The PR3 cost of capital for ESB Networks
Executive summary

Note prepared for ESB Networks

June 8th 2010

CER is currently considering whether to assume a PR3 cost of capital for ESB Networks based on the analysis performed by its consultants, Europe Economics. Europe Economics has proposed a cost of capital of 4.6%, which compares with an assumption of 5.6% in PR2. Europe Economics' analysis makes a number of assumptions, including that:

– ESB's cost of debt can be estimated by a modest premium over government bond yields in France and Germany;

– ESB's cost of equity can be estimated by assuming an equity risk premium (over French and German government bond yields) which is within the 'normal' range for such premia.

In effect, Europe Economics is assuming that:

– the financial crisis in Ireland (and, indeed, in the Euro Area more generally) is unlikely to last through any significant part of the PR3 period; and/or

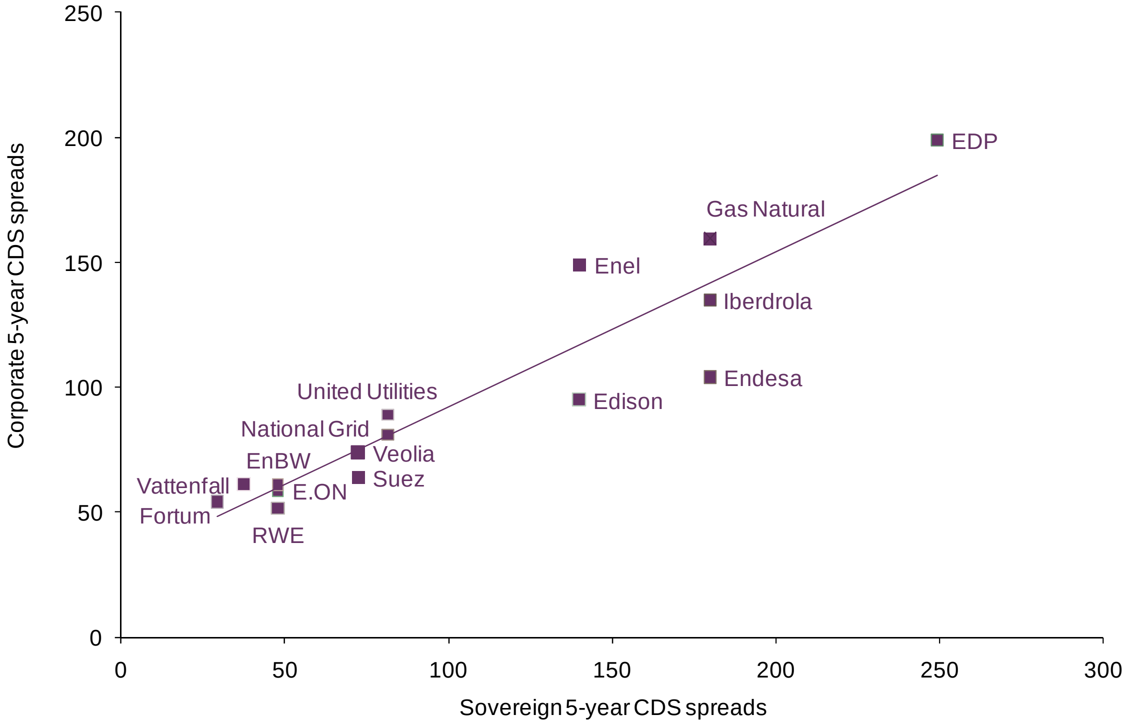
– ESB is somehow insulated from the broader Irish economy.

Neither of these assumptions is either reasonable or prudent.

– Irish government bond yields remain well above those for France and Germany—the current spread over bund (May 31st) is around 200 basis points. No major European financial authority appears to expect the crisis in the Euro Area to resolve any time soon—especially in the non-core Euro Area economies.

– Utility bond yields *in all European countries* are strongly correlated with the perceived risk of sovereign default in the individual utility's own country, as shown by Figure 1 below.

