Benefits of a 'Baa1'/'BBB+' debt rating over 'Baa2'/'BBB'

This briefing note sets out National Grid's positions on the importance of maintaining a strong investment grade debt rating.

Context

In the Sector Specific Methodology Decision (SSMD) Finance Annex published in July 2024, Ofgem consider the credit ratings thresholds that should apply for the financeability assessments in the RIIO-ET3 price control.

Specifically, Ofgem say *"The network companies have argued that we should target credit metrics in line with 'BBB+' (S&P) and 'Baa1' (Moody's) ratings when assessing financeability. We do not currently consider there to be evidence of a need to target particular credit metric levels across our assessment of financeability."*

In addition, Ofgem state that *"there may be circumstances in which the consumer costs associated with the adjustments required to achieve 'BBB+'/'Baa1' ratings outweigh the potential costs of accepting a slightly lower credit rating for a period."* Ofgem also note *"that a 'BBB'/'Baa2' investment grade rating (rather than the higher 'BBB+'/'Baa1' rating suggested as required by the Network companies) would meet associated licence requirements."*

National Grid strongly believe that targeting a strong investment grade debt rating equivalent to 'Baa1'/'BBB+' will be necessary in RIIO-ET3 and this paper sets out our rationale and supporting evidence. This paper addresses the current main themes in response to this topic:

- There is strong rationale that a 'Baa1'/'BBB+' credit rating is critical to ensure access to capital throughout this period of significantly heightened capex
- A 'Baa1'/'BBB+' credit rating enables access to a lower cost of long-term debt, helping to keep consumer bills down, and avoiding the increased costs associated with a reduction in access to capital
- A switch to a lower rating than 'BBB+' goes against the average of the iBoxx £ 10+ utilities index, which risks under remunerating appropriate debt costs if credit metrics checks deliver 'BBB' outcomes
- Ofgem are rightly focussed on providing an investable outcome for RIIO-ET3, whilst ensuring electricity transmission remains a financially resilient sector, and a weakening of financeability targets could undermine this.

There are clear benefits of maintaining an investment grade debt rating equivalent to 'Baa1'/'BBB+', enabling the cost of debt to be kept low for consumers, as well as enabling continued access to greater capacity and strong bond markets. Furthermore, such rating leads to low facilities and short-term borrowing costs and ensures an appropriate buffer to the minimum credit rating required for our network licence.

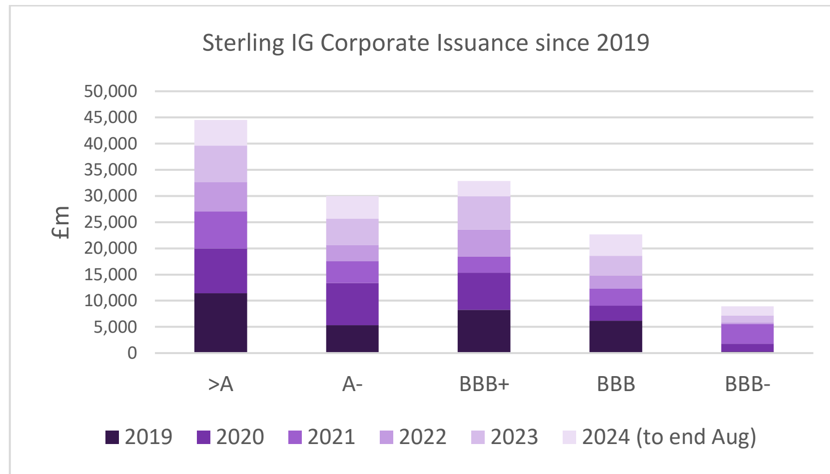
There is strong rationale that a 'Baa1'/'BBB+' credit rating is critical to ensure access to capital throughout this period of significantly heightened capex

Given the scale of investment in RIIO-ET3, and therefore the associated level of required issuance, NGET will need to access both domestic and non-domestic markets. Any move below NGET's current rating level is likely to cause a loss of confidence for both investors and credit ratings agencies and ultimately increase the cost of borrowing for consumers.

