

# Agenda

Advancing economics in business

## Regulation taking the credit: securing capital for utilities

**The scale of investment facing the UK infrastructure sector demands that independent economic regulators allow regulated entities to take a long-term perspective. Standard & Poor's believes that, in this respect, the regulatory frameworks in place are generally supportive of credit quality. Michael Wilkins, Managing Director and Regional Head of the Infrastructure Finance Ratings practice at S&P, explains why the UK airport, gas and water sectors benefit from supportive regulatory frameworks**

When viewing UK regulated industries from a credit perspective, established regulatory frameworks are typically supportive. Business risk profiles across regulated sectors are generally backed by stable and transparent regulation. These strengths are partly offset by regulatory reset risk<sup>1</sup> and UK regulators' use of comparative competition. However, the reviews conducted by regulators to rebalance prices in response to input costs can also act as a 'credit positive'—protecting critical infrastructure sectors against fundamental changes in key variables, such as operating costs and capital expenditure (CAPEX).

### Business profiles

Regulation plays a significant role in the assessment of credit quality in several UK sectors, and the UK airport, gas and water sectors are worth comparing from a credit perspective.

Certainly, all these sectors boast similarly strong business risk profiles, upheld by supportive and transparent regulation, a lack of competition, a stable economy and solid operations. The water sector has slightly less risk due to the sound usage fundamentals and lack of product substitution availability.

However, despite their stable underlying business, owners of gas and water utilities are employing aggressive financial structures to maximise returns, thereby limiting their credit ratings.

Ratings for airports are likewise suffering downward pressure due to the sector's expansion outside the regulated business, resulting in a more aggressive financial profile. Therefore, airports tend to have credit ratings towards the middle of the investment-grade

spectrum—with BAA, the UK's largest airports operator, rated at BBB+. The recent downgrade of BAA follows its defence against a takeover proposal from Airport Development and Investment Limited (ADI), a consortium of bidders led by Spanish infrastructure group Grupo Ferrovial SA. The board has since recommended the takeover and ADI formerly took control of BAA on July 10th 2006. The rating remains on CreditWatch with negative implications pending a review of the credit impact generated by the acquisition financing. The 'BBB+' rating reflects S&P's expectation that existing bondholders will be migrated to a special purpose vehicle, where BAA's existing debt will be rated at least at the current rating level. Other airports, such as Birmingham and Newcastle, are rated at A– and BBB+ respectively.

### Supportive and transparent regulatory environments

All three sectors—airports, gas and water—benefit from the credit strengths provided by their regulatory environments as well as close oversight by politicians and environmental regulators.

#### Airports

The airport sector regulatory framework has proved workable throughout its approximately 20 years of existence. However, the regulatory process is becoming increasingly complex and lengthy, with two authorities—the Civil Aviation Authority (CAA), the primary regulator of UK airports, as well as the Competition Commission—having increasingly divergent views as well as overlapping roles. Despite this, the outcome of the 2003–08 review has provided a clear platform for investment, giving visibility and stability to the revenue base.

This article is based on 'The Role of Ratings Agencies', a presentation by Michael Wilkins at the Oxera conference, 'The Future of Infrastructure Regulation', London, May 15th 2006.

This most recent regulatory review contained a number of decisions that were viewed favourably by S&P. For example, from a credit perspective, the ability to recover the cost of investment during construction allows BAA to collect revenues associated with long-term projects before completion. This will boost operating cash flow and therefore reduce the negative impact on the company's financial profile of the substantial increase in debt necessary to finance BAA's long-term investment plan.

Other CAA decisions have given us comfort that the investment plan is feasible, such as the increase in the real rate of return from 7.5% to 7.75%. This demonstrates the CAA's recognition of the higher investor risk posed by a hefty CAPEX plan—in particular the construction of Terminal 5 at London's Heathrow. In addition, BAA and its investors have been given a long-term view of what airport charges to expect—a key cash-flow driver—via the recommendation of a ten-year profile for the price caps.

### Gas and water

Despite being relatively challenging, regulatory frameworks in the gas and water sectors remain supportive, providing predictable cash flows to finance the utilities' operations when targets are met. Unlike airports, the gas and water sectors have relatively modest CAPEX programmes.

The UK gas and water sector regulators—Ofgem and Ofwat—utilise a five-year regulatory framework under a price cap approach. Environmental regulators also operate in the form of the Health and Safety Executive in the gas industry, and the Environment Agency and the Drinking Water Inspectorate in the water industry in England and Wales.

Gas transmission and distribution revenues are governed by the RPI – X price control formula, accounting for operating costs, CAPEX, replacement expenditure, cost of capital, regulatory asset values, and distribution volumes where appropriate. Water prices are determined in accordance with a formula based on annual price caps (RPI + K) and efficiency incentives (the X factor). Ofwat determines the K and X factors for each company based on the scale of capital investment programmes required to meet quality obligations and maintain the network. Companies' historical performance, and a 7.3% pre-tax cost of capital, are also accounted for.

Rolling incentive mechanisms enable the utilities to retain efficiency savings versus regulatory assumptions until the next review. It is therefore unlikely that a utility will significantly miss its cost determination.

In the gas industry there are explicit ring-fencing provisions built into the licences that allow Ofgem to

restrict cash flows in the event of a substantial deterioration of credit quality to non-investment grade. This means that the likelihood of the operating companies becoming insolvent is remote.

Ofwat is incorporating similar ring-fencing measures into water licences as they are reviewed. Notably, the regulator has expressed its view that a BBB credit rating is unsustainable for a water company over the long term—as was the case when Northumbrian Water was downgraded to BBB on its acquisition by Aquavit plc. These reactive ring-fencing provisions protect the licensed business from the utility's parent company. For example, Wessex Water is protected to an extent from the lower credit quality of its owner, YTL Power International Berhad.

