WESTERN POWER DISTRIBUTION
*Serving the Midlands, South West and Wales*

**Relationship Bank Questionnaire**
**2nd May 2013**

1. What specifics do banks take into account when lending to the UK Electricity Distribution sector?

**Regulatory Factors**
Stable regulatory regime
OFGEM performance measures
Relationship with Regulator

**Credit Metrics**
Ratings/Ratings Headroom
Leverage – net debt / RAV
Interest cover – different measures e.g. FFO/net interest
Financial Covenants/Legal protection in documents

**Company Factors**
Management strength
Operational record/efficiency (vs. peers)
Low business risk
(Stable) ownership

**Financial Factors**
Pensions Deficit
State of network/capex needs going forward
Structure of the business including position of debt (i.e. any structural/ contractual subordination issues)
Stable and Predictable cash flows
Dividend policy
Use of proceeds

**Other Factors**
Ancillary/Economics/Relationship/Existing exposure
Future issuance/funding plans/hedging requirements

2. What specifics do you think that bond investors take into account when investing in the UK Electricity Distribution sector?

As above plus:

Scale of future funding/ Future supply expectations
Tenor
Competing Supply/ Market technical
Comparable company issuance and relative value
Liquidity of any bonds raised (benchmark size)
Access to Management and engagement
Existing holdings in the sector/with borrower

3. How do your credit team rate the UK Electricity Distribution sector against those in the following jurisdictions?

| | More risky | Similar | Less risky |
|---|---|---|---|
| US | | | |
| Australia | | | |
| Northern Europe | | | |
| Southern Europe | | | |

**The majority responses suggested that that the UK Electricity Distribution sector was similar or less risky than with the US. All who stated a view said the UK was similar to Australia and also similar to the Northern Europe. The majority also stated that the UK sector was less risky than the comparable sector in Southern Europe.**

4. Please rate your credit team's perception of the risk of the UK Electricity Distribution sector relative to the sectors listed below:

| | More risky | Similar | Less risky |
|---|---|---|---|
| Electricity Transmission | | | |
| Generation | | | |
| Gas Transmission | | | |
| Gas Distribution | | | |
| Rail Infrastructure | | | |
| Airports | | | |
| Communication networks | | | |

**The majority of banks consider the UK Electricity Distribution sector to be similar to the electricity transmission and gas transmission sector with 2 considering electricity distribution to be more risky.**

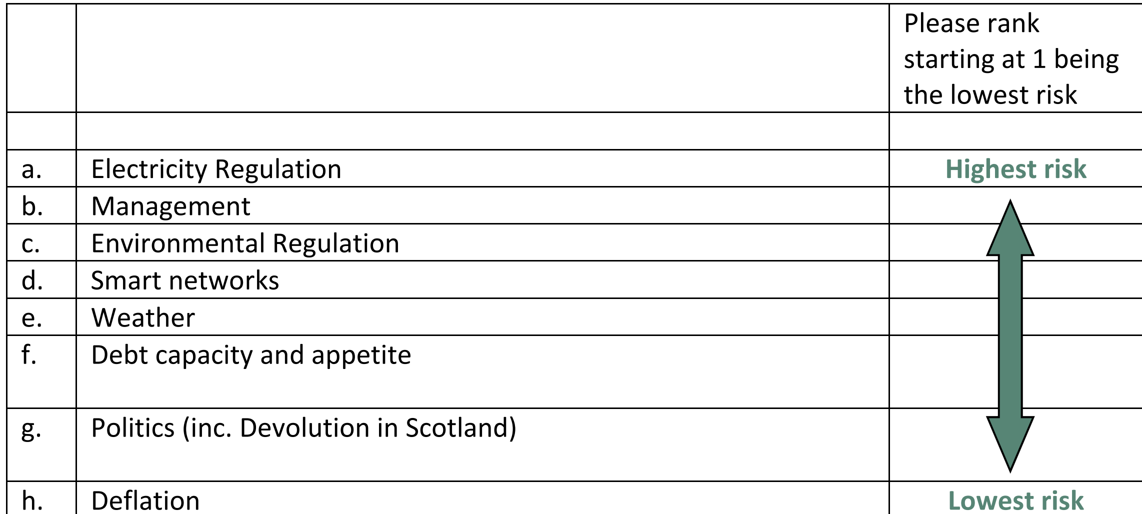
**All the banks agreed that electricity distribution has the same risk level as gas distribution and all agree that electricity distribution is less risky than generation, rail infrastructure, airports and communication networks.**

5. Please set out your institution's view of the 3 largest risks facing the UK Electricity Distribution sector

| | |
|---|---|
| 1. | **Regulation and Regulatory change** |
| 2. | **Capex requirements and Financing the plan** |
| 3. | **Low Carbon Technologies (whilst balancing views of all stakeholders)** |
| 4. | **Management** |
| 5. | **Operational, Politics, Deflation, Leveraged structures, cost of new debt** |

**The above is ordered by the number of that category of answer received from the bank e.g. the majority stated regulation, whereas only a single bank stated deflation**.

