USING DEBT TO REDUCE EQUITY

MALCOLM COOPER OF LATTICE GROUP PLC DESCRIBES HOW TRANSCO PLC REPLACED EQUITY WITH DEBT THROUGH A SERIES OF COMPLEX BUT SUCCESSFUL TRANSACTIONS.

Transco plc is the main operating subsidiary of the Lattice Group. It is a regulated utility transporting most of the gas used in Britain and in peak periods it provides more than 50% of the UK's primary energy needs. It is one of the three successor companies to British Gas plc: the integrated gas business that was privatised in 1986.

UTILITY REGULATION. When setting allowed prices for a UK utility, the regulator will consider two main parameters when determining an appropriate level of income: the asset value on which the return is earned, the regulatory value (RV); and the allowed return.

The calculation of the allowed return will often be based on the regulator's assumption that the company can move to an efficient capital structure – that is, the amount of the RV that could be funded by debt while minimising the overall weighted average cost of capital (WACC). Once this return has been incorporated within a price control, the regulated entity is not required to apply this underlying capital structure: the value of the firm will still be maximised with a capital structure that minimises the WACC, irrespective of the level of gearing. However, if the actual level of debt is lower than the level of debt assumed by the regulator then some of the equity used to fund the asset value will be earning a debt return, rather than an equity return.

The assumed appropriate level of gearing for a utility has changed considerably in the past five years. In 1997, a level of less than 25% was accepted for Transco. In 1999, 50% was considered to be appropriate in the REC (electricity) price control review. In 2000, 60%-65% was used for NGC. In 2001, the Glas Cymru structure has gearing of more than 90%, although this 'mutual' structure is considered to be exceptional. With RV as a proxy for enterprise value, RV gearing of greater than 50% implies debt:market capitalisation less than 100%. Even excluding the Glas structure, these levels of gearing may look extreme, but the relatively low business risk, and the certainty that exists for five years once a regulatory review is completed, mean that utilities can sustain debt at these levels.

TRANSCO 1997 TO 1999. In mid-1997, coming out of a price

Lattice
THE INFRASTRUCTURE TECHNOLOGY GROUP

☐ The Lattice Group is one of the three successor companies of British Gas. With unrivalled experience and expertise in the gas sector, our purpose is the provision, management and servicing of infrastructure networks. We specialise in those complex information-based networks which provide the basis for the competitive utility markets increasingly being formed in the developed economies of the OECD.

Transco not only owns and operates one of the largest and most complex gas transportation systems in the world, but also achieves the highest standards of customer service and reliability. As pioneers in enabling the introduction of full competition to the British gas market, Transco's expertise is unique and world-leading. Lattice is building on that heritage, applying our network management skills to telecoms and exploiting growth opportunities outside price regulation across the liberalising utilities sectors in Great Britain and overseas.

Lattice companies are infrastructure and network experts, applying advanced technology, software and management skills in an increasingly fast-moving, innovative and dynamic business environment.

- ☐ Turnover £3,092m
- ☐ Operating profit (before excepional items) £1,014m
- ☐ Market Capitalisation £5.7bn
- ☐ Listing: UK
- ☐ Rating September 2001: Transco plc A2/A/A
- ☐ Main countries of operation: UK

control review, Transco had gearing (debt:RV) of less than 25%. By the end of 1999, it had increased gearing to about 55%, in line with the change in thinking over that period. Three techniques were used to substitute £2.9bn of equity with debt:

▪ B share scheme	£1.2bn
▪ Market purchases	£0.2bn
▪ Court scheme	£1.5bn
	£2.9bn

'B' SHARE SCHEME. This transaction was undertaken in the second half of 1997. The structure was used by a number of companies around that time. The basic steps were as follows.

- issue of a circular to shareholders;
- seek shareholder approval for the transaction at an EGM;
- issue £1.3bn of preference shares (the 'B' shares) as a bonus issue;
- consolidate the ordinary shares to reflect the new shares issued;
- offer to redeem the 'B' shares (several times). In our case, shareholders with £1.2bn of 'B' shares accepted the offer; and
- convert the outstanding B-shares back into ordinary shares.

From a balance sheet perspective, the main impact was:

- the reduction of £1.3bn in share capital/premium;
- the creation of a £1.3bn capital redemption reserve;
- an increase in debt of £1.2bn; and
- a reduction of £1.2bn in distributable reserves.

The transaction took about two months from mid-September 1997 until early November. The documents were issued to shareholders in late September, with an EGM in October.

MARKET PURCHASES. Market purchases of shares are covered by the Companies Act and the Association of British Insurers (ABI) guidelines. The Companies Act sets out requirements in relation to authority for a company to purchase its own shares. For example, the authority must be approved by an ordinary resolution of shareholders, the authority must expire no later than 18 months after the date of the resolution and must specify the maximum and minimum prices which can be paid. The ABI guidelines are more restrictive than the provisions of the Companies Act. The main features of the guidelines are that the authority must be approved by special resolution, the authority may not last more than 12 months, and the purchase should result in an increase in earnings per share.

Once a company has bought its own shares they are treated as cancelled and consequently the issued – but not the authorised – share capital of the firm is reduced. In 1997 to 1999, shares were bought and cancelled with a value totalling some £177m.

COURT SCHEME. The 'B' share scheme, the market purchases and the 1997 demerger of Centrica left Transco plc (then known as BG plc) with limited distributable reserves. Given the need to maintain some reserves to act as a buffer for accounting 'shocks', this precluded a material increase in debt through any action that required distributable reserves (such as special dividends and the two techniques described above).

