Financial stakeholder engagement

For SGN's RIIO-GD2 Business Plan

November 2019

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1. Key findings

The feedback SGN received from the Consumer Challenge Group (CCG) on its July 2019 RIIO-GD2 Business Plan submission highlighted that they would like to see more engagement on financeability issues with stakeholders. PwC were therefore commissioned by SGN to engage with a number of financial stakeholders with involvement in the UK utilities industry to gather their views on various aspects of the RIIO-GD2 regulatory methodology.

Our preliminary findings from the interview programme were presented in SGN's October Business Plan submission. We have now completed the stakeholder engage programme and we present a summary of our key findings below. We note that these findings do not represent the views of either PwC or SGN.

1.1 The risk of investing in UK utilities

Of the 15 stakeholders interviewed, 10 identified that there has been a **material increase in the risk** associated with investing in the UK utilities market over the past 5 years, while the remaining 5 considered the **risk to have increased somewhat**. The three factors most frequently cited as being responsible for this change are the **proposed changes to the regulatory regimes** in both RIIO-2 and PR19, **renationalisation** policies and **broader political pressure to deliver pro-consumer policies**.

Most stakeholders consider that the **risk associated with investing in energy networks specifically has increased** across the same time period. The proposed changes to the regulatory regime under RIIO-2, such as the reduction in the allowed return to 4.3% (real, CPIH) and the upside performance cap, were cited as important factors behind elevated risk levels. There is also **growing concern around the risk of asset stranding in the gas industry** specifically, owing to the current pace of change within the industry, the direction of UK energy policy and the Committee on Climate Change's recommendation to stop installing gas in new homes.

With a number of new regulatory mechanisms that depart from previous price controls, most interviewees considered that the profile of prospective risks in the energy sector has been skewed to the downside. Stakeholders also considered that these changes have made the **regulatory regime for UK energy networks less predictable and stable**.

Equity investors generally regard the Labour party's renationalisation policy as an important risk, particularly if this is done without compensation at market value, which they suggest would reduce investor confidence in the UK economy. Conversely, **debt investors perceive the risk from renationalisation to be much lower**, as the Labour party has indicated that debt would be repaid when due, limiting the effect on debt investors.

Overall, **interviewees generally viewed the energy and water networks as having broadly similar risk**. The regulatory and renationalisation risks are viewed as greater in water. However, the potential for asset stranding means the gas distribution sector has higher medium to long-term risks. All interviewees agree that **Brexit poses a relatively low risk to UK utilities**.

1.2 The financial parameters of RIIO-2 price controls

Most stakeholders consider that Ofgem's proposed **allowed return on equity (4.3% real, CPIH) as too low to compensate investors** for the risk associated with investment in energy networks. Some interviewees commented that an allowed return which followed the RIIO-1 approach would demonstrate greater stability and consistency. Interviewees thought regulators are not expecting any adverse reaction from equity and debt investors, but, in their view, there will be.

Conversely, two interviewees considered that the cost of capital components are broadly in the right region. They suggested that if Ofgem removed the proposed 50 bps outperformance adjustment, which is creating uncertainty and hasn't been communicated well, then around a 5% allowed return on equity (real, CPIH) is reasonable.

Several interviewees considered that Ofgem had been selective by using different time periods to estimate different WACC components, the proposed betas were too low and **the 50 bps reduction for expected outperformance is too aggressive and wrong from a conceptual standpoint**.

Several stakeholders suggested that **Ofgem could do more to enable companies to deal with longer-term industry risks**, such as asset stranding for gas distribution networks. Stakeholders commented that the **lower WACC forced companies to focus on short-term financial targets** instead of longer-term plans, which risks passing the expense and risk of investing in new assets onto future generations. Several interviewees considered that lower returns will reduce appetite to spend on innovation and more risky capital expenditure, which means that companies are going to face difficult trade-offs and proposed investment projects will be scaled down or not go ahead.

The majority of stakeholders who expressed a view consider that **the switch from RPI to CPIH will have short-term benefits for liquidity and credit metrics**, but some also noted it may have detrimental impacts over the long run. However, most interviewees did not express strong concerns over the change, commenting that it could be managed successfully.

1.3 Equity market conditions

Most equity investors stated that the UK energy sector is not currently an attractive investment opportunity. Some cited the proposed regulatory changes and low cost of capital as the main factors, whereas others mentioned the risk that there could be value losses if the industry is renationalised.

Generally speaking, those currently invested in the sector[1] were more pessimistic. The general consensus from existing investors is that there are few international and domestic investors actively seeking to invest in the UK energy sector at the moment. **Interviewees with a pessimistic outlook typically questioned the decisions of investors that have recently bought equity in the electricity and water sectors at a significant premium to RAV**. Some interviewees compared the UK utilities market with overseas opportunities and commented that 'regulatory risk is skewed to the downside across Europe' and 'global funds can find superior risk-adjusted returns in other markets'.

In contrast, those who are not currently invested in UK utilities[2] were less pessimistic and saw continuing equity investor demand for UK utility assets. The **interviewees with a more positive outlook suggested that new sources of equity remain available** from both domestic and foreign sources. They observed that in transactions involving a whole business or partial stake, this required investors to 'get comfortable' with renationalisation risks. One interviewee noted that the recent transactions that have occurred at a premium to RAV shows that there is still an appetite to invest in certain segments of the energy utilities market.