In addition, there are mechanisms in the gas industry to reduce the impact of weather variability and throughput on gas distribution networks (DNs).

### Credit weaknesses and risk mitigants

The airport, gas and water sectors each face an array of credit weaknesses. However, mitigants are in place throughout each sector—often via the regulatory framework—reducing the impact of such concerns on companies' credit qualities.

#### Airports

With the possible exception of BAA following the ADI acquisition, UK airport companies tend to be modestly geared—with debt to capital ratios typically at 50–60%. However, the major CAPEX programmes faced by these entities are a significant credit weakness, due to the forecast gradual increase in leverage within the sector.

Similarly, the enhanced role of the airlines in the next regulatory review of BAA's London airports and Manchester Airport is viewed cautiously by S&P. Certain parts of the regulatory process are set to become a bilateral bargain between the airports and the airlines, known as constructive engagement. This change could be detrimental to the regulatory process and the financial health of airports—with pressure being placed on tariff increases—since the interests of airports and airlines are not aligned. However, the exclusion of the cost of capital from the constructive engagement process mitigates this risk.

Important issues also arise concerning the timing, the method and the extent to which the CAA will ultimately allow BAA to recover from its significant investments in the 2008–13 regulatory period. Yet BAA has publicly stated that such extensive investments will only be made if future regulatory determinations are supportive, and it is confident of its ability to raise the necessary finance

without putting its financial robustness at risk. This provides S&P with some assurance.

External shocks are a risk for airports—more so than for the gas and water industries—and they are becoming more of an industry risk in nature, rather than an event risk, as illustrated by the recent threat of terrorist attacks in the UK on August 10th 2006, which disrupted operations across the industry. Stress-testing has therefore become essential in our credit analysis of airports.

S&P sees customer concentration and the dependence of airports on the lower-rated airline sector as weaknesses. However, airports with strong competitive positions are partially protected from this risk, as it is the strength of an airport's routes that underpins traffic stability, not the strength of individual airlines.

### Gas

UK gas utilities face regulatory risk due to a form of surrogate competition, in which Ofgem enforces efficiency targets and competition by comparison, resulting in downward pressure on regulatory tariffs and operating costs. Further to this, the gas sector could be adversely affected as a whole by a harsh regulatory view on the cost of capital or efficiency levels, making the sector less attractive to investors.

Newly rated gas DNs present a credit risk as a result of their lack of operating track record as independent entities, as well as their lack of historical audited financial information. S&P also recognises that the finite availability of gas and potential trend towards the use of alternative fuels are both significant weaknesses.

Unexpected pipeline bursts present a credit risk for UK gas utilities because of the stringent environmental and safety standards imposed. Similarly, weather variability presents a risk, causing fluctuations in monthly cash flows due to seasonal usage generating large swings in gas demand between summer lows and winter peaks, since gas is used predominately for home heating. This necessitates adequate liquidity reserves within a company's financial structure.

However, only 35% of gas DNs' annual revenues are based on volume. Furthermore, revenues are weighted towards domestic use and are therefore less dependent on large and very large users, and gas DNs are able to interrupt such contracts for balancing purposes. This low exposure to volumes is supported by the gas utilities' ability to recover allowed revenues in the following year in the event of under-recovery via a correction factor, and vice versa for an over-recovery.

### Water

Akin to gas, water utilities face credit risks in the form of regulatory uncertainty and comparative competition. The water industry also has increasingly stringent water quality and environmental standards. Monthly cash flows fluctuate due to seasonal usage, driven by the dry, hot weather during the summer months. The potential exists for usage caps to be enforced (as many are experiencing at the moment) as a result of low water supplies during dry conditions. In addition, any increase in metering could negatively affect revenues.

Unlike gas, water utilities suffer from negative cash flows and large, mandatory CAPEX programmes—especially for waste-water operations. Furthermore, stand-alone water companies tend to be small, thus increasing their susceptibility to credit shocks.

Nevertheless, Ofwat has been providing mitigants to the credit risks that S&P has identified. In the 2004 periodic review, Ofwat gave companies a finance adjustment, adding 1% to price limits for 2007–08 across the industry, rising to 1.3% in the following period. This revenue uplift ensures that key credit ratios are maintained at levels satisfactory for an investment-grade rating—clearly positive for credit quality.

The IDOK (interim determination of K) mechanism employed by Ofwat provides a key downside protection. Prices may be reset between periodic reviews if a water company experiences an adverse or favourable shock that affects turnover. Water utilities' tendency to prefund a high percentage of their expected financing requirements, and hedge interest rates, also mitigates the credit risks we have identified.

### Credit risks in the future

S&P recognises that various issues face all three industries that could potentially have an impact on their future credit quality. The new business and financial strategies to be pursued by BAA's new owners, ADI, could affect credit quality, as could, for example, the remote (although possible) break-up of BAA. Such an event could significantly affect its business profile with the loss of its monopolistic position and diminished diversification. Future international expansion could also pressurise credit ratings for airports, as could capacity constraints if the expansion of Stansted Airport were to be delayed.

For the gas and water sectors, we believe that regulatory risk will continue to be the key driver of future credit quality.

### Michael Wilkins

<sup>1</sup> Regulatory reset risk is the risk that the sector's regulator will reduce a utility's revenue via stricter price controls during a review.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email [d\\_holt@oxera.com](mailto:d_holt@oxera.com)

Other articles in the August issue of *Agenda* include:

- deconstructing entry barriers: crystal ball gazing or hard economics?
- open access: the price of fair competition
- who's in good health? measuring performance in the NHS

For details of how to subscribe to *Agenda*, please email [agenda@oxera.com](mailto:agenda@oxera.com), or visit our website

[www.oxera.com](http://www.oxera.com)