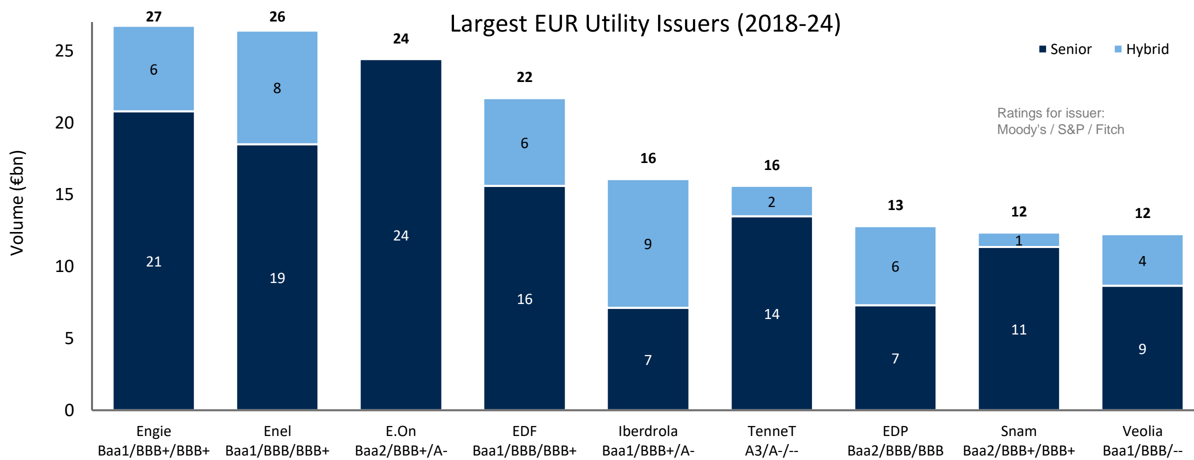
Stronger bond market access and greater capacity

Although there is corporate issuance and utility sector issuance across the credit ratings spectrum in global bond markets, it is well understood and evident from historic periods that higher rated borrowers have stronger access to debt markets, particularly in times of market stress. To illustrate this point, we can examine investment grade ("IG") corporate issuance trends during historical periods of market disruption, and in particular the US Dollar and Euro bond markets, as there is typically not sufficient issuance in the Sterling market to identify clear trends. For example, looking at the USD IG market, during the financial crisis in 2008 there was a three-month period with no issuance from 'BBB-' corporate borrowers and the majority of issuance was from 'single A' rated borrowers. The notion that higher rated borrowers have stronger access to debt markets during periods of market disruption is further supported by Ofgem's comments within the ET2 FD finance annex where it was stated ''better access to capital, particularly in times of market disruption'' was a benefit of targeting notional company credit quality two notches above minimum investment grade rating.

In terms of market capacity, examining total Sterling IG corporate issuance since 2019, 45% of issuance (~£63bn) was rated ‘A-‘ or ‘BBB+’, with ~32% from debt rated ‘A’ or higher. Only ~23% of issuance (£32bn) was rated at ‘BBB’ or ‘BBB-‘. Therefore, if NGET and other UK regulated networks were rated ‘Baa2/BBB’ this would present a significant increase in lower rated supply and may stretch the market’s ability to absorb this issuance, potentially increasing credit spreads and new issue premiums. Reinforcing this point, over this period, UK Utilities represented ~20% of all issuance.



We also examined utility bond issuance in EUR since 2018. We expect the Euro market to become increasingly relevant for UK networks as funding needs increase. While there are large issuers with a ‘Baa2’ or ‘BBB’ rating, we’d highlight that all of the top 6 largest utility issuers in this period have at least a ‘BBB+’ rating on average across Moody’s, S&P and Fitch. Similarly, the largest utility transactions in each year of the analysed period also came from the same group of entities with ratings at least ‘BBB+’ on average.



Revolving credit and liquidity facilities

Bank margins, commitment and upfront fees are higher for lower rated borrowers, reflecting the higher risk faced by banks. A ‘Baa2’/’BBB’ rating would likely mean increased fees as well as potentially reduced willingness from banks to lend, given requirements to hold more capital against riskier loans. The potential lower capacity of lending from banks would likely force NGET to other sources of funding and liquidity, which in turn could exacerbate the cost of funding in markets which are already saturated for lower rated entities.

