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Key questions for RIIO-T2 and GD2

LESSONS FROM THE SALE OF NATIONAL GRID GAS DISTRIBUTION

This is part of a series of notes that are relevant for the next RIIO price controls.

Over the past fifteen years, sales of equity stakes in UK regulated infrastructure have generally taken place at sizeable premia to the companies' Regulated Asset Values (RAV). The sale of a 61% equity stake in National Grid's gas distribution business (NGGD) in November 2016 was no exception: the implied valuation premium is the highest in the energy, water or transport sectors since 2000, and will attract attention from Ofgem as well as other industry stakeholders. This note comments on the implications of the MAR for the cost of finance in gas distribution.

THE HEADLINE MAR OF 1.53 IS HIGHER THAN WE HAVE SEEN IN UK REGULATED SECTORS

The market-asset ratio (MAR) compares the implied Enterprise Value (EV) from a transaction or share price to the RAV. NGGD's EV was reported as £13.8 billion, which appears consistent with information from NGGD's latest balance sheet. The resulting MAR is 1.53,[1] meaning that the transaction valued NGGD at a 53% premium to its RAV – highest of any transaction premium seen in UK regulated sectors since 2000.

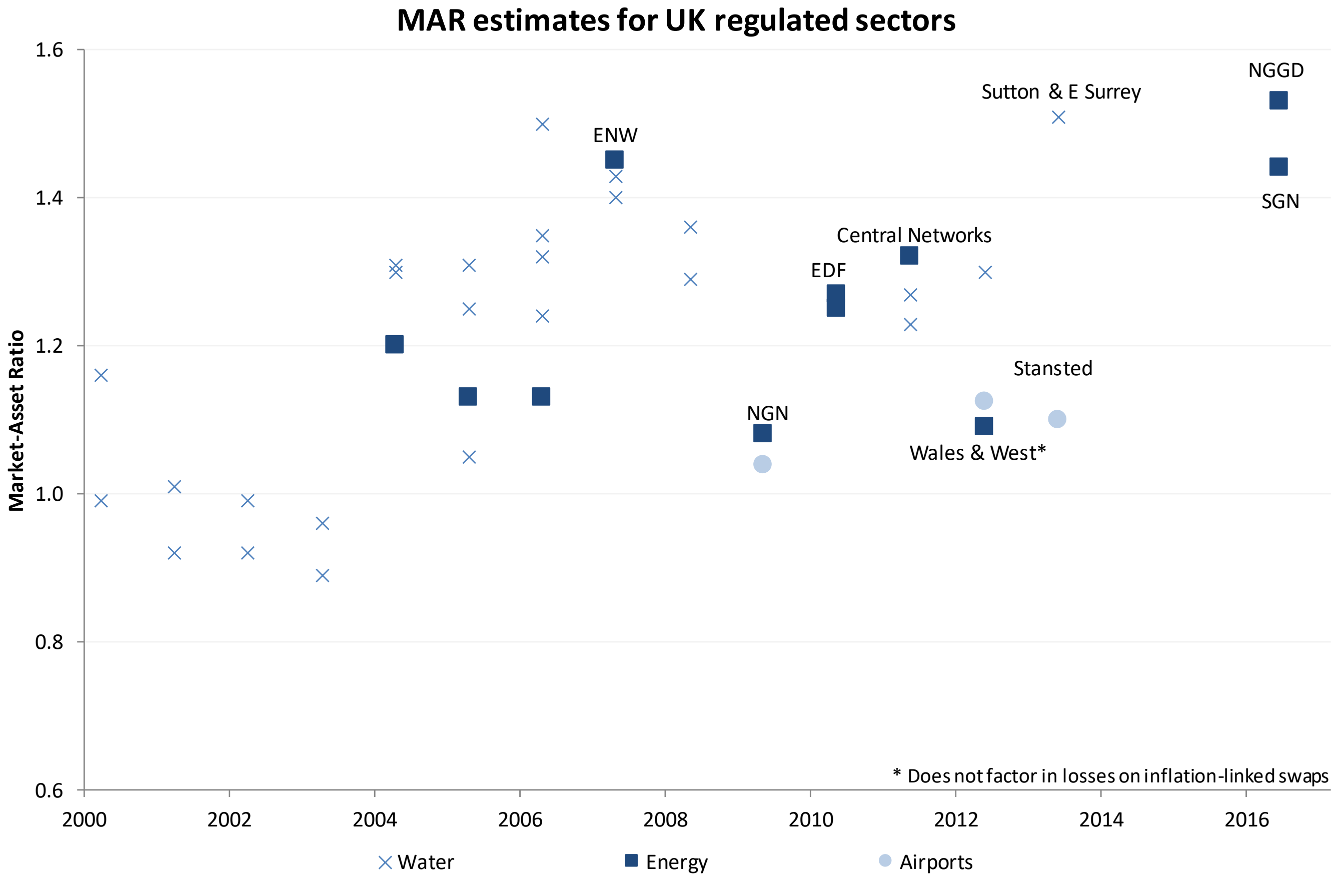
Why might the new investors be willing to price in a 53% premium? There are a range of sources of excess value over and above the RAV, including cost efficiency, income from incentives, outperforming Ofgem's financing cost assumptions and, in this case, currency movements. The rest of this note considers these factors.

PART OF THE PREMIUM MAY REFLECT ANTICIPATED EXCHANGE RATE CORRECTIONS

The timing of this transaction is unusual. The sale takes place in a period of uncertainty following the Brexit vote, with the GBP exchange rate at historic lows on a trade-weighted basis. Our analysis suggests the basket of currencies used to finance the transaction were around 15% stronger relative to the British pound than they were in June 2016. If exchange rates were expected to revert to their June levels, this could account for as much as 11 percentage points of the observed 53% premium.

