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Agenda

Advancing economics in business

Cash or promises: how should regulators deal with deteriorating balance sheets?

The way in which regulators have dealt with the deterioration in credit quality associated with persistent cash-flow deficits has varied. Some largely ignore the issue; some try to reprofile revenues; while others have addressed this by uplifting returns for affected companies. Derek Holt, Oxera Director, discusses the merits of these options

As has been highlighted in previous *Agenda* articles,[1] utilities and infrastructure companies have seen a substantial increase in investment requirements in recent years, driven by factors ranging from environmental regulations, the need to upgrade ageing systems, and dealing with growth. In some cases this has begun to stretch the balance sheet capacity of the companies, which have tended to rely on access to the debt markets to fund this investment.

How should regulators deal with this challenge? Should they even take notice, or should they instead rely on setting a sufficient allowed return (at least equal to the cost of capital) which, in principle, would enable the company to decide how to manage the investment programme?

Increasing attention has been paid to this issue by regulatory bodies globally. Ofwat and Ofgem have jointly issued a paper designed to stimulate debate in this area, and, more recently, Water UK, an industry association, has published an Oxera report investigating the key issues.[2] This article seeks to draw out the key questions that regulators will need to consider in relation to this debate in upcoming price reviews.

One of the more controversial aspects of the recent periodic review of charges in the water sector in England and Wales was the application of an uplift to companies' revenues totalling around £430m in net present value (NPV) terms. It was argued that the payments reflected the industry's continued high levels of investment and the impact this might have on companies' financial health if revenues were to be derived purely from the normal building-block approach to price-setting.[3]

At the same time, these payments, known as financeability payments, led to an average increase in the rates of return for the water companies of approximately 0.4%, which feeds through directly to consumers' bills.

A number of important policy questions for regulators emerge from this debate.

- Why were the financial positions of the companies under threat?
- Was Ofwat's approach appropriate?
- What is the best way to enable companies to finance investment in the future?
- What are the circumstances under which regulators can rely on companies accessing equity markets to resolve financing constraints they may face due to large capital investment programmes?
- What is the purpose of financeability payments?

In countries where detailed, price control regulation is well established, such as the UK, Ireland, Australia and New Zealand, most regulatory reviews include a check to ensure that the regulatory package is bankable, or, in other words, whether companies may be expected to be able to finance their activities. This generally includes an assessment of whether the companies will be able to maintain a sufficiently strong investment-grade or better credit rating (usually around BBB+ or A–), thus ensuring wide access to financial markets. Regulators will therefore often look at a package of indicators of financial health, to assess the likely impact of the regulatory control on the company. See the box below for more details.

This article is based on Oxera's report prepared for Water UK, 'Testing for Financeability: An Assessment', March 2006. Available at www.oxera.com.

Financial indicators

The main credit rating agencies—Standard and Poor's, Moody's and Fitch Ratings—base their assessments of the probability of default on a wide range of factors, including business risks, the strength and track record of management, and expected profiles of key financial indicators which are linked to default probabilities. In undertaking financeability tests, regulators often look at indicators (in consultation with financial stakeholders) such as the following, used by Ofwat in the 2004 review.

Cash interest cover (funds from operations (FFO):gross interest)	Around 3×
Adjusted cash interest cover (FFO less capital charges:gross interest)	Around 1.6×
Adjusted cash interest cover (FFO less capital maintenance expenditure:gross interest)	Around 2×
FFO:debt	Greater than 13%
Retained cash flow:debt	Greater than 7%
Gearing (net debt:regulatory capital value (RCV))	Below 65%

In general, financial indicators may be put under pressure as a result of one or more of the following factors.

- The company faces a substantial investment programme, generally in excess of the cash flows being generated from the recovery of past investments.
- A further cash imbalance may arise from the fact that payments to creditors in nominal terms may for a period exceed the corresponding allowed returns if the latter are based on real (pre-inflation) returns on an inflation-indexed asset base, consistent with the approach adopted by many regulators.
- The balance sheet already has a relatively high amount of debt.[4]

These factors explain why financeability may not have been an issue immediately at privatisation, when many companies are established with a fairly healthy balance sheet. As investment requirements build over time, however, this position can change.

Figure 1 provides an indicative example of how a company with high investment, and which faces an imbalance between real returns and nominal outflows, can experience a downward trend in its financial indicators.

