trust - warning signals mitigations
- Transparency - complexity
- Predictability - surprises

Credibility and confidence are easier lost than won