1.4 Debt market conditions

Overall, the rating agencies and debt investors did not currently foresee any major issues with energy companies refinancing debt over GD-2. Most debt investors commented that the proposed regulatory changes under RIIO-2 will make it harder for the industry to attract debt capital at companies' current credit rating; however, the impact of these changes is likely to be **experienced as an increase in the price of debt rather than its availability**. Several interviewees observed that the impact on debt markets will largely depend on the final RIIO-2 regulatory package.

Debt investors and ratings agencies generally agreed that **target ratings for the energy sector should be around A/BBB+**. However, stakeholders consider that cuts to returns will make it harder for companies to achieve the A/BBB rating level that Ofgem uses to benchmark the cost of debt, with some interviewees suggesting that firms would find it **difficult to secure financing at ratings lower than BBB (flat)**. In order to improve financeability, debt investors generally suggested that companies could adjust their capital structures. A small number of stakeholders suggested they could potentially engage in more aggressive financing decisions, while others were more cautious about taking this approach.

The switch to a CPIH indexation regime for RIIO-2 means that companies will naturally seek to raise CPI index-linked debt. The market for CPI index-linked debt is currently nascent, but **all interviewees expected a CPI index-linked debt market to grow gradually over the RIIO-2 period**.

[1] 3-4 interviewees

[2] 3-4 interviewees

2. Introduction

The feedback SGN received from the Consumer Challenge Group on its July 2019 RIIO-GD2 Business Plan submission highlighted that they would like to see more engagement on financeability issues with stakeholders.

PwC were therefore commissioned by SGN to engage with a number of financial stakeholders with involvement in the UK utilities industry to gather their views on various aspects of the RIIO-GD2 regulatory methodology.

Our preliminary findings from the interview programme were presented in SGN's October Business Plan submission. We have now completed the stakeholder engage programme and this report summarises our approach to gathering the views of a range of financial stakeholders and the outcomes and key themes arising from this engagement. It does not represent the views of either PwC or SGN.

3. Our approach

The interview programme consisted of three phases of work:

- **Phase 1** – Development: preparing a list of interview questions as agreed with SGN and identifying a target list of stakeholders to approach;
- **Phase 2** – Engagement: undertaking the interviews; and
- **Phase 3** – Reporting: aggregating, comparing and reporting our findings.

3.1 Phase 1 – Development

Together with SGN, we developed a list of financial stakeholders, which included both debt and equity investors as well as corporate banks, equity analysts and credit rating agencies.

We also developed a list of questions to be asked in the interviews. As far as possible, we adopted a consistent core set of questions across stakeholders to aid the comparability of responses. The consistent set of questions was supplemented by additional questions tailored to equity investors and analysts, and a separate set of questions for debt investors and credit rating agencies to attempt to draw out the key issues in their main areas of focus.

3.2 Phase 2 – Engagement

Interviews were conducted across September, October and November 2019. In total, 15 interviews were conducted during this period.

Interviewees[3] included equity investors (both from the UK and globally), equity analysts, debt investors, corporate banks and ratings agencies. The combined investments of the firms we interviewed totals more than £1 trillion.

The financial stakeholders that we interviewed can be categorised into five main areas, as shown in the table below.

Table 1: Financial stakeholders involved in the interview programme

Financial stakeholder	Number of interviews
Equity investor	5
Equity analyst	2
Debt investor	4
Ratings agency	2
Corporate bank	2
Total	**15**

3.3 Phase 3 – Reporting

During the final phase we aggregated our findings and produced this report. As noted previously, the responses shared in this document do not represent the views of either PwC or SGN. No views are attributed to individual interviewees.

[3] Note that the terms stakeholder and interviewee are used interchangeably.

4. Summary of responses

In this section we set out a summary of responses to the questions asked in the interviews. These are categorised under four main areas:

- The risk of investing in UK utilities;
- RIIO-2 price control parameters;
- Debt market conditions; and
- Equity market conditions.

4.1 The risk of investing in utilities

A. The majority of financial stakeholders interviewed consider there has been a *material* increase in the risk of investing in UK utilities in the past 5 years.

When asked whether the risk of investing in UK utilities has changed in the past 5 years (options were: materially increased/somewhat increased/about the same/somewhat decreased/materially decreased), ten interviewees stated that they considered the risk had **materially increased**, with the remaining five considering the risk had **somewhat increased**. No stakeholders thought that the risk of investing in UK utilities was about **the same, somewhat decreased** or **materially decreased.**

Interviewee's perception of the risk of investing in UK utilities since RIIO-GD1

The most frequently cited factors behind elevated risk levels include the risks associated with the **proposed changes to the regulatory regimes** in both RIIO-2 and PR19, **renationalisation** policies and broader political pressure to deliver pro-consumer policies.

Some interviewees expressed frustration that regulatory changes in energy and water are happening more frequently, and although regulators hold workshops, consult stakeholders and regularly publish information the changes are often poorly signalled and can still occur within the regulatory periods. Additionally, the point was raised that the expectations of regulators (around customer bills, performance targets etc.) are higher than in previous price controls, with requirements for greater stakeholder engagement and a more aggressive position on the cost of capital.