The example shows how gearing can rise quickly as net new investment is required, with the effect exacerbated by the fact that the company typically pays interest in nominal terms to creditors while receiving initially lower 'real' interest returns from customers.

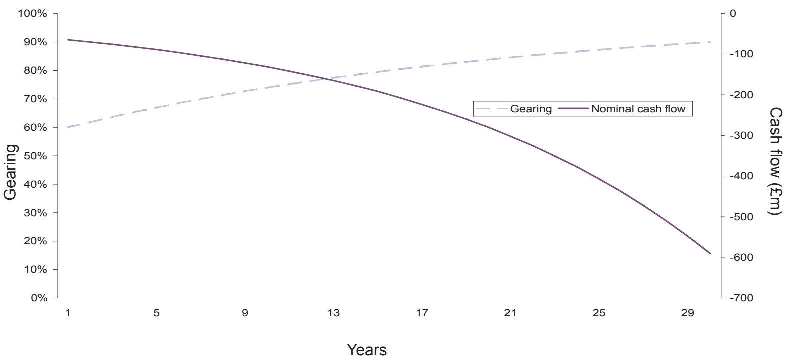
What can be done about this?

While it may be interesting to measure the impact of the investment programme on companies, it is perhaps more difficult to identify exactly what, if anything, should be done about this issue.

Regulators have several possible policy options at their disposal. They can:

- do nothing, under the assumption that rebalancing of the capital structure will suffice;
- reprofile returns to try to avoid deterioration of financial indicators;
- permit increased revenues to ensure that reasonably strong credit ratings may be retained by efficient companies.

Figure 1 CAPEX assumption changed to annual net CAPEX of 5% of RCV



Source: Oxera (2006), op. cit.

There are, of course, a myriad of variations on each of these themes.

Do nothing

The do-nothing scenario would assume that regulators do not need to test for financial robustness, provided they set controls that allow sufficient returns to cover the cost of capital for efficient companies. At its heart this assumes an absence of capital market and regulatory failures which may otherwise restrict companies' ability to address the problem through capital restructuring (eg, by issuing equity).

The problems associated with issuing equity (eg, through a rights issue) are well known: due to information asymmetries, it may signal low expectations about future performance, and the market often responds negatively when companies take this step. However, this is a general issue, not limited to regulated infrastructure companies, and has not prevented companies from using equity markets in other contexts.

In regulated sectors, investors must rely on future regulatory decisions, often over many review periods, in order to recover any upfront investments. While regulators have on the whole made progress in relation to the transparency of the regime, they are still in a position whereby they cannot fetter the discretion of their successors. In such a situation, investors (and credit rating agencies) may place more emphasis on returns within defined regulated periods, which are seen as offering lower risk than the promise of future cash flows. These reasons may offer an explanation as to why the experience of rights issues by utility companies in the UK is so limited.

Indeed, a recent investors' survey undertaken by Water UK identified such concerns:

> The majority [of respondents] said their reaction to any rights issue would depend on the reasoning behind it. A number stated that they would react negatively to a rights issue to fund capital expenditure, on the basis that this should be addressed through the IDOK [interim determination] process. None of the investors surveyed believed that rights issues would be a major source of funds over the next five years.[5]

A related point is whether it would be advisable, given existing evidence on access to the market, for a regulator such as Ofwat to rely on companies' ability to access the equity market at reasonable cost when facing a persistent cash-negative position and deteriorating credit quality. Given that terms of access can vary over time according to market sentiment, alongside the very limited evidence of utility rights issues, Ofwat's approach to take some action in response to the financeability issue appears reasonable.

Reprofiling

An alternative approach that regulators could adopt to reduce cash imbalances would be to reprofile revenues. There are many ways this could be achieved, some of which are briefly outlined in the box below.

One potential advantage of the reprofiling options cited in the box is that they are NPV-neutral: they do not require customers to pay more overall. However, some care must be taken when adopting any such approach. Some of the options would lead to considerable price increases in the short run, as well as an increase in the volatility of prices over time.

Furthermore, there may be a concern that relying on a change in depreciation allowances to rectify a financing problem will only delay the problem: cash will be improved now, but if investment requirements are not expected to decrease, the future ability of the companies to sustain the investment programme could be compromised. In particular, the size of the asset base will be reduced by any material acceleration of depreciation allowances, increasing the operational

Reprofiling revenues

In principle, regulators have some control over the profile of cash flows to companies through the way in which returns are set and through the depreciation formulas adopted. Options for bringing forward revenues, which might avoid a deterioration in the cash flows and financial indicators, could include the following.