Short-term borrowing and commercial paper (“CP”)

NGET accesses the commercial paper market for short-term funding needs. Investor appetite and pricing is primarily driven by short-term credit ratings, with the highest ‘A1’/’P1’ ratings (S&P/Moody’s) seeing the highest demand and cheapest pricing. Based on the agencies’ methodologies, ‘Baa1’/’BBB+’ long-term credit ratings always map to ‘A2’/’P2’, a rating level which typically sees good demand from CP investors. While a S&P ‘BBB’ rating still maps to an ‘A2’ short-term rating, Moody’s methodology can map a ‘Baa2’ long-term rating to either ‘P2’ or ‘P3’. A lower ‘P3’ rating could reduce access to the market, shorten the tenors available, particularly in times of market stress, and increase pricing.

Swaps

As the largest corporate bond issuer in the market, NGET faces capacity constraints in the Sterling bond market and is not able to efficiently raise all its debt directly in GBP. It is therefore necessary to issue in foreign currency markets and use cross-currency swaps. Similar to RCFs, when facing counterparties with lower credit ratings banks hold more capital against their potential exposure. This means that banks' total capacity is smaller for lower rated borrowers and that swap charges are likely to be higher. As we expect NGET to rely heavily on non-GBP bond markets over T3, a 'Baa2'/'BBB' rating may necessitate collateralising swaps or dealing with a broader range of banks, including those of lower credit quality, both of which increase risk.

A 'Baa1'/'BBB+' credit rating enables access to a lower cost of long term debt, helping to keep consumer bills down, and avoiding the increased costs associated with a reduction in access to capital

In previous price control consultations (RIIO-ET2/ED2) many networks cited lower cost of debt as a reason to target a 'Baa1'/'BBB+' rating rather than a weaker investment grade rating. We note that in the RIIO-ET2 Draft Determinations (July 2020), Ofgem commented on the benefits of 'Baa1'/'BBB+' rating in the Financeability section of the Finance Annex. A lower cost of debt was mentioned among a number of other benefits, with the cost "estimated at 15-30bps between 'Baa1'/'BBB+' and 'Baa2'/'BBB'". While this difference can move over time, NGET would have a higher exposure to the increased cost of raising debt at a lower rating, given the significant amount of new debt issuance that will be required to fund higher capex over RIIO-ET3. NGET is currently expected to issue c. £19bn of new debt over the ET3 period, an amount that's almost double its gross borrowings at March 2024.

At a lower 'Baa2/BBB' rating, a regulated network would have less confidence in being able to raise long-term debt in times of market stress, as outlined above in the section detailing access to the USD IG market, during the 2008 financial crisis, or could be forced to pay an elevated premium to guarantee market access. This is particularly relevant for NGET given the significant debt issuance requirements expected in RIIO-ET3. In addition, as mentioned in the previous section, at a lower rating we would anticipate increased costs in securing revolving credit and liquidity facilities, as well as executing swaps and issuing commercial paper.

Opting for net present value (NPV) cash neutral solutions to maintain credit ratings would be more favourable for consumers in the long run

If a one-notch downgrade to 'Baa2'/'BBB' is assumed, networks would face higher costs when raising debt to finance the transition to net-zero and networks would have to pay a premium to access certain debt markets. These additional costs would ultimately be passed on to consumers as an extra burden to finance the same investments.

However, maintaining financeability targets at 'Baa1'/'BBB+', and utilising NPV cash neutral solutions to uphold credit metrics, such as depreciation policy and fast money, would enable consumers to pay less over the course of the investment, even if they would be repaying the investment faster.

A switch to a lower rating than 'BBB+' goes against the average of the iBoxx £ 10+ utilities index, which risks under remunerating appropriate debt costs if credit metrics checks deliver 'BBB' outcomes

While we recognise that utility credit ratings have trended lower over the last several years, we have examined the constituent bonds in the iBoxx £ 10+ utilities index as at the start of September 2024. The average credit rating across the three major agencies remains at 'BBB+'. In fact, the average is slightly stronger than 'BBB+', which reflects a marginal improvement compared to when this analysis is ran for the prior year (average = 'BBB+'). Such improvement can be attributed to the removal of Thames Water from the index, S&P's upgrade of E.ON to 'BBB+', as well as the addition of London Power Networks and South West Water. UK regulated electricity networks (~16-17% of the index) are rated between 'BBB+' and 'A' on average, with gas networks (~11-12%) slightly stronger than 'BBB+' on average. Similarly, water sector issuers included within the index (~27-28%) remain slightly stronger than 'BBB+'. The overall average is brought slightly downwards due to the impact of European utilities (42%) which are slightly weaker than 'BBB+'.

