

 Indepen



## The views of investors in the UK water and electricity sectors – Summer 2009

25 September 2009

Water UK Financing Utilities Seminar - London Stock Exchange

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# Structure



- 
1. Introduction
  2. Electricity survey – a quick review
  3. Water survey – more detailed look
  4. Implications and issues arising



# 1. Introduction

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)

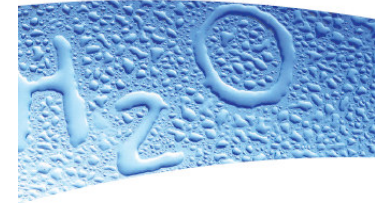
- Firm proposals with 'flat' prices

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



www.ofgem.gov.uk



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 audience: Consumers and their representatives, distribution network operators (DNOs), independent distribution network operators (IDNOs), owners and operators of distributed energy schemes, transmission owners, generators, electricity retailers 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 revenue that each DNO can collect from consumers at a level that allows an efficient business to finance its activities. We also place incentives on DNOs to innovate and find 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 objectives and measures we propose. We are consulting on our proposed approach to setting the cost of capital and the overall balance of risk and reward in the settlements. 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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Email: [DP09.rachel@ofgem.gov.uk](mailto:DP09.rachel@ofgem.gov.uk)  
Team: Electricity Distribution

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## 2. Electricity findings – a quick review

Reasonable but incomplete (WACC, pensions, tax)

- Sensible evolution but package difficult to access WACC (Ofgem used DPCR4 assumption)
- PwC WACC range (too wide; low end unrealistic)
- Risk and cost of capital risen since 2004

Access to credit okay if mkts remain open but concern over terms

Reopeners

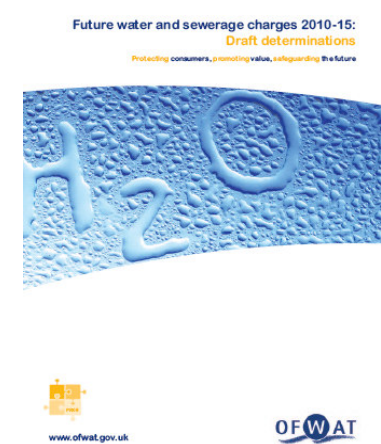
- Can be difficult to operate - clarity
- Concern over discretion - clarity or
- Preference for inclusion in WACC

Some disappointment on level of capex

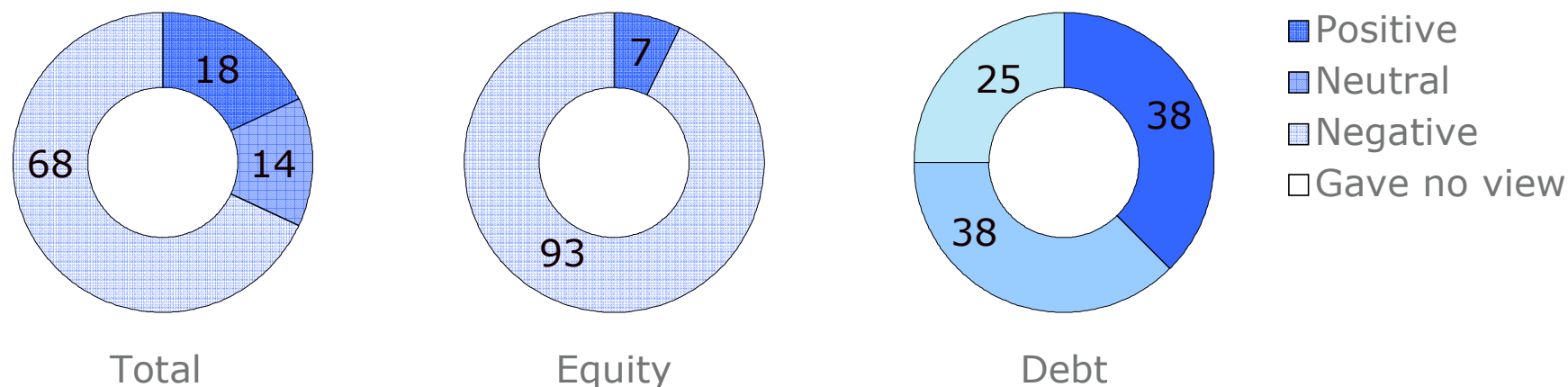
The screenshot shows the cover page of an Ofgem document titled "Electricity Distribution Price Control Review Initial Proposals". The document is a consultation paper (Ref: 92/09) published on 3 August 2009. It details the regulatory framework for electricity distribution price control, including the target audience (consumers, network operators, etc.), the overview of the regulatory process, and the specific proposals for price control. The document sets out the maximum revenue that each DNO can collect from customers and the overall balance of risk and reward in the settlement. It also provides contact information for Rachel Fletcher, Director of Distribution, and the Ofgem team.