Some interviewees went on to say that there appears to be a 'race to the bottom' on setting allowed returns across UK regulators. Interviewees thought regulators are not expecting any adverse reaction from equity and debt investors, but, in their view, there will be.

While most stakeholders accept challenge in individual aspects of the price control, when the challenge is tough across all aspects of the price control (allowed returns, cost performance, and incentive performance), then the overall package becomes very difficult for the regulated businesses to achieve.

Furthermore, the majority of interviewees consider that a tough regulatory settlement involves greater risk to utilities. It means they have to work harder operationally, focusing on working capital and short-term financial performance, rather than long-term company and customer value. This is compounded by the longer term risk that utilities will not deliver the desired performance outputs.

Other interviewees stated that **political environment**, media reporting and public opinion are pressuring regulators to establish regulatory packages that shift from a balance of achieving fair returns and good consumer outcomes to prioritising good quality services at affordable prices, while also protecting the most vulnerable in society. Some interviewees felt that the economic regulators haven't supported the companies in shaping political and consumer perceptions of the industry. However, other interviewees considered that some companies had contributed to this perception with some areas of poor performance and opaque financial structures.

All interviewees considered the **financial risk** of investing in utilities has risen. This is because strong performance and higher returns has previously provided companies with 'financial buffers' to manage

shocks, but these buffers will be substantially reduced with tougher performance targets and lower allowed returns. Interviewees pointed to there being less headroom on the forward-looking credit ratios in energy and water, which has already led to the water sector receiving a negative ratings outlook. They also mentioned that over 10 water companies have said they are not financeable at the notional level and they are unwilling to provide board assurance on the financeability of PR19 draft determinations.

Interviewees didn't think **operational risks** in utilities have moved significantly in recent years. While operational risks clearly remain (e.g. connections activities and uncertainty on repex[4] programmes in gas distribution), these have generally been well managed by the industry.

Lastly, several interviewees also mentioned **other growing risks**, such as cyber and drone attacks. Some also noted that regulatory fines have significantly increased in size and if companies are unable to manage compliance risks then this becomes a greater financial risk to investors.

B. Most financial stakeholders consider that the risk of investing in energy networks since RIIO-1 has increased. Interviewees generally agreed that the proposed changes in the regulatory environment are most important factor behind the higher levels of risk.

Interviewees mostly considered that the RIIO-2 regulatory changes are tougher than anticipated and generally negative for investors. One stakeholder acknowledged that Ofgem have included more stringent requirements in the proposed RIIO-2 regulatory package, but considered that they have approached this sensibly and they are acting in an inclusive manner.

Some interviewees suggested that the Ofgem RIIO-2 package is negatively skewed as potential rewards are constrained but companies have greater risk on the downside. It was suggested that this is compounded by focusing too much on short-term outcomes at the expense of longer-term resilience of the industry.

Interviewees generally accepted that financial outperformance and returns will be lower in future price controls. Several stated that given the large financing and operating efficiencies achieved across the industry during the previous price controls, it is going to be much harder to achieve further gains. Consequently, businesses will be less financially resilient with greater uncertainty for investors.

One interviewee raised the issue that companies with higher gearing continue to put pressure on credit ratings, and this has been masked by strong operational performance during RIIO-1. If companies are subsequently downgraded to a lower rating this may require a gradual de-gearing in order to reduce credit risk. Alternatively, financing new investments at a low cost of debt can reduce the average actual cost of debt and may be able to offset the decrease in allowed return.

The majority of interviewees also raised the issue of a growing risk of asset stranding[5] in the gas industry. They cited the current pace of change in the industry, direction of UK energy policy and recommendations by the Committee on Climate Change on the need to stop installing gas in new homes. They questioned whether the network and required investment will be sustainable if there's decreasing demand and volumes over a long-term period.

C. The majority of interviewees considered that changes proposed by Ofgem for RIIO-2 have made the regulatory regime for UK energy networks less predictable and stable.

With a number of new regulatory mechanisms that depart from previous price controls, most interviewees considered that the profile of prospective risks in the energy sector has been skewed to the downside. At the same time the baseline return has also been reduced, which has significantly reduced headroom against covenants and defaults.

However, most stakeholders perceive that the regulatory changes are 'more aggressive' in the water sector and Ofwat's[6] actions are more unpredictable. Specifically, two interviewees suggested that *Putting the sector*

[4] Repex refers to the replacement expenditure required of gas distribution companies in order to comply with the Health and Safety Executives Mains (HSE's) Replacement Programme.

[5] A stranded asset is one which has suffered unanticipated or faster than expected write down, devaluation or conversion to a liability.

[6] Ofwat is the body responsible for economic regulation of the privatised water and sewerage industry in England and Wales.

back in balance[7] came 'out of the blue' and was poorly designed and executed. One interviewee suggested that this uncertainty around the regulatory regime and poorly communicated decisions are 'putting investors off the sector'.

Stakeholders generally view the changes in energy as having been less pronounced and more clearly communicated, although they recognise that energy is not as far through the current regulatory timetable. They are also wary that changes in water sector regulation may transfer across to energy regulation.

The majority of interviewees still considered the overall framework as a sound basis of regulating the sector.

D. Equity investors generally view the Labour party's renationalisation policy as an important risk. Debt investors perceive it as lower risk as they view that they are more likely to be compensated at market value.