6. Please rank the following factors in order of perceived risk for the UK Electricity Distribution sector going forward:



| | | Please rank starting at 1 being the lowest risk |
|---|---|---|
| | | |
| a. | Electricity Regulation | **Highest risk** |
| b. | Management | |
| c. | Environmental Regulation | |
| d. | Smart networks | |
| e. | Weather | |
| f. | Debt capacity and appetite | |
| g. | Politics (inc. Devolution in Scotland) | |
| h. | Deflation | **Lowest risk** |

7. Moody's and Standard & Poor's rate the four Western Power Distribution companies at Baa1 and BBB respectively.

Please comment on how you believe an upgrade from the ratings agencies would impact:

| | | |
|---|---|---|
| i. | Your institution's appetite to lend | • **Marginally positive**<br>• **It depends on the cause of the upgrade (we have our own internal view of the credit)** |
| | | |
| ii. | Debt Investors' existing holdings | • **(Marginally)Positive**<br>• **Potential to reduce required capital if upgraded into single A category, subject to Solvency II**<br>• **We might see some profit taking if spreads tighten on the back of upgrade to "A" ratings category but generally expect paper to be well bid.**<br>• **A small tightening in credit spreads (c. 5bps)** |
| | | |
| iii. | Debt Investors' ability to buy further bonds | • **Positive (particularly at A3/A-)**<br>• **If both ratings are "a" rated we would expect hold limits to increase especially as it related to index linked.**<br>• **Some increase in total capacity / appetite, particularly for longer-dated or RPI-linked bonds. Depending on market conditions, tighter pricing (c. 5bps). For WPD in particular, a 1-notch upgrade from S&P would be most keenly anticipated as investors tend to price to the** |

| | | |
|---|---|---|
| | | lowest rating, though in current market conditions the pricing impact is unlikely to be particularly marked unless an A3/A- rating is achieved. |
| | | |
| iv. | Your thoughts about the UK Electricity Distribution sector | • Positive<br>• No change, subject to reasons for upgrade<br>• Would clearly give comfort and would help when seeking increased limits for any particular client in the sector.<br>• Depends on impetus for upgrade – if the driver is applicable to the whole sector this would be positive. |

**(Where similar answers were given these have been consolidated into one.)**

Please comment on how you believe a downgrade from the ratings agencies would impact:

| | | |
|---|---|---|
| i. | Your institution's appetite to lend | **Negative – reduced appetite**<br>**Depends on reason for downgrade as own internal view taken.**<br>**Impact on pricing going forward for renewals and new financings.** |
| | | |
| ii. | Debt Investors' existing holdings | **Negative**<br>**Depends on market at the time. Investors are less rating agency focused than before. Many are buy and hold.**<br>**For a WPD specific downgrade (I.e. not a sector ratings shift) we would expect to see some sellers into other issuers not at Baa3/BBB-. Therefore, WPD would see some spread widening. This will be most acute on (i) bonds without step ups and (ii) for accounts that cannot hold sub IG paper.**<br>**Little/no impact at BBB, some selling at BBB-, significant selling if below investment grade.** |
| | | |
| iii. | Debt Investors' ability to buy further bonds | **Negative**<br>**Reduced appetite, need for coupon step up on sub IG rating (likely +125bps). Limited to no index linked appetite.**<br>**A downgrade, particularly from S&P, would reduce investor appetite and increase the new issue premium that would be required. In weaker market conditions being a ratings outlier in the sector could significantly reduce market appetite and increase execution risk.**<br>**Although a low probability, investors may seek a coupon increase if the bonds were downgraded below investment grade for any reason.** |
| | | |

| iv. | Your thoughts about the UK Electricity Distribution sector | **Negative**<br>**No change, subject to reason.**<br>**We would probably seek to justify maintaining existing limits unless there was a specific, individual reason for such downgrade.**<br>**Overriding impact from new regulation**<br>**Disappointing got see the sector downgraded** |
|---|---|---|

**(Where similar answers were given these have been consolidated into one.)**

8. What are your expectations about the outcome of RIIO-ED1? E.g. provide a longer period of certainty, enhance the profile of UK Electricity Distribution sector, etc.?

**Longer period of consistency**

**Longer regulatory period has positive and negative implications: longer period of comparative funding certainty and reduction in regulatory risk associated with reviews.**

**The outcome depends on the specific impact of the review (allowed returns, cost of equity etc.)**
**The trailing cost of debt index is also less helpful as it pushes companies to issue shorter dated debt**

**Once the new WACC mechanism is fully understood we believe the longer rest periods will be a positive for the industry. The fact that issuers are likely to become more frequent borrowers will also increase awareness and understanding.**

**Greater potential for differences in performance between companies.**

**Greater risk of performance not being broadly aligned with allowances or allowances not being aligned with the company's needs in the future.**

**Stronger incentives allowing for greater variance in investor returns arising from out/under performance.**

**RAV depreciation transition period plus adequate WACC to ensure short and long term financeability are secured.**

**Appropriate allowances for asset replacement / maintenance given ageing asset base.**

**Indexed cost of debt improves visibility but likely to change company's funding policies to reduce mismatch between actual debt portfolio and the index. Could result in sub-optimal financing.**

**Embedded debt risk: Cost of debt index could drop substantially once a period of high rates leaves the trailing average, whereas companies issued long term bonds (>10yrs) in the past.**
**Positive indication of pension deficit funding, better tracking a deficit repayment profile.**

**It does create some uncertainty in the run-up to the review date as long-term investment**

**decisions will be influenced by a review within say 18 months.**

**Expectations are steady state for credit profiles**

9. Do you have any comments not covered above that you believe would impact bond investors' desire to investor further in the UK Electricity Distribution sector?

