Australian Regulated Utilities (31/12/2012)

The fund is short a number of Australian regulated utilities. The rationale for these positions reflects the fundamental change currently occurring in the Australian regulatory environment and our scepticism on their underlying cash generation.

Regulatory Environment

For regulated assets it is the regulatory allowances and returns that drive the earnings, cashflow and economics of the business. These parameters are currently primarily determined by the Australian Energy Regulator (AER).

The AER uses the building block approach to regulation that is widely applied throughout the United Kingdom, Europe and Australia to regulate the earnings of utilities. The approach enables utilities to earn a return on capital (debt and equity) plus recover operating expenditure (opex), depreciation and other items (for example, tax, working capital, etc). The sum of these items is the revenue allowance from which the utility pays its expenses with the residual being the earnings available to equity.

We believe under the building block approach, with an effective regulator and regulatory framework, utilities should be valued at close to their regulated asset base or RAB (the RAB is the amount of capital on which a utility earns a return). Under this framework the utilities are being appropriately compensated and incentivised to maintain and expand their networks and shareholders receive an appropriate return for their investment.

The regulation of Australian utilities has undergone considerable change over the past 5 or so years as a result of regulation moving to a national level and rule changes. This has lead to a favourable environment for utilities.

We believe that this environment is in the process of changing and see confirmation of a move to more effective regulation going forward. Some investors and utilities fear any change will lead to a fall in investor support and the utilities are threatening lower network investment. We regard this as a tenuous threat and see the central issue as current valuations are high and balance sheets significantly leveraged, meaning that more effective regulation could materially impact utility shareholders.

While regulatory change is evident in the building political pressure and press articles, we want to refer to some specific aspects:

- The Australian Energy Market Commission (AEMC) has recently modified the framework to be used by the AER to regulate utilities. Previously utilities were able to use the rigidity and other aspects of the rules leading to attractive returns. We see this as untying the AER's hands and giving it the flexibility needed to operate effectively. This new framework will take time to implement but is an important step in the future regulatory environment;

- The recent decisions issued by the AER (for example, Brisbane to Roma Pipeline final, Victorian gas distribution draft, South Australian electricity transmission draft) have clearly shown lower future utility returns (without the benefit of the AEMC changes referred to above). In particular:

    - Lower allowed returns on capital (or WACC): A large part of this reduction is not really a change in AER attitude but a reflection of the fall in the long term Australian government bond rate from 5-6% in prior regulatory determinations to around 3% today. The utilities recognise the impact this move will have on their businesses and have proposed a range of arguments to justify a higher allowed return – we see these arguments as tenuous and to date they have been resisted by the AER. Some utilities respond to this lower return by threatening to reduce capex, however, they need to be very mindful of their license and other conditions. We believe there are aspects of the WACC that continue to be very generous, especially the cost of debt allowance which continues to be materially above recent refinancing benchmarks;

    - Tougher opex allowances: Some utilities are spending much less on opex than allowed by the regulator (they have been able to pocket this saving). This benefit will end with the start of a new regulatory period as the opex allowance is rebased;

    - Realignment of volumes: Some utilities have benefitted from higher volumes than previously forecast by the regulator which has enabled higher revenues. This benefit will end when volumes are rebased;

    - Capex allowances: The Victorian gas draft decisions have severely cut back capex plans to address concerns regarding gold plating of assets; and

    - Regulatory depreciation: We note that in some cases the utilities have requested very high regulatory depreciation allowances which to date have been rejected by the AER. While the motivations for such requests are unclear, it may be an attempt to prop up near term revenue and cashflow;

- Reflecting community and policy maker concerns, there are a plethora of government and other reviews being conducted or recently completed which will impact utility regulation. They include the limited merits review, productivity commission inquiry into electricity network regulation, Senate Select Committee on electricity prices, transmission frameworks review, and others; and

- Serious questions are being asked about the role of the AER including its future as part of the ACCC, recruitment and training, etc.

But it is not all bad for the regulated utilities. In particular:

- The recent AER Victorian gas distribution decisions are still draft. While we expect the final decisions to be an improvement on the draft, we still expect material deterioration from the current determination;

- The reduction in bond rates will enable some utilities to re-hedge their interest costs at lower rates. This will provide assistance to maintain current distribution levels. Although it will be interesting to see the extent of the interest saving given prior hedge levels and margins;

- The draft decisions to date relate to only part of the utilities businesses and it will take time to roll out across all their assets; and

- The utilities can hope that bond rates go back to 5-6% in the very near term, leading to the AER increasing the allowed return.