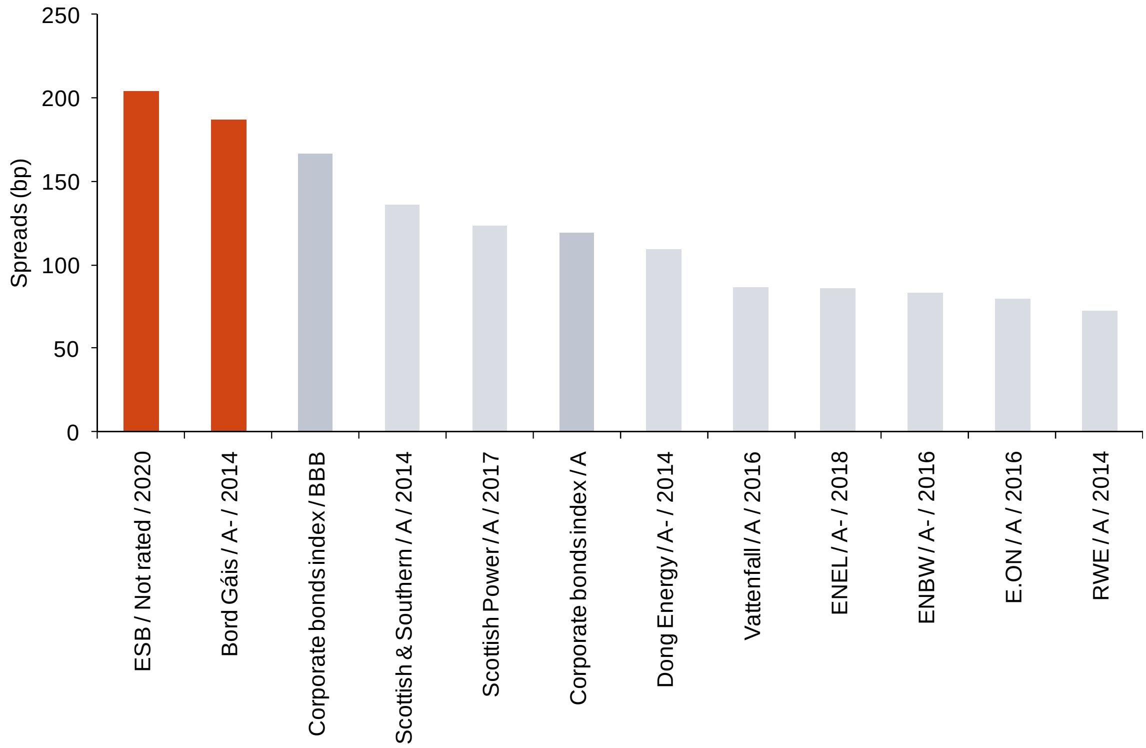
Figure 1 Credit default swap spreads of European utilities compared with the spread of their country of incorporation



Notes: CDS spreads are as at May 18th 2010; the line on the chart is based on the ordinary least squares regression.
Sources: Bloomberg, Oxera analysis.

– There is clear evidence that Irish utility debt trades at wider spreads than for A-rated debt elsewhere in Europe, thus invalidating Europe Economics' assumption that ESB's cost of debt can be estimated from the cost of debt for a generic company with an A credit rating. Thus, CER's choice of benchmarks for the cost of ESB's debt should include BBB-rated debt generally or A-rated debt specifically in the Irish context. This is illustrated, in respect of Bord Gáis, in Figure 2.