**Bond investors are particularly keen on stability across regulatory periods.**

**Fixed income investors appear reasonably comfortable with rolling cost of debt mechanism as it uses bond market technology**

**Solvency II is still uncertain and if passed in current from will penalise longer darted and lower rated issuance**

**Investors place some reliance on OFGEM ring-fence although there could still be an impact if there was a major ratings impact or change of control at PPL**

**Further regulatory (or other) change which leads to rating agency concerns can have a large impact. We saw this most recently with the RPI review which shows the impact third parties can have on the market and available sources of funding.**

**RIIO model well understood by the market and seen as quite sensible**

**However, shift in depreciation from 20yrs to 45yrs will generate a gradual, but material change in DNO's cashflow profile which rating agencies will be particularly focused on.**

**To the extent that the behaviour of bond issuers changes with smaller deal sizes, more frequent bond issuance concentrated in the medium-dated tenors instead of traditional longer-dated benchmark bonds, this could reduce demand over the medium term due to a "crowding" effect of new borrowing, though in the near term demand remains strong.**

**Bond investors will be cautious about the perception that the sector may be subject to a bout of M&A, as this would introduce an uncertainty and additional risk factor that would potentially impact negatively investor sentiment and thus demand for bonds.**

**While relatively minor, there are concerns among investors that the long talked about move to 'embedded generation' (where households and companies install their own electricity generation and delink from the grid) – and in the longer term to 'smart grids' – is going to change the industry and lead to volatility in capex and electricity flows. Investors will be keen to know what plans companies have for responding to these changes, however slowly they occur.**

10. In general what tenors appear to be the most attractive to investors at present?

**Institutional GBP: demand is skewed to 12yrs +, with particular sweet-spot in 20-30+ yrs, Retail GBP: 5-10 years, USPP: 7-12 years, Euro: 5-15 years, Maple up to 10yrs.**

**Traditionally GBP investors have had a greater preference for longer dated assets. However in recent months we have witnessed growing demand across the curve and we see short dated pricing in GBP converging toward the equivalent levels available in the EUR market. This is partly due to the lack of supply. Conversely EUR investors are currently more willing to look at longer dated paper in order to pick up greater yield. Overall it is a very positive market for issuance. GBP index linked demand has returned since the start of the year with a large number of reverse inquiries being received.**

**For bank lending to the sector focus is tenors up to 5 years. Pricing widens considerably and appetite reduces within the bank market for debt greater than 10 years.**

**(The above is an aggregated range created from the responses from the banks)**

11. Do you consider the new cost of debt methodology adopted by OFGEM will impact the length of tenor being issued by the UK Electricity Distribution companies going forward?

**The majority of banks suggested that, yes; it would have an impact on tenors. In summary it is suggested that the Ofgem cost of debt index is likely to see a variety of different responses in terms of debt issuance strategy, but overall the widely held expectation is that tenors are likely to drop to around the 10-15 year area in Sterling, though multi-currency funding, more frequent but smaller bond issues and hedging strategies will also likely be used to best match (or beat) the index.**

12. Do you perceive any significant change in the supply and demand for utility bonds occurring within the short term and also subsequently into the RIIO-ED1 period?

**Some banks suggested that the level of supply and demand will not significantly change. Other were of the opinion that demand is expected to continue to outstrip supply in the near term, however, to normalise over the medium term (where the outlook for financial markets is clearly less certain).**

**It was also stated that RIIO-ED1 is arguably a lesser source of uncertainty than other market factors in the medium term, and thus a marginal rather than key influence in the supply / demand balance over that time period.**

13. WPD will need to raise significant debt during the eight year review period. Do you perceive any impediments to prevent this from being achieved?

**All the banks suggested that there should be no impediment in the normal course of business (although periods of inaccessibility can be experienced these are generally temporary and short in duration). As long as the new debt is financeable (comfortable investment grade rating) within the regulatory framework (i.e. RIIO-ED1 should provide adequate allowances to support the additional funding requirement) no major problems can be foreseen.**

**Management of capacity in Sterling is considered crucial. This can be optimised by: issuing when the market is strong so that each deal performs, regular investor dialogue, judicious use of other markets.**

14. Which markets are best suited for such issuance?

**All the banks agree that Sterling is the natural market. To maximise capacity, it is suggested that issuances are spread across maturities. Additionally, further index-linked could be raised and the retail market could be targeted.**

**The US 144a market as well as US Private Placement and Euro were suggested as reliable back-ups to Sterling and certainly accessible by WPD.**