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Dear Emma

Financing Networks: A Discussion Paper

We have pleasure in providing our comments in response to this joint Ofgem and Ofwat consultation. We summarise the important points of our response below. Detailed comments along with responses to the specific questions raised in the document are set out in the Appendix 1, which we are happy to be made public along with this letter. In Appendix 2 we discuss our current capital structure, the rationale behind its adoption in 2002 and some of its implications in the context of this debate. Appendix 2 should be treated as commercial-in-confidence and not made public.

The consultation is a welcome step in addressing the issue of financeability and how regulators, policymakers, markets and the industry ought to respond to it. Finding a sustainable approach will be important to the ongoing stability and success of the water industry. This consultation goes a long way towards this goal and we hope that it presages the development of a rational, transparent approach in forthcoming price reviews.

AWS is among the more highly geared water and sewerage companies. Arguably, our capital structure represents in practice what has caused debate and perhaps concern amongst regulators, policymakers, stakeholders and commentators in recent years. In this response, as well as responding to the specific issues raised, we aim to provide some insight about the rationale for our structure and to its benefits. In summary, we believe that our capital structure is efficient while at the same time provides strong incentives and discipline which benefits both customers and investors.

The key points in the response are:

- It is for companies to manage their own capital structures and their costs of finance. The regulatory framework should encourage prudent and efficient financial management by companies
- A continuing and consistent track record of regulatory transparency will be crucial to maintaining the confidence of investors. The track record is not yet very long. This is not to say that there should be no change but that any change should be well signalled and rational.
- Financeability issues should be part of the policy debate about appropriate scale and pace of capital expenditure
- Moving to a nominal cost of capital is not appropriate because of the impact on prices faced by customers, therefore financeability issues will continue to need to be addressed as part of the price review
- Leaving financeability problems entirely for the market to deal with is too risky. Ofwat should continue to test for financeability and retain regulatory mechanisms for addressing it
- Ofwat will need to make reasonable assumptions about potential market responses, including use of index-linked debt. But it should be cautious in doing so and should not second-guess the capital markets.
- Regulatory mechanisms involving advancing or uplifting revenues should take into account the potential long term consequences for risk and financeability and fairness to customers, especially if such mechanisms apply across different regulatory periods.

The consultation provides a clear exposition of the issues and options available to address them but at the same time it leaves open what the next steps are to be. Given the likely importance of the issue at PR09, early clarification of how Ofwat intends to take this forward would be welcome while recognising that developments in capital market conditions and approaches of other regulators at determinations preceding PR09 will and should impact the approach. We look forward with interest to further debate on the issue as it applies to the water industry.

Yours sincerely,

Jean Spencer
Director of Regulation

Appendix 1: Detailed response to the consultation

1. In this Appendix we provide more detailed comments in response to the consultation in three parts:

   - Context and general comments
   - Reponses to questions raised by Keith Palmer in the forward
   - Responses to specific consultation questions

Context and general comments

2. Although we are convinced about the need for attention to this issue it is worth setting some context. At PR04 the financeability adjustments were not large in the context of overall revenues allowed. This is not to say that similarly derived adjustments would not be larger in future but, in broad terms, resolving the issue at PR04 did not require a wholesale reassessment of the fundamentals of the regulatory regime. In this light, Ofwat's approach can be seen as a prudent and practical way of finessing the building blocks approach to dealing with a specific problem of concern to investors.

3. The consultation includes an admirable explanation of the underlying problems associated with the "mismatch" between how companies are compensated for the effects of inflation via regulatory mechanisms and how, typically, investors prefer to be remunerated for it. However, the problem only becomes a major one if there is substantial negative cashflow arising because of large capital investment programmes. This will continue to be the situation in water. It is not necessarily the case in other industries suggesting that the resolution to the issue needs to be industry-specific.