### 3. Views of the Draft Determinations In the Water Sector



# In overall terms, what do you think about the draft determinations?

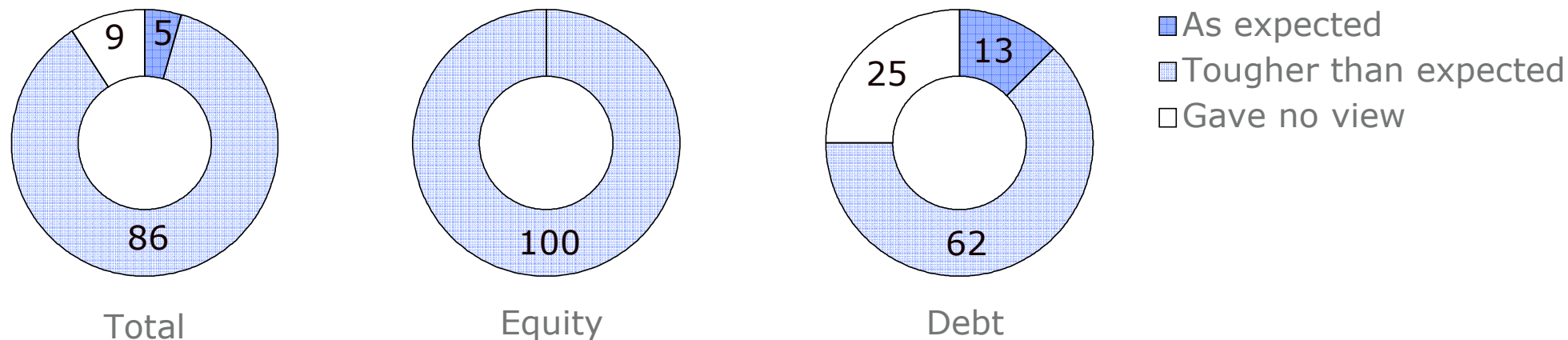


Fundamental building blocks remain in place but

- Tough - opex, capex, CIS, WACC (equity small co premium)
- Tougher than expected (particularly given circumstances)
- Complex, and a lack of transparency
- Risk transfer to equity (risk up but question value of mitigations)
- Sector less attractive or even unattractive to equity

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

# Was it as you expected?



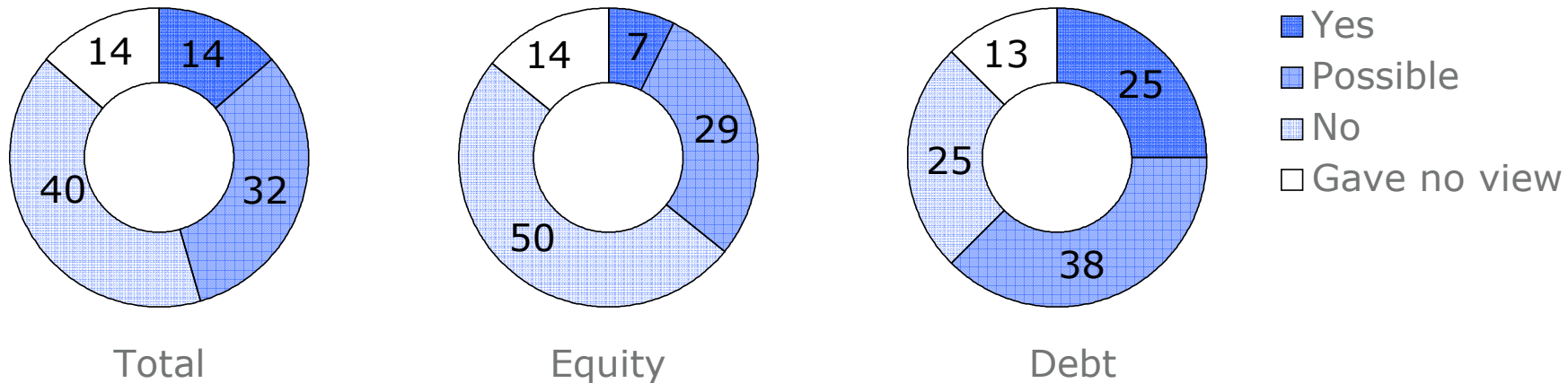
Why was the DD tougher than investors expected?

- Misread the signs? Misled? Unexpected turn?
- Approximately half thought Ofwat had worked back from the answer

*"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?