The Labour party's renationalisation policy is a key risk factor for equity investors. However, some interviewees noted that large-scale renationalisation would require a significant Labour majority, which, at the time of our interviews, looked unlikely.

The exact process for implementing the Labour party's policy of renationalising UK privately held utilities remains unclear; however, the consensus view from our interviewees is that any form of renationalisation would have a negative impact on utility investors.

It was also suggested by several interviewees that full renationalisation could be unlikely due to the complexities and costs involved; a more likely outcome could be further policy interventions to benefit workers and customers. Examples cited include greater board representation by employees and further constraints on distributions to investors.

Some equity investors suggested that there is now not enough upside – with both the challenging RIIO outlook and renationalisation risk – to justify investing in the sector, with some investors suggesting that it was becoming increasingly difficult to complete transactions.

Some interviewees stated that renationalisation without adequate compensation[8] would be hugely detrimental to the UK economy as it would undermine investor confidence in the UK. It would lead to a worsening in the credit quality of utility holding companies, which could be particularly problematic for companies that are highly geared. While investors do not currently view this as part of their central planning assumptions, Labour's policy remains unclear and it's partly contributing to a lower appetite to invest in the sector.

On the debt side, some interviewees suggested that if renationalisation happens it would be credit positive for operating company ('OpCo') debt. They noted that the Labour party has indicated that the current debt in place would be paid when due, and theoretically it would be guaranteed by the government which is lower risk than a private company so the credit rating could even improve.

However, additional financing within the corporate structure (at a middle company level ('MidCo') or at the holding company ('HoldCo')) requires strong operating company performance, which is likely to be weakened in a renationalisation situation. This would reduce the credit quality of the middle company level or holding company debt.

Another interviewee suggested that the renationalisation impact will depend on:

- The extent of guarantees given to the creditors; and

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[7] In April 2019, Ofwat consulted on the incentives they place on companies in their price controls to assess whether companies are encouraged to strike the right balance between the interests of customers and investors when deciding on how to finance their business. They published their final decision in July 2019.

[8] Labour's 'Bringing Energy Home' plan suggested that Parliament may seek to make deductions for compensation on the basis of asset stripping since privatisation amongst other things.

- The nature of regulation post-renationalisation, which they view as likely to be less independent and this would be a negative for the industry. However, if there are creditor guarantees this may lessen the impact.

One interviewee summed up potential renationalisation as “a low probability, high impact event”.

E. All interviewees agreed that the risks posed by Brexit are relatively low for UK utilities.

The majority of stakeholders expect there to be limited operational impacts from Brexit on regulated utilities (relative to other sectors of the UK economy). They suggested that the potential impact of a ‘no deal’ Brexit has been planned for across UK utilities with additional arrangements in place to maintain access to critical supplies.

Interviewees noted the potential exchange rate impacts from Brexit and the associated costs involved in hedging various financial positions. However, several also observed that sterling devaluation typically leads to inflation, which would tend to be positive for most utilities (because they are likely to benefit more from inflationary customer bill increases than suffer from cost inflation pressures).

Notwithstanding limited operational impacts for UK utilities, interviewees consider Brexit will reduce global investors’ appetite for UK assets and it is anticipated that some global investors will hold back from investing until the outcome of Brexit is clearer.

One interviewee also stated that the current political instability, could in turn lead to a Corbyn-led Labour government, thereby increasing the renationalisation risk. Similarly, one interviewee added that Brexit could increase risks of a Scottish vote for independence (which would be particularly disruptive to SGN’s business).

Ultimately, most interviewees consider the operational risks from Brexit for utilities are small, and it is the impact on macroeconomic variables which are more important. However, regulatory risks are of far greater concern.

F. Interviewees had contrasting views on whether the energy or water networks were currently more risky for investors. Some viewed gas networks as more risky due to the uncertainty around how long gas will be an important source of energy for the UK. Whereas others viewed water as more risky due to the regulatory environment being currently perceived as more onerous.

On balance, interviewees generally viewed the energy and water networks as having broadly similar risk. Approximately half suggested that the sectors were equally risky, with the remaining half split between viewing either energy or water as riskier.

Several interviewees suggested that regulators were closely aligned in terms of their regulatory packages and cost of capital allowances. However, others suggested that they do appear to be operating differently, with some interviewees suggesting that the incentives and allowances are more significantly skewed to the downside in the water sector.

Most stakeholders viewed the regulatory changes in energy to be less significant, although they suggested that the 50 basis points (bps[9]) reduction on allowed equity returns (from the wedge between expected and allowed returns) is severe and is a change from regulatory practice.

Several stakeholders noted that there is more public scrutiny of the water sector and it is higher up the Labour party’s ‘renationalisation wishlist’. One interviewee suggested that a contributing factor for this is because there is only one provider in each region and so they are more open to scrutiny, unlike gas or electricity where customers have a choice of retailer.

Most interviewees suggested that the long-term risks are greater in energy, for example, the issue of long-term use of the gas distribution network, the move to biogas and potential for using hydrogen in the gas distribution network. Most interviewees suggested that there is a risk that energy companies could be

[9] Basis points (bps) is a common financial unit of measure (e.g. for interest rates). 1 bps denotes a 0.01% change.

managing an asset in decline and there is the potential for stranded assets in the industry. Two stakeholders noted that this could reduce investor appetite for long-term debt in the gas sector. In addition, it was suggested by one stakeholder that Ofgem need to develop a regulatory framework which is effective in managing a shrinking regulatory asset base; something which has never occurred before in the UK.