- ***Allow returns on a nominal basis*—most regulated sectors earn real returns on an inflation-adjusted asset base. An alternative would be to allow nominal returns on a non-adjusted base. This approach is common in the regulation of US utilities. The NPV should be the same in both cases, although a change in approach could lead to a substantial short-term impact.**
- ***Accelerate the depreciation allowance*—for any given investment, cash could be returned more quickly to investors by reducing the period over which the investment is amortised. An extreme version of this would be to adopt a 'pay-as-you-go' model for paying for infrastructure investment, in which revenues sufficient to cover the costs of new assets are raised from user charges rather than funded on the balance sheet. A partial version of this approach was used in the most recent review of gas transportation charges in Great Britain.**
- ***Pre-funding of assets or borrowing from future periods*—regulators could 'borrow' from periods where cash flows and other financial indicators are likely to be robust, and use these to boost the financial position of companies during intensive periods of investment. An example of this approach is to allow pre-funding (early inclusion in the regulatory asset base) of assets in the course of construction. In its review of airport charges at the London airports, the Competition Commission recommended that BAA's returns be profiled over a ten-year period to avoid a substantial increase in charges towards the end of this period as new investments came into operation.[1]**

Note: [1] Competition Commission (2002), BAA plc: A Report on the Economic Regulation of the London Airports Companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd).'

gearing (sensitivity to shocks) that the company will face in the future.

For these reasons, regulators may need to exercise some caution before relying on this method to deal with any financeability issues.

Amending the returns

A third set of options relates to uplifting the level of revenues to improve the financial position of the firm. Again, various options for dealing with this are possible, including setting an industry-wide premium for returns, or providing revenues to those companies most affected. Factors to consider in relation to these options include whether it is reasonable for customers to pay higher bills than necessary to address the fundamental problem (which might suggest that a more targeted approach is appropriate), versus the potential distortion that might arise if companies are 'incentivised' to plan their capital programme (or choice of capital structure) in order to encourage a more lenient regulatory package.

It will certainly be important for regulators addressing financeability problems to be aware of any distortion to incentives that may be generated through any of the approaches identified. For example, Ofwat was very clear to exclude from its modelling any debt which companies had voluntarily incurred through capital restructuring when analysing the impact of the regulatory review on the companies' financial health. In this way it was able to focus on the underlying investment drivers, rather than financial factors directly under the control of management.

Key questions for the future

Oxera's research suggests that the financeability issue will not go away. It may even become more significant as investment requirements in water (driven by the Water Framework Directive) persist or even increase further; while in other sectors the issue may become more prevalent.

Central to the debate is the question of market (and regulatory) failure. The purist approach would suggest that companies should sort out profiling issues for themselves. However, in a context where investors are dependent on regulatory decisions over several decades in order to recover their cash, this view may not be expected to hold. At the same time it is crucial to understand the relationship between the regulatory framework and access to capital markets. It may be that more evidence of favourable access to equity markets by utilities emerges, in which case regulators may be more comfortable about standing back and letting the market decide how best to fund persistent cash-flow gaps in the future.

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[1] See, for example, Oxera (2006), 'Incentivising Infrastructure Investment: The Role of Regulators', Agenda, February, available at www.oxera.com.
[2] Ofwat and Ofgem (2006), 'Financing Networks: A Discussion Paper', February; and Oxera (2006), 'Testing for Financeability: An Assessment', report prepared for Water UK, March. Available at www.oxera.com.
[3] The building-block approach includes the determination of returns to investors by applying a weighted average cost of capital to the regulatory asset base.
[4] In the England and Wales water sector, Ofwat accepted that trends in the industry meant that it was appropriate to assume a starting level of gearing of around 55% for the purposes of modelling financeability. Industry levels had increased as a result of ongoing high levels of investment since privatisation. However, Ofwat did not reflect the gearing of those companies that had adopted highly leveraged models in its modelling, in part to avoid providing incentives for firms to adopt such models.
[5] Water UK (2005), 'Investor Survey: Key Findings', Whelan, A., Ecofin, and Indepen, March 29th.