

Managing the impact of XD4 asset investment plans on Distribution Network Operators' share prices

The Challenge:

As Electricity Distribution Network Operators (DNOs) start to face the task of preparing their business plans for the forthcoming distribution price control review, a key question for Finance Directors, Chief Executives and their board colleagues is how to manage the process to enhance their share price and future shareholder value, or at the very least, how to avoid the outcome having a seriously negative impact on the company's share price. Although many of the UK DNOs are subsidiaries of larger groups, and hence may not be quoted directly on the stock market, parent companies are equally affected by the outcome. Since the price control settlement determines your income for the next 5 years, sets your investment spend and puts an upper bound on your opex spend, and since between them, from a financial perspective, these figures define the value of your business, the outcome is share price critical.

In the yardstick regulation environment, where companies are penalised for falling too far behind the current frontier, there is pressure to submit responses which look as "efficient" as possible. But there are also risks associated with the process, as too low a bid could have potentially disastrous consequences for future performance. Conversely, too high a figure may introduce funding issues, which could also impact on shareprice. A key component of the price control submission is the proposed capital investment profile over the review period, with asset replacement accounting for anywhere up to 50% of the total capital spend, perhaps up to £300m for the 5-year period – so getting it wrong by even 10% is a significant figure.

To protect shareholder value, companies need to take into account how the city evaluates investments, and combine this with an understanding of the impact of investment decisions on future asset performance. This requires a combination of physical asset management skills and financial asset management awareness and understanding, linked together in a coherent and credible way to create a persuasive submission to the regulator, taking into account the risks involved.

The regulator is keen to foster a better understanding of the risks associated with distribution assets, and to develop and share best practices on risk management. Ofgem have stated that one of their key objectives is to help ensure quality of service to customers, including incentives for timely and efficient investment in the network. A better understanding of the link between risk and equipment renewal will allow companies to develop more persuasive price control submissions particularly in support of the capital investment requirements. This area will be even more complex for this review, with the need to reflect the future impact of distributed generation on the network. The additional risk and uncertainty associated with this makes it all the more important to get an excellent grasp of all the other aspects, to minimise the overall risk and uncertainty.

With Ofgem due to complete its initial consultation on PCR in May 2003, now is the right time for distribution companies to be planning how to manage the process, to ensure the outcome gives the best possible result for share price, corporate image, and long term asset performance.

The response:

Planning how to approach the PCR submission preparation needs to address the three-fold risk to share price / shareholder value arising from setting too low a capital investment level:

- Insufficient funds available from the investment budget will either have to be found from elsewhere (taken out of shareholders margins) or will result in an insufficient level of capital replacement work being carried out;
- Insufficient capital replacement, resulting in a greater level of equipment failures, will lead to greater expenditure on maintenance, and any associated reduction in network performance may lead to direct financial penalties;
- Reduction in network performance is likely also to have a direct impact on company image and hence share price.

Any reduction in share price increases the effective cost of capital, making it even more expensive to carry out the investment required to break out of this downward spiral.

Any company that is seen not to have done a good job in this process is likely to achieve a disappointing regulatory settlement, in turn having an impact on shareholder returns, and city perceptions. Getting the wrong answer from the analysis risks leaving companies with deteriorating serviceability levels, and an under-funded requirement for capital maintenance. Given the capital maintenance sums involved in a typical electricity distribution company, even a 10% error could represent a funding shortfall in the region of £30m over the period. So the people responsible for the development of their companies X4 responses are responsible for major business risks to their organisations.

A solution to this challenge for developing asset investment plans has been developed by Heathgate Associates. Using a data driven approach supported by computer models to link asset investment requirements to the risks and consequences of failure, it provides a means not only to help calculate capital requirements for regulatory purposes, but also to help you understand where the biggest benefits come from in future asset performance. The process has been developed over more than a decade in a range of asset intensive industries including the aviation, defence, nuclear, oil and gas, electricity and water sectors. Pulling together leading thinking from the worlds of both financial asset management and physical asset management, it provides a coherent means to identify the business impacts of asset management decisions, and supports a rational justification of the expenditure requirements to the regulator.

Benefits of Heathgate Help

The Heathgate process has the potential to give electricity distribution companies a powerful tool with which to manage and optimise spend on assets and their associated performance. But the potential to enhance shareholder value is significantly greater than that. Those companies that do the job well will be well placed not only to manage their own assets effectively, but will have the tools to substantiate aspirations of managing other assets, supporting strategic acquisition and business development plans. By being seen to do a good job in this process, companies can enhance both their opportunities for growth, and their perceptions in the city, producing a double bonus on the share price.

Managers who achieve that will be widely sought after and well rewarded. Ask Heathgate to help you to be one of them.