The actual portion accounted for is likely to be smaller. There is no guarantee that exchange rates will revert to previous levels, and bidders are unlikely to have priced in such a movement in full. But we expect that up to five percentage points of the premium can be attributed to exchange rate expectations.

[1] Reported figures occasionally require adjustment to account for additional balance sheet items (e.g. cash or other short-term assets and liabilities), but in this case these appear to be immaterial.



THE TRUE COST OF EQUITY CONSISTENT WITH THE PREMIUM APPEARS TO BE BELOW 6%

What then accounts for the remaining portion of the premium? If NGGD were to perform precisely according to the assumptions Ofgem uses to set its price control allowances for an efficiently financed and operated 'notional entity', the value of future cash flows by definition would be equal to the RAV. Clearly the successful consortium expects to outperform one or more of the key price control parameters. Many of these are observable, but one – the actual cost of equity – cannot be directly observed. Market transactions such as the NGGD sale provide an opportunity to assess the underlying cost of equity implied by the MAR premium, by breaking down the contribution to the premium of different sources of potential outperformance.

The equity stake in NGGD was sold through an auction process. This is likely to have encouraged the winning consortium to price in the maximum feasible degree of outperformance. Equally, however, the transparency of the regime means that bidders are likely to have understood the constraints on outperformance. In our view, these constraints are likely to have been:

- Cost outperformance of 12.5% across the industry in RIIO-GD1 is unlikely to be repeated in the longer term. All gas distribution networks have performed strongly on iron mains replacement costs (repex). Ofgem is likely to respond by setting lower allowances in future price control settlements that reflect these efficiency gains.
- Ofgem can similarly be expected to recalibrate its incentive mechanisms in light of outperformance. Nevertheless, these are an important part of Ofgem's RIIO regime. It may be that strong RIIO-GD1 performance can be maintained in the longer term.
- Ofgem has signalled a reduction in the allowed cost of equity from the 6.7% allowed for RIIO-

GD1. Its decision of 6.0% in RIIO-ED1 provides a more likely precedent for future decisions.

- Finally, with uncertainty over future gas network utilisation (acknowledged by Ofgem through its front-loaded depreciation policy), growth in the real-terms RAV is unlikely. This will tend to reduce the long-term absolute value of outperformance.

The table below summarises the range of assumptions that could plausibly have underpinned the winning bid. We have also calculated the implied actual bid cost of equity that would be consistent with these assumptions and the observed transaction premium.

Plausible ranges for winning consortium assumptions and implied cost of equity

Parameter	Current or forecast RIIO-GD1 value	Possible bid range
Long-term RAV (£ 2016/17)	9,000	6,000-10,000
Long-term annual totex (£2016/17)	900	600-1,000
Average totex outperformance (% totex)	c. 10%	5-10%
Average incentive performance (bps RoRE)[1]	c. 100 bps	75-125 bps
Target/actual gearing (% RAV)	60%	75-80%
Typical cost of debt outperformance	c. 125 bps	50-125 bps
Long-term expected cost of equity allowance	6.7%	6.0-6.5%
Implied actual bid cost of equity (real)		**3.1-6.3%**

[1] RoRE is 'return on regulatory equity'

WHAT ARE THE IMPLICATIONS FOR RIIO-GD2 AND BEYOND?

The NGGD transaction was high-profile and the premium paid earned a lot of attention. But it is not the only piece of relevant evidence – last year Abu Dhabi Investment Authorities purchased a 17% stake in Scotia Gas Networks (SGN) for a premium of 44%. A number of differences between the two transactions are important to consider when interpreting the implications for the cost of equity:

- SGN is currently outperforming NGGD – for example, SGN has underspent its totex allowance for the first three years of RIIO-GD2 by 20%, compared to 10% for NGGD. So the SGN transaction is likely to have priced in less potential for future outperformance.
- The SGN transaction had a lower profile than NGGD, so may not have resulted in the same level of competitive bidding.
- The SGN transaction did not result in the buyer gaining a controlling share of the business.

Even after accounting for the differences between the two transactions, our analysis suggests that investors may be willing and able to finance gas distribution assets at an actual cost of equity below the RIIO-ED1 allowance of 6.0%.

Consumer representatives are likely to argue that the NGGD sale provides Ofgem with important information on which to base a recalibration of the financial elements of its price controls. Gas distribution investors, on the other hand, may argue that the sale price represents an expression of confidence in improving NGGD's performance – with the risk of failure to deliver improved performance sitting firmly with investors.

Effect on different industry players

Network companies
• Will have to develop arguments that explain and/or counter the low cost of equity implied by the NGGD sale
Suppliers
• The low cost of equity implied by the NGGD sale provides suppliers with an argument for a lower cost of equity in RIIO-GD2 (and maybe T2)
Ofgem
• Will have to balance different evidence and unpick the assumptions that informed the premium on the NGGD transaction in order to set cost of equity at the right level
Consumers
• The cost of equity directly affects consumer charges, as well as the incentive on network companies to invest in the network

Key questions

1. To what extent might NGGD's investors reasonably expect to deliver outperformance at such a high level? What is the likelihood that future RAV growth will offer additional value?
2. Would sustained outperformance on this scale for an entity accounting for around half of the gas distribution industry be consistent with Ofgem's objectives and framework?
3. Does the evidence suggest that Ofgem may need to consider a cost of equity below the 6.0% set in RIIO-ED1?

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