One interviewee commented that if they were going to lend to anyone they would choose electricity distribution because there is longer left in ED-1[10] and electricity is lower risk than gas. They also observed that cash flow and credit ratios are currently stronger in electricity distribution. Another stakeholder considered there to be more potential upside in electricity distribution.

Another noted that, while water is a lower risk business, there is greater variation in company performance compared to the energy sector, and therefore it depends on which companies an investor is allocating capital to.

Overall, interviewees generally viewed the energy and water networks as having broadly similar risk. The regulatory and renationalisation risks are viewed as greater in water. However, the potential for asset stranding means the gas distribution sector has higher medium to long-term risks.

4.2 The financial parameters of RIIO-2 price controls

A. Most stakeholders considered that Ofgem's proposed allowed return on equity (4.3% real, CPIH [11]) is too low to compensate investors for the risks associated with energy networks.

Most interviewees consider that the regulated energy sector has offered an attractive risk/return trade-off over the last 10 years which has resulted in a high level of capital investment. The lower allowed returns proposed by Ofgem in RIIO-2 fundamentally change this trade-off. In summary, the equity investors we interviewed consider the risks have risen, but allowed returns have fallen. The proposed allowed returns are therefore no longer commensurate with the risks borne by equity.

Another interviewee commented that while utility businesses are relatively low risk compared with other assets, they still require complex infrastructure and operational management. This means they require commensurately higher returns than the allowed equity return currently being proposed by Ofgem.

Another investor suggested that there is higher appetite to invest in lower risk stand-alone infrastructure projects, such as OFTOs[12] and Thames Tideway, as the risk-return payoff is better than for energy networks.

Additionally, the majority of interviewees considered that the 4.3% allowed equity return (real, CPI[13]-linked) presents a significant financial risk through lower buffers to absorb shocks. The rate is significantly lower than in RIIO-GD1 and although companies have some scope to capture return through efficiency plans, the interviewee observed that the companies have to do 'more for less'. The upside cap[14] is perceived to disincentivise investment and one stakeholder commented that the energy sector is 'increasingly looking like an investment with little upside and greater downside'.

Specifically, a number of interviewees observed that a rate reduction in Ofgem's proposed allowed equity return does not make sense in light of the increased risk position. They view that Ofgem's proposed allowed return should be increased to reflect the higher level of risk.

Some interviewees considered that the lower cost of equity will reduce spending on innovation and long-term planning, whereas returns that followed the RIIO-1 approach would demonstrate stability and consistency. Several interviewees observed that a predictable regulatory approach which doesn't change but results in lower returns is preferable to an unpredictable regime which delivers lower returns through unforeseen methodological changes. Another interviewee suggested these low returns will incentivise companies to look again at financial structuring and higher leverage, which regulators have signalled they don't support.

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[10] ED-1 refers to the current price control for energy distribution companies.

[11] CPIH is a measure of the annual rate of consumer price inflation in the UK which includes occupier housing costs.

[12] Offshore transmission owners

[13] Consumer Price Index (CPI) measures inflation through consideration of the costs of goods and services bought by households.

[14] An upside cap limits the return an investor can achieve over a set period.

One interview commented that in the case of Ofwat, there are strong dividend tests being implemented as part of PR19. This means there will be situations where companies deliver high returns but if they miss their performance targets they won't be able to pay out dividends. The interviewee suggested that instead of using this approach, Ofgem should allow a higher WACC[15] to give companies 'more breathing room' and incentivise more efficient long-term investment, but then apply stricter measures for sharing outperformance to reduce gains to equity holders.

Some noted that a higher cost of equity would improve financeability thereby giving companies more capacity to make innovative investments, which would benefit society over the long-term. This would also improve investor appetite.

B. Several interviewees considered that Ofgem had been selective by using different time periods to estimate different WACC components, the proposed betas were too low and the 50 bps reduction for expected outperformance is unreasonable.

In addition to the point raised by most interviewees that Ofgem's proposed WACC is too low, several commented on specific components of the WACC and how they are calculated. Stakeholders suggested that Ofgem's betas[16] are too low and incorrectly estimated. Two interviewees observed that Ofgem have selected different time periods for different WACC components in order to 'produce the lowest overall estimate', which they view to be an inconsistent approach.

As already mentioned in this report, many interviewees viewed the 50 bps outperformance deduction (the wedge between expected return and allowed return) as too aggressive and wrong from a conceptual standpoint.

On the cost of debt, several interviewees suggested that a 20-year cost of debt indexation would be a more appropriate match for the energy industry's long-lived assets. Some commented that Ofgem should use the tromboning approach across all the RIIO price controls, as currently used in electricity distribution. Indeed some interviewees considered not enough attention had been given to the cost of debt allowances, particularly as they make up 60% of the capital structure.

Two interviewees considered that the cost of capital components are broadly in the right region. They suggested that if Ofgem removed the proposed 50 bps outperformance adjustment, which is creating uncertainty and hasn't been communicated well, then around a 5% allowed return on equity (real, CPIH) is reasonable. The interviewees acknowledged that bond yields and other WACC components have reduced since the RIIO-1 price control and hence a lower estimate is consistent with market conditions.