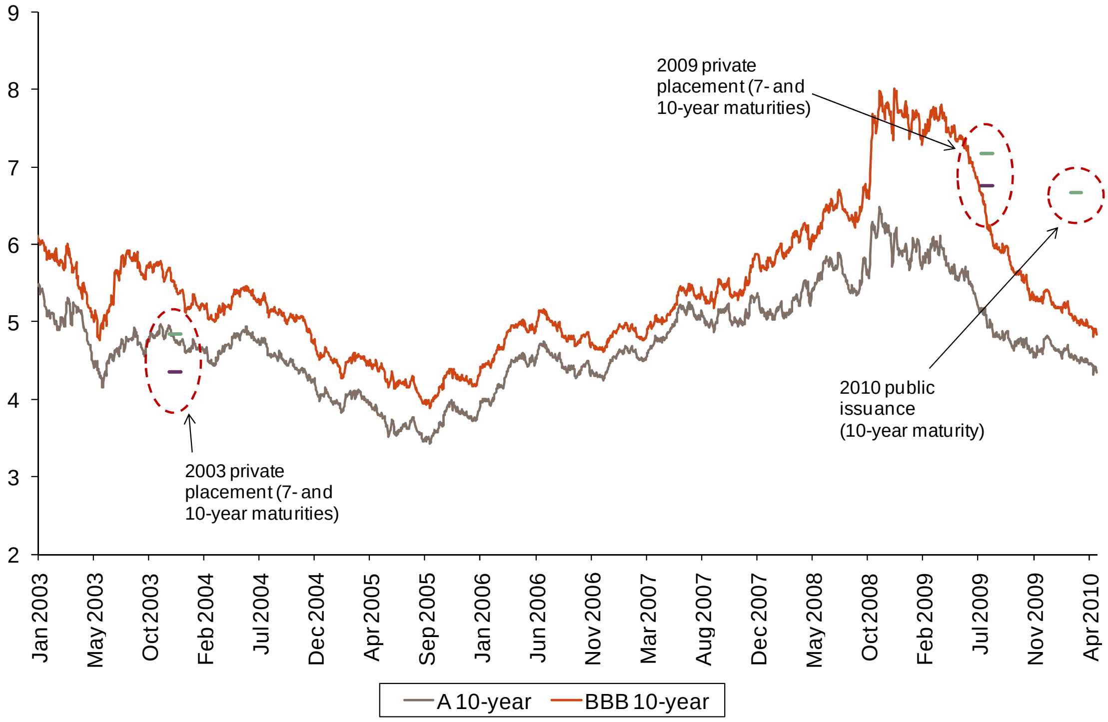
Figure 2 Bond spread of Bord Gáis compared with European peers



Note: Spreads are as at May 5th 2010 and are calculated over UK gilts for GBP issuances, and over French and German sovereign bonds for EUR issuances.
Source: Datastream.

– What evidence there is specifically on ESB's cost of debt suggests that ESB's funding costs have deteriorated significantly over the last few years, both in absolute terms and relative to the yields achieved on both generic A-rated and BBB-rated corporate bonds. This is shown in Figure 3, again undermining Europe Economics' assumption of spreads on generic A-rated debt being a reasonable proxy for ESB Networks' borrowing costs.

Figure 3 Launch yields of ESB compared with market indices



Source: Bloomberg, ESB Networks and Oxera analysis.

– Although hard evidence on *equity* costs is hard to come by, academic research shows that lower sovereign credit ratings correlate with higher expected equity returns. This is the basis for Oxera's assumption of a sovereign element in the appropriate equity risk premium to be used in estimating ESB Networks' cost of equity.

In addition, two further points should be borne in mind.

– Europe Economics' analysis is contentious in a number of more detailed technical dimensions.

  – It proposes a downward adjustment to the cost of debt (in respect of the expected probability of debt default), an adjustment that no other UK regulator makes.[1]

  – It does not make the uplift to its estimate of ESB Network's risk that is made by the majority of market practitioners and estimation services.[2]

  – It has used data for its estimate of ESB Networks' risk which Oxera has been unable to replicate from publicly available sources.[3]

