



Caught in a mousetrap

The German regulator announced that it may cut equity returns for the electricity sector just one day after a group of institutional investors concluded the acquisition of the country's fourth-largest electricity grid. No wonder regulation is seen as the number one risk in infrastructure today.
By **Bruno Alves**

IN LAST MONTH'S issue of this magazine, Henk Huizing, head of infrastructure investments at Dutch pension provider PGGM, said that "regulatory risk has proven to be the biggest risk in infrastructure over the last two years".

As if to validate his assertion and keep investors' pulse rates from slowing, German regulator *Bundesnetzagentur*, the watchdog for the country's gas and electricity sectors, forcefully demonstrated in early September just how much infrastructure investors have to fear.

WORST NIGHTMARES

The scenario in question was the stuff of investors' worst nightmares. On September 6, Commerz Real, a subsidiary of Commerz Bank which manages a range of property funds, triumphantly announced the closing of its acquisition of Germany's fourth-largest electricity network from utility RWE, billing the deal "unprecedented in Germany in terms of its form and scope".

The majority of the grid (74.9 percent), known as Amprion, was acquired by a group of German pensions and life insurers led by Commerz Real for an enterprise value of €1.3 billion (as at January 1 2011). The buyers included the likes of Munich Re, ERGO, MEAG, Swisslife and Talanx as well as the Westfalen-Lippe doctors' pension fund. Commerz Real will manage the asset.

But a day after Commerz Real and the institutional investors cracked open the champagne, *Bundesnetzagentur* made sure the festivities were followed by a massive hangover. In a statement published on September 7, the regulator announced that it is mulling a cut of just over 1 percent to allowed returns in the gas and electricity sectors, reducing them to 8.2 percent before taxes from the current 9.29 percent.

The proposed changes, which have now been submitted to grid operators for consultation, would take effect in 2013 for the gas sector and 2014 for electricity networks. The regulator said it expected to announce what the future return ceiling will be later this year, once results from the consultation, which

ends on October 5, are taken into account.

The news dropped like a bomb and on September 9, a befuddled Commerz Real spokesman told *Infrastructure Investor*: “This came as a surprise to all involved. We are still making up our minds on what this means and have no further statement at this time.”

Infrastructure Investor again contacted Commerz Real for this feature, but could only obtain a general emailed statement in answer to several of our questions. It read: “The announcement by the *Bundesnetzagentur* came as a surprise – in terms of the timing as well as in terms of the message itself, since the plan to lower ceilings for equity returns would be contradictory to recent statements. This of course leads to confusion among grid operators and investors. However, it is important to point out that no final decisions have been taken and consultations have just begun. Market players will bring in their arguments as far as possible. We are confident that the final solution will support the further development of Germany’s utility sector.”

UNPLEASANT ... BUT UNPREDICTABLE?

This is where things get a little uncomfortable for the buyer. While most would empathise with the unpleasantness of the predicament facing Commerz Real and its institutional investor clients, not everyone agrees that the German regulator’s behaviour was unpredictable.

For Peter Jümpertz, a partner specialising in utilities at German consultancy Theron Advisory Group, *Bundesnetzagentur*’s change of heart was anything but surprising.

“We predicted this change [in regulation] a couple of months ago. We knew there was a lot of pressure [on the regulator] driven by restrictions to the budget and tax income. Also, this is a matter of politicians expanding their power,” Jümpertz says.

If the equity cuts proposed by the regulator go ahead, then one-third of returns on the Amprion deal might be wiped out, Jümpertz predicts.

To make matters worse, Germany’s current allowed rate of return, “post taxes [...] is probably close to 5.5 percent, i.e. below the cost of capital of most large utilities in Europe, which in turn explains why RWE

and E.ON have been sellers of their respective high-voltage (power) grids,” Vincent Gilles, head of European utility equity research at Credit Suisse, wrote in a note following *Bundesnetzagentur*’s announcement.

A spokeswoman from the German watchdog told *Infrastructure Investor* that there was no relation between the announcement of the Amprion deal’s conclusion and *Bundesnetzagentur* firing the starting pistol for the consultation period of what it calls its “second regulatory period”.

But were the bidders aware that the watchdog was about to start consultation for a new regulatory period, which would determine new equity ceilings?

“They didn’t know the exact date, but they knew that the law required us to start consultation for a new regulatory period,” the spokeswoman argued.

The allowed rates of return for the first regulatory period were determined in July 2008, *Bundesnetzagentur* said in a statement, marking the first time the regulator set returns for the gas and electricity sectors. Prior to that, the spokeswoman explained, returns were fixed by law, and stood at 7.91 percent for both sectors. In 2008, they were increased to the current 9.29 percent.

Since allowed returns actually increased during the first regulatory period, did bidders have any indication that they were about to decrease for the second period?

Judging by the emailed statement from Commerz Real, the asset manager and its institutional clients were caught off guard. But the regulator has a different opinion:

“The bidders and their consultants do their research and take their own view on these [possible] changes, just as we do,” the spokeswoman said. “This [Amprion] is a private deal. The private sector asks to talk to us, but they do not require any authorisation on our part to conclude the deal,” she added.

‘EFFECTIVE INCENTIVE’

In a statement published on September 7, the regulator explained the reasons behind its proposed rate cut: “This is attributable to the development of interest rates in general, but also reflects the fact that network operations generate very stable and consistent returns in comparison with the overall market, which has recently been highly volatile.”

Bundesnetzagentur added that “this proposal again creates an effective incentive for network operators to make the urgently needed investments in network infrastructure. Moreover, the regulatory framework conditions guarantee a sufficient level of investment certainty unparalleled in the competitive economy”.

Whether investors in Germany’s electricity and gas sectors will agree with the above assessment remains to be seen. For now, though, the only thing investors can do is steel themselves for a fight with the regulator. After all, as the Commerz Real spokesman pointed out, “no final decisions have been taken”. But the *Bundesnetzagentur*’s initial manoeuvre indicates investors will have a struggle to stop returns from heading downhill. ■

A TOUGH SALE

The regulatory uncertainty surrounding future returns in Germany’s electricity and gas sectors might also complicate another aspect of the Amprion transaction.

When Commerz Real announced the conclusion of the acquisition, it mentioned that it was holding an indirect stake of 13 percent in the 11,000-kilometre network through the buying consortium. Likewise, RWE also holds an indirect stake of 10.8 percent in Amprion. However, Commerz Real said that it and RWE only planned to hold the stakes temporarily, with the asset manager tasked with placing the holdings with other investors “in the short term”.

Commerz Real added that “potential investors [had] already entered the process of detailed assessment,” indicating that the sale process was underway. Of course, that was before the regulator signalled its intention to decrease returns for the sector. According to industry sources, the stakes are now probably much more difficult to unload, at least until there is some clarity regarding changes to returns.