C. Financial stakeholders thought that the regulatory regime proposed by Ofgem could do more to enable companies deal with longer-term industry risks, such as the asset stranding risk for gas distribution networks.

Some stakeholders suggested that the lower WACC makes it harder for companies to make long-term plans as they are more focused on hitting short-term financial targets. As a result, some stakeholders considered that Ofgem was passing the risk and expense of investing in new assets onto future generations. One interviewee suggested that the reduced focus on the long-term risks and resilience could significantly impact the future of UK gas networks.

Another interviewee commented that if an asset has a long useful life (e.g. 50 years for a gas pipeline), then regulation should protect the company and the agreed return over this time period and against technological advances, such as electrification. This will remove the risk of stranded assets. An alternative suggestion was an accelerated depreciation profile (such as the sum of digits method) so that gas network assets are highly depreciated by the time they are at risk of being stranded.

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[15] Weighted Average Cost of Capital.

[16] A beta is used in Ofgem's cost of equity calculation and refers to the volatility of a stock in relation to the broader stock market.

Most interviewees shared the view that the energy sector has changed considerably in the last 10 years and there's uncertainty as to how it's going to evolve in future years. Therefore, there is value in the flexibility of having shorter term financing arrangements.

D. Interviewees suggested that there should be greater incentives for innovative investment in energy networks.

There was praise from one interviewee in relation to Ofgem's low carbon innovation funding, but less praise for companies due to not addressing some of the bigger technological challenges.

As noted previously, several interviewees considered that Ofgem's overall focus has shifted towards the short-term and there is now less incentive for companies to innovate. Lower proposed returns have reduced appetite and ability to spend on more risky capital expenditure, which means that companies are going to face difficult trade-offs and proposed investment projects will be scaled down or not go ahead.

Several stakeholders consider that the focus of companies is likely to move more towards day-to-day cash flow and risk mitigation and away from innovation and outperformance under the RIIO-2 regulation regime. The overall view is that the transition to operating companies on a short-term basis may be 'the right thing to do for the company and their investors' to meet short-term regulatory requirements, but not for the sector and the UK economy over the long-term.

One interviewee commented that companies are not incentivised to make innovative investments because they do not always get the additional benefit of investing in innovation as it's constrained by the regulatory regime.

Another interviewee commented that UK energy companies are lagging behind their international counterparts in their preparation for changes in the energy sector such as the advent of biogas or, longer term, hydrogen. Sweden was noted as a country where companies have made good progress in their adaptation to such changes.

E. The majority of stakeholders who expressed a view considered the switch from RPI[17] to CPIH will have short term benefits for liquidity and credit metrics, but also noted it may have detrimental impacts over the long run.

Most interviewees did not express particularly strong concerns about the transition from RPI to CPIH and considered it could be managed successfully. Some observed that the transition will take time, particularly in relation to long-term financing arrangements and this will result in financial mismatches in the intervening period. In this regard, the Ofwat approach of a phased transition is viewed more positively.

Most interviewees that expressed a view considered the switch to CPIH as positive for financial cash metrics over RIIO-2, with offsetting reduction in RAV[18] growth. It was also noted that the current outlook for RIIO-2 would make such liquidity support important to companies. Several suggested that the change to CPIH is being used to 'paper over' fundamental financeability challenges in the sector and one suggested financeability testing should still be conducted on an RPI basis (even if returns are set in relation to CPIH indexation).

The majority of interviewees considered the switch to CPIH to be a fundamental change for regulators (Ofgem and Ofwat) and viewed it as more significant than changing capitalisation or depreciation rates. This was confirmed by rating agency interviewees, who treat the switch to CPIH as a permanent change and therefore the cashflow advantage of CPIH indexation can reasonably benefit financial ratios such as interest cover. This contrasts to changes in capitalisation or depreciation rates which can be reversed or have clear medium-term opposing effects.

One stakeholder observed that one of the challenges when an entire sector has been funded on the basis of one set of assumptions (e.g. RPI indexation of RAV, some potential for outperformance, and no net penalties) and these are changed, then the premise on which the investment case is built is substantially

[17] Retail Price Index (RPI) measures inflation based on the cost of a sample of retail goods and services.

[18] The Regulatory Asset Value (RAV) is the value ascribed to the capital employed in the regulated business.

altered. This can result in less willing, or indeed inappropriate equity investors owning utility assets. Such investors are not likely to invest further in the business and are more likely to be seeking exit opportunities, a position which is not in the best interests of the company or its customers. This also demonstrates the benefit of a stable regulatory regime with well suited investors.

4.3 Equity market conditions

A. Most equity investors stated that the UK energy sector is not currently an attractive investment opportunity. Some cited the proposed regulatory changes and low cost of capital as the main factors, whereas others mentioned the risk that there could be value losses if the industry is renationalised.

Despite a number of utility transactions occurring at a premium to Regulated Asset Value (RAV) in recent years, several interviewees suggested that companies might struggle to attract new equity investors during RIIO-2. The view of the extent of this struggle varied according to the type of interviewee. Generally speaking, those currently invested in the sector[19] were more pessimistic, whereas those who are not currently invested in UK utilities[20] were less pessimistic and saw continuing equity investor demand for UK utility assets. One interviewee noted that the recent transactions that have occurred at a premium to RAV shows that there is still an appetite to invest in certain segments of the energy utilities market.