A 'Baa2/BBB' rating for regulated UK electricity/gas networks would therefore be a departure from the credit quality of the GBP utility bond universe. Furthermore, given the average rating of the iBoxx £ 10+ utilities index is at, or slightly above 'BBB+', NGET diverging away from a 'BBB+' rating would lead to a misalignment between costs of debt and NGET's debt allowance (set on a 'BBB+' average index).

Ofgem are rightly focussed on providing an investable outcome for RIIO-ET3, whilst ensuring electricity transmission remains a financially resilient sector, and a weakening of financeability targets could undermine this

In order to unlock the consumer and societal benefits of net zero, it is critical that transmission networks can attract and access the capital required to deliver the transmission network that will facilitate those benefits.

Ofgem have provided a strong overall narrative in their publications to date on the need to ensure the sector is 'investable', however the statements on credit ratings in the SSMD are a very negative signal, conflicting with this high-level aim. It is critical that Ofgem ensure a consistent message on investability through their overall narrative, and the detail of their proposals for the financial framework, to ensure the overall objective is met.

Ofgem are also focused on maintaining and improving financial resilience for GB energy networks and as part of this in SSMD decided to introduce a dividend lockup gearing threshold of 75%. Ofgem state in SSMD, *"we are introducing a distribution block that will prevent companies from paying money to shareholders if gearing (debt as a percentage of total capital) exceeds 75%."*

We strongly believe that reducing the financeability thresholds to 'Baa2'/'BBB' would not only send a negative investability message at the wrong time, but also work against Ofgem's stated aim to improve financial resilience by signalling a lower credit rating would be acceptable. There is a need for strong credit metrics to ensure companies are financeable. Additionally, a 75% gearing block aligns with the practices typically observed in companies maintaining a credit rating of 'Baa1'/'BBB+' in Moody's Rating Methodology of Regulated Electric and Gas Networks.

Knock-on impact - investor and credit rating agency views of Ofgem regulation

Whilst we recognise that in the RIIO-ED2 determinations Ofgem commented that a 'Baa1'/'BBB+' rating should not be adopted as a fixed target for notional companies, Ofgem did state in the finance annex of their final determination that "in principle, there would be benefits for notional companies if credit quality was stable at two notches above minimum investment grade (i.e. 'BBB+'/'Baa1')." We also note that a weakening of support for 'Baa1'/'BBB+' ratings in RIIO-ET3 would be a departure from Ofgem's prior statements during RIIO-ET2 determinations.

Given the significant increase expected in NGET's debt issuance over RIIO-ET3, we believe a weakening of support for 'Baa1'/'BBB+' would be viewed negatively by debt investors and credit rating agencies and could lower their assessment of the consistency of the regulation. For rating agencies, this could potentially lead in turn to a lowering of their assessment of business risk, which could create pressure to tighten credit metric thresholds. In addition, we expect that existing debt investors would react negatively, as a one-notch downgrade across their holdings of regulated networks would lead to mark-to-market losses and they may have invested in Ofgem-regulated issuers on the assumption that there was regulatory support for 'Baa1'/'BBB+' ratings.

Buffer over sub-IG rating and licence required 'BBB-'

Targeting a 'Baa2'/'BBB' rating does not provide sufficient buffer against unexpected shocks to credit quality as it is only one notch above the minimum rating requirement for our network licence

In conclusion, there are strong benefits of 'Baa1'/'BBB+' and it is critical that these remain targets for financeability assessments

This is critical to ensure strong market access at a time when a huge amount of investment needs to be accessed, to ensure Ofgem's investability and financial resilience focus is not undermined, and to ensure both costs for the consumer are kept low and the consumer and societal benefits of net zero can be realised.