In our mind the regulatory environment is deteriorating from a highly favourably level which has enabled attractive returns. While the impact of the recent Victorian gas draft decisions varies by asset and it is hard to be definitive, our analysis suggests at least a 15% reduction in asset EBITDA and in some cases much more. For one asset the reduction in EBITDA is more than 30%.

This is an important shift for asset and capex heavy businesses that have highly leveraged capital structures and tight distribution payout ratios. Moreover, investor search for yield has pushed valuations to 1.2-1.3 times RAB. There are precedents where a deterioration in the regulatory environment has lead to regulated utilities trading at or below 1 times RAB (for example, refer to UK experience in the early 2000s). If this precedent were to repeat here and RAB multiples fell from 1.25 to 1.0 times (assuming leverage is 80% of RAB), utility equity prices would fall more than 50% from their current level.

<u>Maintenance Capital Expenditure and Cashflow</u>

Maintenance capital expenditure (capex) is often an amount disclosed by utilities when showing the cash generation of their businesses (directly or indirectly). For example, operating cashflow pre interest and tax (or EBITDA as proxy) less maintenance capital expenditure less interest paid less tax paid shows the free cashflow generated by the business. Often this cashflow waterfall is used when presenting the free cashflow available to pay distributions and to make a contribution to funding expansion capex. It is important to investors as it goes to whether the capital structure and distribution is sustainable.

We when see the term maintenance capex we think of it as the essential capital expenditure required to maintain the existing assets so they can operate efficiently and generate cash into the future.

Our scepticism arises with the level of maintenance capex being communicated by some companies. From what we can tell maintenance capex is not an audited amount and typically is disclosed in result presentations.

We have seen maintenance (or stay in business) capex amounts as low as 0.6% of the written down value of ageing plant and equipment. We struggle with the credibility of such a low amount. This implies that $1,000 million of written down value of relatively aged plant and equipment requires maintenance capex of a meagre $6 million per annum.

Keep in mind that the utilities the fund is short have large regulated businesses and the building block approach outlined above is important to understanding the economics of a regulated business. One of the building blocks is the RAB (recall that the RAB is the amount of capital on which a utility earns a return). Over time the RAB value increases with capital expenditure and inflation (the RAB can be indexed to inflation) and decreases with regulatory depreciation.[1]

If we are to accept that maintenance capex is 0.6% of the written down value of plant and equipment (an amount a fraction of the regulatory depreciation) and feed this into the RAB calculation as the capex, the RAB would decline (dramatically) in fairly short time which would quickly undermine the earnings power of the business. In effect, the maintenance capex cannot be right in both senses – i.e. it cannot be used to prop up the appearance of cashflow without recognising the impact it has on the RAB and future economics of the business.

The approach we have taken is to consider the regulatory depreciation amount which is used in the RAB calculation and to use this as a proxy for maintenance capex. Hence, for the regulated utilities to keep their RAB constant (in real terms), maintenance capex needs to equal regulatory depreciation. In this sense the economics of the business is maintained.

Some regulated utilities have used a similar approach to us by using regulatory depreciation as a proxy for maintenance capex in the cashflow waterfall. However, they have made an adjustment - from regulatory depreciation they have subtracted the RAB inflation indexation amount to derive "net" regulatory depreciation. We do not believe in this approach as it results in the RAB declining in real terms (thereby eroding the real value of the asset), whereas in the approach we have used the RAB is constant in real terms. This is an important issue as regulatory depreciation (without inflation deduction) is approximately double "net" regulatory depreciation (with inflation deduction).

What we found is that the regulatory depreciation amounts are typically materially larger than company stated maintenance capex. In some cases the regulatory depreciation is multiples higher. When we use regulatory depreciation as a proxy for maintenance capex in the cashflow waterfall and in the context of the deteriorating regulatory environment, we found a very material negative impact on valuations, distributions and capital structure sustainability.

Conclusion

The issues we are concerned about regarding regulation and maintenance capex are both very material in our minds. Some utilities appear highly susceptible to these circumstances given their high valuations, highly geared capital structures and high distribution payouts.

[1] While regulatory depreciation is added to the building block revenue allowance, it is subtracted from the RAB (a return of capital).

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