The general consensus from existing investors is that there are few international and domestic investors actively seeking to invest in the UK energy sector at the moment. This may be explained by: (i) some investors viewing the sector as unattractive at current valuations and risk profiles; and (ii) other investors considering the UK wider political environment as too uncertain at the moment. These two explanations are expanded below.

Evolution in the investor base

Interviewees with a pessimistic outlook typically questioned the decisions of investors that have recently bought equity in the electricity and water sectors at a significant premium to RAV. They also acknowledged there has been a move away from traditional private utility fund investors and towards investors that have different business models and target returns. More recent utility sector investors have expanded out of infrastructure, seeking a reasonable yield in a low interest rate environment.

Another example of a different type of utilities investor was provided by one interviewee who has an immature fund that has a ‘total return approach’ (i.e. their investment strategy aims to generate returns from interest, growth and dividends). However, the stakeholder acknowledged that they are not completely averse to a dividend-free period as their fund is unlikely to be paying out significant distributions to its investors until the late 2020s and 2030s, so they are taking a longer-term approach to investing. This ability to delay returns was perhaps not as acceptable for a ‘typical’ equity investor that invested in utilities 5-10 years ago, with an assumption of a regular dividend pay-out of between 4% and 8%.

These interviewees considered the loss of diversity of investor type regrettable, but not something Ofgem would actively intervene to prevent. This is because securing low cost financing is a more important objective for Ofgem.

Two interviewees commented that regulators may not act to change something in the regulatory regime until they see assets trading at a significant discount to RAV, although this does not necessarily mean they will always intervene. Generally, European regulators appear to be satisfied that there is no need to intervene when regulated assets trading at a discount to their regulatory value. While UK markets are not there yet, this could lead to a situation of ‘trapped’ equity, where equity is poorly valued, but unwilling to either exit, or invest. Such a situation is unlikely to drive the innovation or productivity improvements needed by customers and broader society.

International comparisons

Some interviewees compared the UK utilities market with overseas opportunities and commented that ‘regulatory risk is skewed to the downside across Europe’ and ‘global funds can find superior risk-adjusted

[19] 3-4 interviewees

[20] 3-4 interviewees

returns in other markets'. Some investors suggested that US utilities offer a more predictable regulatory regime and higher returns. However, it was acknowledged that not all domestic investors or funds are able to access these options.

B. A smaller group of interviewees considered that there are still sufficient sources of equity investment from both domestic and foreign sources.

The interviewees with a more positive outlook suggested that new sources of equity remain available. They observed that in transactions involving a whole business or partial stake, this required investors to 'get comfortable' with renationalisation risks.

Further, they considered that international investors were benefiting from both lower values compared to 12 months ago could obtain an additional 'discount' as a consequence of sterling depreciation.

These interviewees suggested that obtaining additional public equity could be achievable. This is helped by the fact that UK listed utility equity constitutes a small portion of the FTSE-350, and hence investors that seek an allocation to the UK utilities sector have a limited supply of companies to invest in. This route is not available to the privately held gas distribution network sector, and one interviewee noted that none of the talked about potential IPOs[21] of UK network utilities in the past few years has materialised.

C. Existing equity investors will only invest more equity with a strong business case.

Some interviewees suggested that there is a possibility that existing equity holders won't inject more equity capital if the business is unable to fund expansion capital requirements by itself (or use additional debt finance) or if there is a rapid deterioration in the business during a stress event.

Two interviewees suggested that funding investments through retained dividends may be an alternative option to raising debt or equity, however, they recognised that this 'isn't good for the market and gives negative signals to an otherwise stable sector'. They also noted that this raises funds relatively slowly.

They observed that when there is an expectation of achieving very low returns, investors will not want to inject additional equity capital and may seek to use hybrid financial instruments instead.

One stakeholder suggested that investors may seek to avoid injecting additional funds; however, if the investment is required to protect the business from more substantial value deterioration, then investors are still likely to invest. Such decisions are not entirely motivated by target returns; rather value preservation.

4.4 Debt market conditions

A. Debt investors generally viewed that there is currently sufficient capacity and investor appetite to finance UK utilities, but noted that performance risks are now skewed to the downside which will impact utility debt spreads.

Debt investors suggested that companies are currently able to finance themselves with little difficulty, helped by low yields in debt capital markets. Several interviewees pointed to recent bond issuances with low yields (e.g. Southern Water) and also provided examples of large refinancings in the past year, which were successful and demonstrated both debt capacity and investor appetite.

Several interviewees commented that the changes in the regulatory regime will make it difficult for companies to attract debt capital in RIIO-2 at their current credit ratings, which will increase the cost of debt. One commented that there is concern amongst some investors that Ofgem is overly relaxed on high leverage and ownership risks in the industry. In response to regulatory moves in the water sector requiring highly geared companies to share financial benefits they derive from their debt structures with customers, some companies have restructured their financing. In one example, Southern Water undertook a £450 million refinancing in order to move debt out of the regulated utility business into a new MidCo, thereby reducing the leverage in the regulated business. One interviewee suggested that this form of refinancing will become harder, as some of the more traditional sources of debt capital at the HoldCo and MidCo level are

[21] An Initial Public Offering (IPO) is a type of public offering in which shares of a company are sold to investors.

leaving the UK market. Such investors are increasingly allocating more capital to the US and Canadian markets instead.