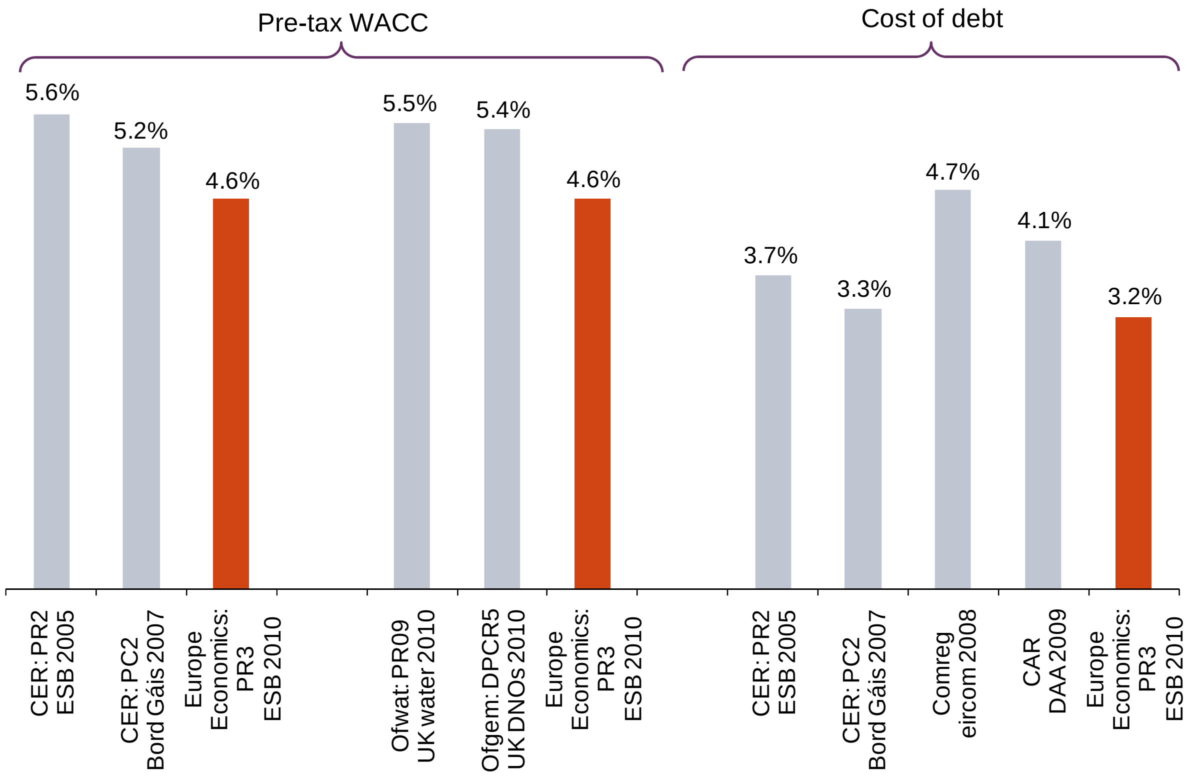
  Each of these features of Europe Economics' analysis has the effect of depressing its estimate of ESB Networks' cost of capital. The last of these alone has the effect of reducing the cost of capital by 50 basis points.

– Although not directly relevant to ESB Networks, Europe Economics estimate of a cost of capital of 4.6% is notably lower than recent regulatory determinations in both Ireland and

[1] See section 3 of the Technical appendix to this note.
[2] See section 4 of the Technical appendix to this note.
[3] See section 5 of the Technical appendix to this note.

the UK, despite the somewhat lower sovereign bond yields in the UK (with all that this entails for corporate funding costs in the UK). This shown in Figure 4.

Figure 4 Europe Economics and regulatory precedent



Source: Europe Economics, regulatory determinations and Oxera analysis.

In total, Europe Economics' analysis and recommendations offer an unsafe basis for estimating the cost of capital for ESB Networks. The Oxera analysis for ESB Networks—which has been provided to CER—has sought to address the key issues in a number of ways, not least by incorporating into the analysis the effects of prolonged (and unlikely-to-end-anytime-soon) financial turmoil on funding costs for European utilities generally, as well as reflecting the current specific reality of the Irish economy.

The fact that Europe Economics' conclusions for ESB's WACC (4.6%) are outside the range of Oxera's conclusions (4.7–7.1%) suggests a significant indifference to the current financial reality in Ireland.