

Protecting consumers, promoting value and safeguarding the future



PR09 Price Review Finance

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29 November 2007



Finance- Topics

- A walk through history
- The present
- PR09 and the future
 - Regulatory capital value
 - Cost of capital
 - Debt Indexation
 - Tax
 - Odds 'n' sods

5 years ago

- Discounts to the RCV
- Low debt costs, but expected to rise
- Dot com boom
- Limited market for index-linked debt



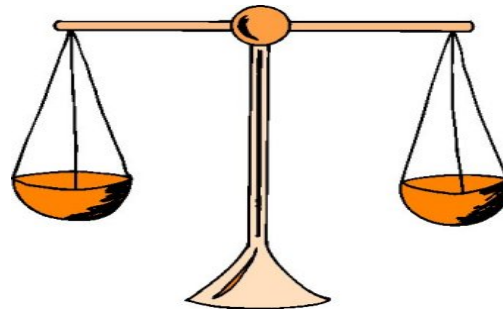
Looking forward

- Consistent regulatory platform
- Considerably lower WACC
- No revenue uplifts for financeability
 - Higher gearing range
 - Indexing market returns?
 - Capital programme

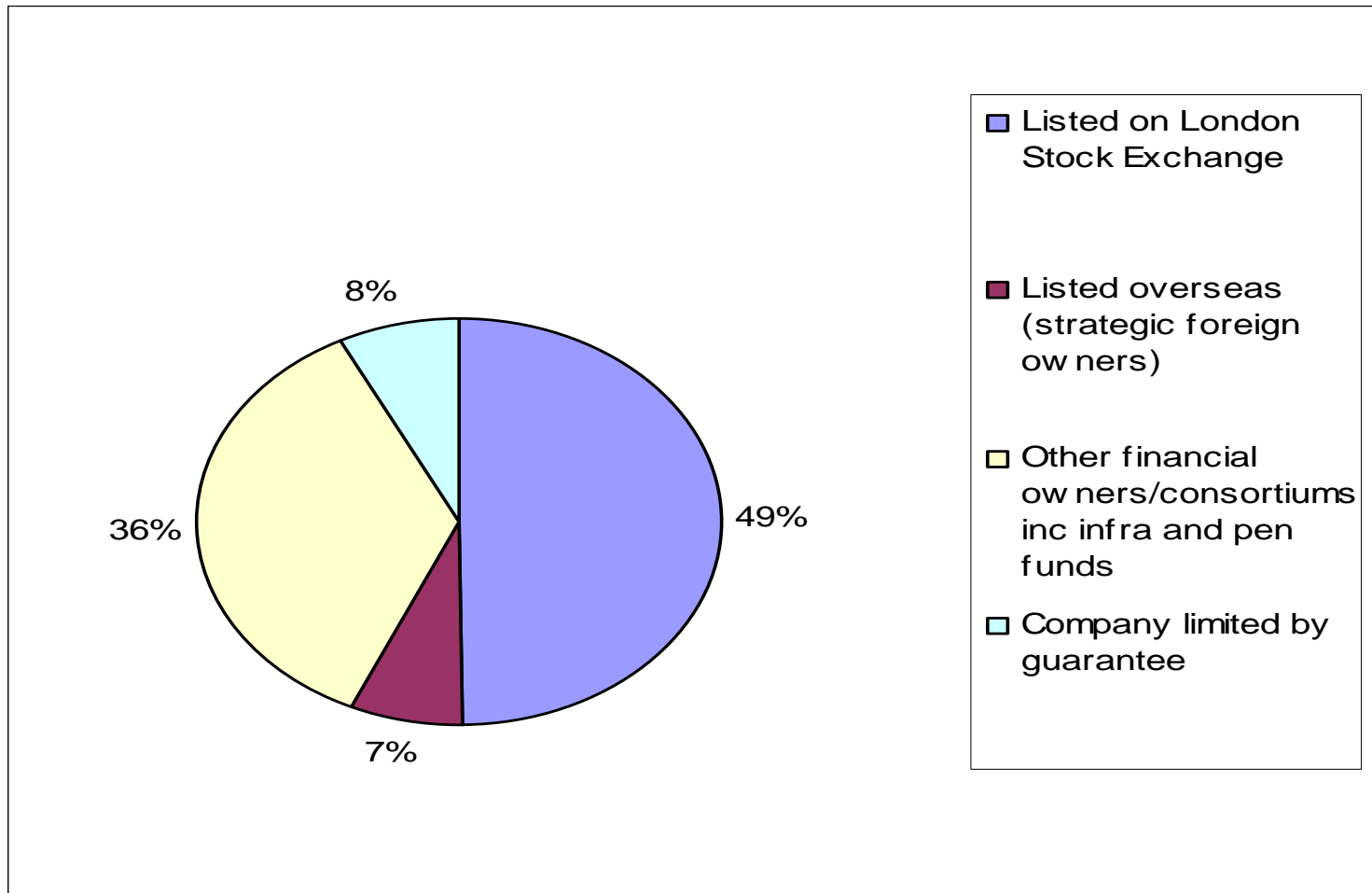


Cost of capital 1 – framework and context

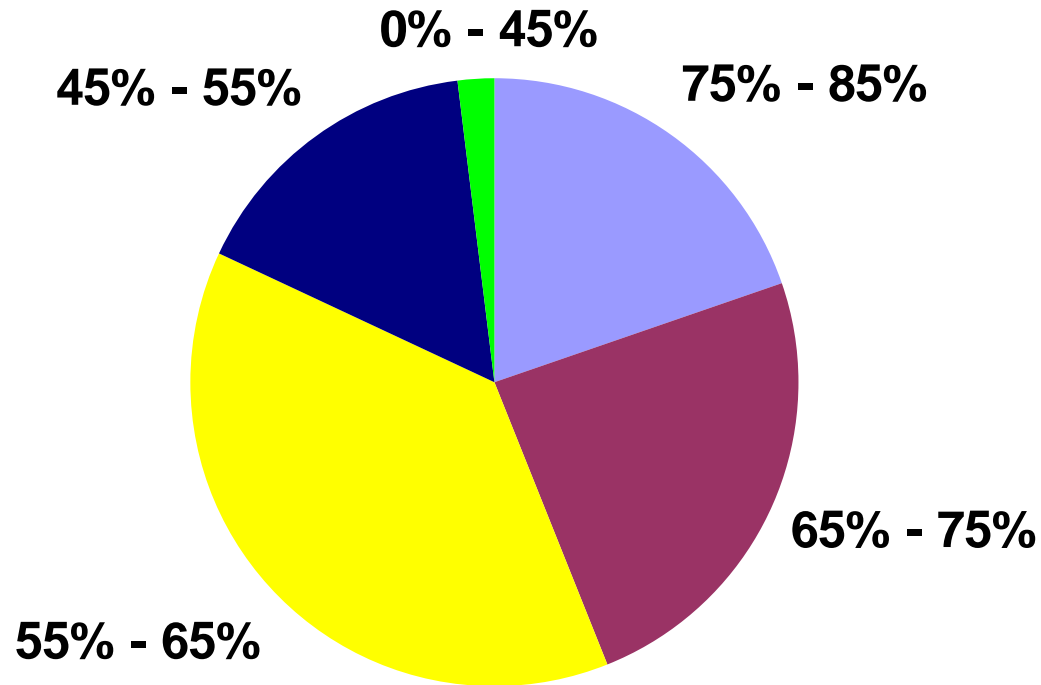
- Financing functions – two strands
- Use overall CAPM framework –taking into account of all market evidence.
- Transaction premiums and MARs – short term infrastructure bubble or long term adjustment to required returns?



Cost of capital 2 - Ownership structures by RCV



Cost of capital 3 - Gearing by RCV



Cost of capital 4 – evidence and other regulators' assessments

- Evidence suggests markedly lower WACC assumption at PR09.
- Other regulators' assessments:

%	DPCR4	TPCR	GDPCR proposal	CC advice Heathrow
	Dec 04	Dec 06	Sep 07	Oct 07
Equity	7.25	7.0	7.0	4.75 - 7.68
Debt	4.1	3.75	3.55	3.55
Gearing	60	60	62.5	60
Vanilla	5.4	5.1	4.8	4.0-5.2
Fully post	4.6	4.4	4.2	3.4-4.6



Cost of capital 5 - Small co premiums and financeability

- Small company premium
 - no evidence that it is required.
- Financeability
 - clear market led solutions particularly for a balanced capital programme.



Cost of capital 6 - Debt indexation

Two opposing views:

- Competition Commission advice to CAA – indexation does not offer sufficient benefits to justify apparent sub-optimal allocation of risk.
- CEPA – without indexation customers bear a very high insurance premium via the allowed WACC.
- PR09/03 consultation document sets out the issues for consideration.



Cost of capital 7 -Tax

- Ex ante at PR09 we will continue to allow for tax based on companies actual structure but with a floor on gearing equal to that underpinning the WACC.
- Ex post at PR14 will claw back tax benefits from any capital restructuring intra 2010-2015 period.
- No retrospective claw back for capital restructuring intra 2005-10 period.



Odds 'n' sods

- Interim determinations
- Change in notified index
- Pensions

Interim determinations

- Five notified items in place for the 2005-10 period.
- We do not see any compelling reason to continue any of the current notified items beyond 2010.



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The PR09 Price Control Finance

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