Debt investors were less concerned than equity investors about the Labour party's renationalisation plans. Some noted that the Labour party has indicated that, where appropriate, the debt would be repaid, which partially mitigates this risk.

Two interviewees observed that debt markets don't like binary risks and they will not ignore this risk altogether. Another investor commented that equity values will be under threat in some companies, which will have knock-on implications for certain debt investors. Several commented that it depends on where the debt is in the capital structure – they assumed that OpCo debt is secure, whereas MidCo and HoldCo debt is exposed to greater risk. One interviewee suggested that a real exodus in the debt markets is possible if renationalisation materialises.

Some stakeholders believe that a trigger event may well result in ratings downgrades across the energy industry, but it is more likely to be a gradual move in both yields and ratings. This means that the historic 'halo' effect where utilities outperform benchmark iBoxx indices is unlikely to be maintained.

Several interviewees considered that the impact on debt markets will largely depend on the final RIIO-2 regulatory package. There will 'certainly be less appetite than during RIIO-1' and if companies have lower cash flows it will cost them more to raise debt. But generally the impact will be experienced through pricing rather than the availability of debt finance. For example, some utilities issued debt shortly after the collapse of Lehman Brothers, but rather than there being a complete shortfall in demand it simply cost more than it would have prior to the crisis. It's unlikely that banks will stop lending but it's going to cost the credit issuers more.

Overall, the rating agencies and debt investors did not currently foresee any major issues with energy companies refinancing debt over GD-2. However, most interviewees agreed that debt costs would likely increase, particularly if ratings are downgraded.

B. Debt investors and ratings agencies generally agreed that target ratings for the sector should be around A/BBB+. Some interviewees suggested that firms would find it difficult to secure financing at ratings lower than BBB (flat).

Most stakeholders consider that cuts to returns will make it harder for companies to achieve the A/BBB rating level that Ofgem uses to benchmark the cost of debt. One stakeholder commented that utilities have gone from being a stable sector to one in which companies can now make losses in any year and this will translate to a more difficult environment to achieve strong ratings.

One stakeholder noted that the sweet spot will always be the A range to attract the widest range and longest-term insurance related capital, however BBB+ might be more realistic in the current environment. Others commented that at A/BBB companies have got some headroom and can 'withstand a downgrade', but at lower ratings it will certainly be more difficult for them as investors are clearly ratings sensitive. However, one interviewee commented that he saw no benefit to the companies of moving from up to an A-rating compared to a BBB+.

Some interviewees suggested that BBB+ or BBB at the OpCo is manageable (for example, one debt investor preferred BBB within the broader BBB range as it offers a better capital/return trade-off). However, at BBB– the yield will rise significantly which will make things more difficult for companies. They would just about meet the licence requirements but it's 'not a comfortable place to be'. Across the BBB range, there is more liquidity at BBB+ and BBB, but if companies were downgraded to BBB– they would lose a lot of liquidity. Additionally, a BBB or BBB– rating does not allow for issuance of subordinate debt, which is typically a rating notch lower.

Some interviewees commented that the extent to which regulators are willing to accommodate lower (investment grade) credit ratings is unclear. They suggested that there is a strong financial incentive to maintain a higher rating than BBB, but it's not clear what the regulators' view on this is or to what extent lower investment grade ratings are acceptable in their view.

C. In order to improve financeability, most interviewees suggested that companies could adjust their capital structures or potentially engage in more aggressive financing decisions.

Most interviewees suggested that companies could make adjustments to their capital structures to improve financeability. Specific options included:

- Debt reduction via cash flow over dividends;
- Shifting debt from OpCos to MidCos – which one interviewee noted has been the reaction of water companies to the gearing sharing mechanism;
- Refinancing to trade historic debt incurred at higher interest rates for cheaper debt; or
- Trading strength in one credit ratio for weakness in another (e.g. using a derivative).

A number of debt investors commented that although financeability may be more difficult, companies can 'always inject more equity'. Several interviewees commented that rating agencies expect this might happen. But, as we note above, the appetite of existing equity investors to invest additional equity at the moment is limited.

One interviewee suggested that companies could engage in more aggressive financing decisions, such as swap restructuring, to improve financeability. However, two further interviewees suggested that companies should refrain from financial engineering.

Another suggested that Ofgem could help by allowing the cost of legacy embedded debt to fully pass through to customers and then focus on setting incentives for the efficient issuance of new debt.

D. Most interviewees expect a CPI index-linked debt market to grow gradually over the RIIO-2 period.

The switch to a CPIH indexation regime for RIIO-2 means that companies will naturally seek to raise CPI index-linked debt. The liabilities for many long-term investors are moving to CPI, so there is a clear demand for a CPI index-linked debt market.

The market for CPI index-linked debt is currently nascent, but all interviewees expected it to grow. It was described as being a 'question of when, rather than if'. Although some interviewees noted that CPI linkers are not coming any time soon and until this happens there won't be the same level of depth in the market.

Some interviewees considered the market for CPI index-linked debt could grow quite quickly. They suggested that there just needs to be a few benchmark transactions (probably issued at higher costs) and then more financing will follow.

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