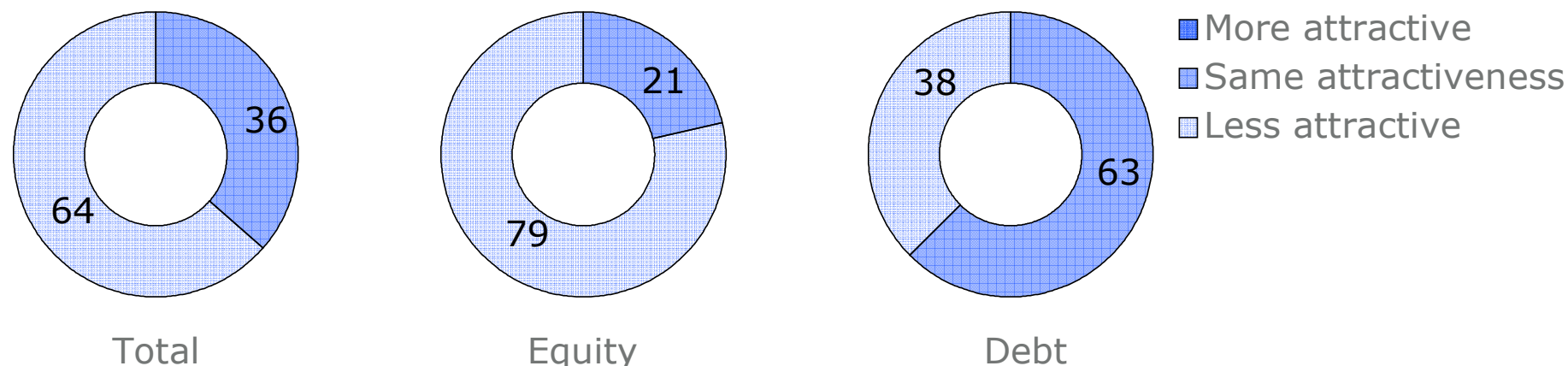
Ofwat appears keen for equity to play an important role in funding the sector

- Ofwat's notional gearing moving down from industry average
- Equity is an appropriate 'fix' for financing constraints

However only 7% expect to earn their return - An acceptable outcome?

*"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?



## Equity

- 4 said they would not invest again in the sector
  - 6 referred to other more attractive investments – outside UK infrastructure
  - 1 had sold a sizeable, long held investment in a quoted WaSC
- 'The regulator should be clear about the change in policy – selling the future for short term benefits - so it can be held accountable'*

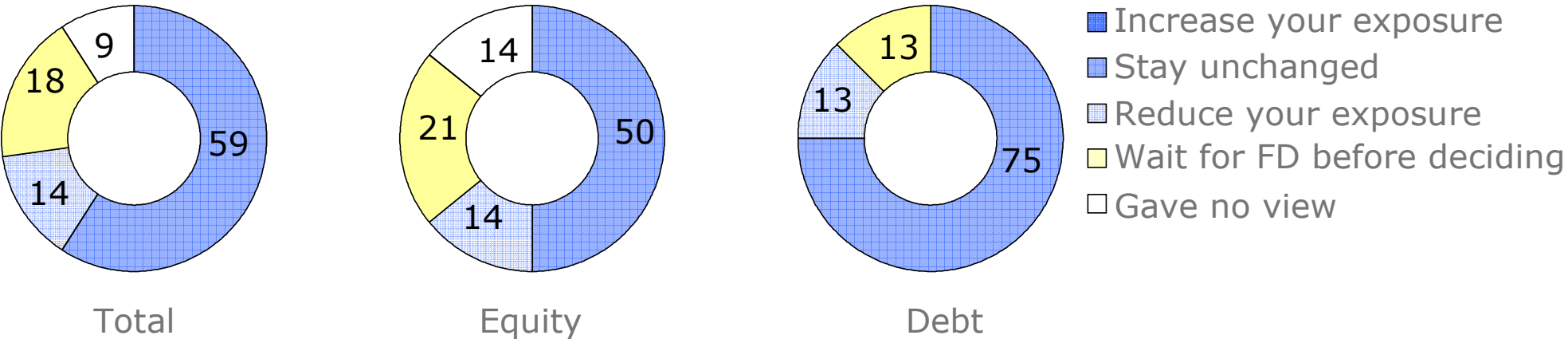
## Debt

One was 'likely to sell BBB+ holdings'

4 said credit committee were reviewing the sector after the DD



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



More muted than expected due to illiquid nature of holdings?

No equity or debt investor will increase their exposure to the sector

## 4. Implications - two different regulatory approaches to current uncertainties



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

- Certainty provided to customers at a cost (initially) to investors
  - This is not the centre of the dart board
  - Short term gains for long term pain
  - 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

### 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

# Implications - Attractiveness of UK infrastructure



Early warning signs that UK infrastructure losing its appeal

- Trust - warning signals mitigations
- Transparency - complexity
- Predictability - surprises
- Relative and absolute attractiveness

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
- Clarity on regulatory objectives and trade-offs
- Recognition that even monopolies compete for capital

*Credibility and confidence are easier lost than won*



## Contact information

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