In addition, as a result of the corporate structure arising from the privatisation of British Gas, the corporate structure was not considered to be optimal. Transco plc was the regulated gas

FIGURE 1
UTILITY GEARING LEVELS.

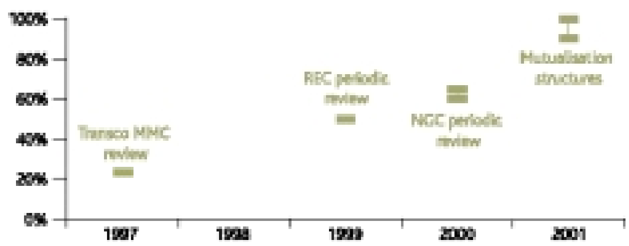
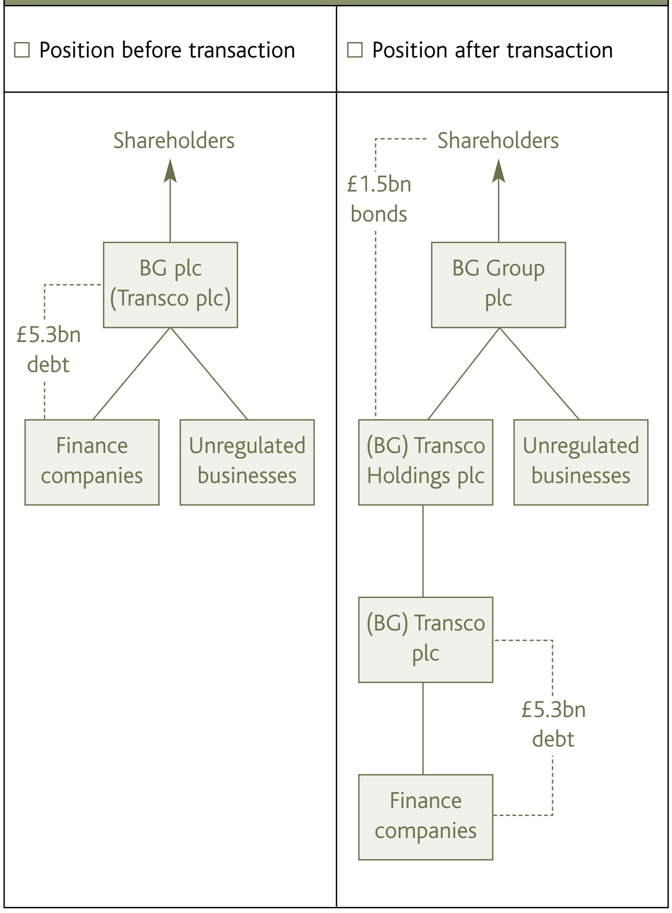


FIGURE 2
BEFORE AND AFTER STRUCTURE.



transportation business, but certain unregulated activities were carried out within the company and other unregulated activities were conducted within subsidiaries of Transco plc.

Following a review, a transaction was devised which overcame both of these issues: it allowed £1.5bn of equity to be retired and replaced with debt issued directly to shareholders, thereby increasing gearing; and it allowed for a restructuring that resulted in all the unregulated activities being removed from Transco plc. Figure 2 summarises the corporate structures before and after the transaction. It should be noted, however, that following the demerger in October 2000, Transco Holdings plc is now a wholly-owned subsidiary of Lattice

Group plc. The principal steps of the transaction were as follows.

- issue of a circular and listing particulars to shareholders;
- seek shareholder approval for the transaction at a court meeting and a separate EGM held one after the other;
- seek the sanction of the court for certain components of the transaction;
- transfer the unregulated activities conducted within Transco plc into new subsidiaries and set up the unregulated corporate structure;
- a new company BG Group plc acquired BG plc, via the court approved scheme of arrangement – shareholders received eight shares in BG Group plc for every nine shares in BG plc;
- BG Transco Holdings plc, an existing subsidiary of BG Group plc, acquired BG plc from BG Group plc;
- BG Transco Holdings plc issued £1.5bn of bonds, which were transferred to shareholders; and
- the unregulated businesses were transferred from Transco plc to BG Group plc via BG Transco Holdings plc.

The proposal to undertake the transaction was announced in June 1999. This announcement was necessary to allow work to commence on obtaining the large numbers of consents that were required. The documents were issued to shareholders in October with the EGM and Court Meeting in November. The scheme was effective on 13 December 1999, with the bonds issued to shareholders soon after that.

The bonds were issued in three tranches of £503m: a 10-year floating rate note; a 23-year index-linked bond; and a 25-year fixed rate bond – each with a £1,000 denomination. This meant that a shareholder needed 7,840 shares to receive a bond package consisting of one of each of these bonds. Fractional entitlements to bonds were sold on behalf of shareholders and they received the cash. The share register at the time was such that the large majority of shareholders by number had less than the minimum number of shares and, as such, received cash rather than bonds. However, by value the large majority of shareholders received bonds.

This transaction may look complex, but this was necessary to overcome a number of complex issues: the lack of distributable reserves; the historic corporate structure; tax issues; regulatory considerations and not least Companies Act and accounting requirements.

THE OUTCOME. From 1997 to 1999, the view on the appropriate level of gearing for utilities increased by about 25%. For Transco, with a regulatory value of about £12bn, this represented a £3bn increase in debt. This increase in debt was achieved in spite of limitations in distributable reserves by three separate transactions in that period, ensuring that Transco maintained consistency with market views.

It should be noted that Transco is in the process of a price control review. At the time of writing this article, the regulator's final views are not known, but it is expected that they will be by the time that this article is read.

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