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Mutual Energy Response to the financing of regulated networks discussion paper

This is a very opportune time to look at the fundamental question of how best to finance networks, with Northern Ireland consumers looking at a huge bill to refurbish its networks to meet the needs of the next few decades. These will be 40 year plus investments and the Northern Ireland consumer knows only too well the cost of overpaying for long term assets.

1. Problems with the existing form of network financing

The paper from First Economics adds to an increasing body of work highlighting the sub optimal way networks are currently financed. This is due to three distinct activities being grouped together, the operations, the capital expenditure and the financing of existing RAB. We would summarize the problems this leads to as follows:

(a) The inability of the market to value the implicit guarantee on infrastructure

Key infrastructure, such as electricity networks is fundamental to the operation of the economy and will always be paid for. This implicit guarantee, similar in many ways to the implicit guarantee that the banking system will not be allowed to collapse, is of great value. However markets are naturally cautious and ignore this, simply pricing the explicit regulatory regime of periodic price reviews and protections in the licence. This leads to much higher cost of debt than is necessary.

(b) The disproportionate impact of operational risk on financing cost

The First Economics paper references the "tainting" of the lower risk capital recovery business by the operating business risk. The impact of the operating costs on the financing cost is best seen by comparing the cost of the margin over government gilts of the WACC allowed in the price controls against the actual operating costs incurred. In Northern Ireland this figure can exceed 200%. In other words the extra financing costs paid (due to the margin



allowed over government gilts) are the same as guaranteeing that the company will be 100% inefficient in operations.

(c) The use of Weighted Average Cost of Capital

There have been numerous deals at premiums to RAB in the utilities industry. The ability to sell at a premium to RAB has often been driven by arbitrage between the **allowed** cost of financing the RAB and the **actual** cost of financing the RAB. As the allowed return is based on a five year ex-ante forecast of **weighted AVERAGE cost of capital**, with an assumed gearing ratio, the ability to increase the gearing has allowed these deals to be done, generating extra return to equity. As the gearing increases the marginal income received at the average of the cost of debt and the (higher) cost of equity, is now met solely by the cost debt, generating additional equity return.

This process was described as far back as 2008 by Professor Helm as “an extraordinary open goal”.

The use of this average is a clear problem. Faced with massive new investment which is inherently more risky than financing an existing RAB, any logical utility will press for a higher WACC or seek to avoid investment.

2. Suggested methods to create a more granular costing of the activities

First Economics suggested two methods of providing a more granular cost to the consumer and therefore providing value for money:

Proposition 1 : RABCO takes out the RAB at par gets supported by primary legislation achieving low cost RAB

Proposition 2: Existing utility contract out the major capex projects with either “design build finance transfer” or “design build finance maintain”

Both of these are very valid theoretical concepts which, although they have practical problems associated, could lead to a practical solution.

The practical considerations which will come into play will include:

- Legal implications and debt falling onto Public Sector Borrowing Requirement (proposition 1)
- Investors / rating agency perceptions: how strong is the regulatory promise and what is the fall back security (proposition 1)
- Complication of asset transfers (proposition 2)
- “patchwork” effect on the network of multiple operators and their interfaces (proposition 2)

None of these are by any way insurmountable. When these practical considerations interact with the pure economic analysis it will lead to slightly different implementations which can achieve the required benefits:

In a proposition 1 type split:

- A business may be split into practical operating units, with a very safe units licence targeted at maximum value in the RAB financing arena;
- When a very high proportion of the cost of the business is RAB related, dilution of the low cost finance by operating cost exposure can be avoided by financially de-risking the small element that is operational ;
- Ownership will likely remain with the RAB in practice in order to achieve investment grade status ;

In a proposition 2 type split:

- There may be a requirement that capex fundamental to existing assets ("reinforcement") needs to remain with RAB-opex co to ensure risk on existing RAB financing is minimised;
- Projects needs to be large enough to encourage new entrants and be worth their while;
- Finance and maintain v finance and transfer should be assessed on a case by case basis, taking into account any disadvantages of additional "patchwork" ownership.

3. Conclusion

For Northern Ireland the reduction in the cost of servicing RAB is fundamentally important. Already built RABS and in particular RAB that is not associated with physical assets (eg previous under-recovery or tariff profiling) should attract a much lower return than they currently do. This can be achieved either within the existing ownership structure, with the existing owners receiving a much lower allowed return for the existing RAB and a higher one for new investment, or by transfer of assets to a separate company.



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