4. It also suggests that moderating the level or rate of investment would reduce the impact on financeability. To this extent, it might be useful to think of financeability as a constraint on the rate of capital investment. We consider policy-makers should be concerned with financeability rather than it being solely a matter for regulators or markets to deal with. Additional or advanced revenues, if necessary, perhaps can be thought of as a cost of accelerating capital investment given the "mismatch" inherent in the regulatory framework. Financeability needs to be part of policy debate about capital investment in the context of the range of other costs and benefits rather than being treated as a policy consequence which regulation is expected to solve.

5. It is also worth making two points about current debt market conditions, which inevitably colour the ongoing debate on financeabilty. While yields are historically very low, there is the obvious point that it is not possible to know how the market might move in the future. Second, to the extent that regard is taken of market conditions, a long-term view is appropriate. It is impossible for a company with a large debt portfolio to refinance more than a small percentage of its debt in the short term. Therefore it is the market conditions over a relatively long period, perhaps 10 years, which should be considered.

Responses to questions raised in Keith Palmer's forward

6. We particularly commend the three questions raised in the forward to the consultation (page 5) as being a concise expression of the key issues for Ofwat and other regulators but note that the consultation does not explicitly address them. We have set out below some general comments about financeability against each of these questions.

Is it reasonable for regulators at future reviews to expect regulated companies to manage their finances to avoid the financeability problem in future? If so then regulators might indicate that financeability adjustments would not normally be countenanced?

7. In principle it is for companies to manage their own finances. However two of the main causes of the financeability problems are largely beyond their control to manage, namely: the size of the capital (enhancement) programme and the way in which capital markets operate.

8. Despite these major constraints companies do have some flexibility to be able to manage the risks of financeability and shareholders should therefore bear some risk.

9. However, we do not believe that Ofwat should avoid its responsibility to ensure an efficiently managed company can finance its functions. The option of a regulatory response needs to be retained. In practice, regulators need actively to test for financeability constraints in making price determinations and retain the option making adjustments to deal with them. In doing so, Ofwat should treat companies consistently.

10. However, in undertaking financeability tests, more thought should be given to what "efficient" means in the context of financing. How does one measure the "efficiency" of AWS' highly geared and structured approach with that of a company that has a more conventional capital structure? We believe that a diversity of different capital structures might be consistent with being financially efficient.

11. Regulators therefore need to be careful about what assumptions are reasonable to make about capital structures in testing for financeability. The costs and constraints of assumed market solutions need to be taken into account and these costs will be driven largely by capital market responses. In other words we think it would be risky for a regulator to second-guess the capital markets. For example, a proportion of index-linked debt might be considered efficient, and therefore a reasonable assumption, but how much IL debt is it reasonable to assume given the depth of the market? How should the direct and indirect costs of issuing equity be accounted for?

12. Contrast this with the approach on operating and capital efficiency. Here, regulators feel they are in a much stronger position to assess what efficiencies might be achievable and therefore it is less risky to pass a proportion of them to customers immediately.

13. However financing efficiency is judged, we consider that efficient companies should be rewarded for being efficient thus providing the incentives to achieve capital efficiency. Arrangements for sharing the risks and rewards for efficient financing should be clear and equitable.

14. It is also worth pointing out that companies' were privatised with dissimilar capital structures. These differences have influenced companies' approaches taken to financing and will continue to be important for some time. For example, AWS was privatised with relatively high debt and high capital charges (based on asset replacement values) relative to its RCV. Such dissimilarities remain relevant now and will continue to be relevant for some time. We therefore believe regulators should have regard to them.

If regulators decide that they must retain the option to advance revenues then what are the circumstances and how will the problem be dealt with?

15. We argue above that regulators should retain the option to address financeability constraints by uplifting or advancing revenues. There are a number of possible mechanisms but whichever is adopted we believe that regulators need to take account of the long-term implications of the solution proposed and have regard to perceived risks caused both by introducing new arrangements and by any inherent uncertainty in the arrangements themselves.

16. One option put forward is to move to a nominal cost of capital. Although this is potentially an obvious and permanent solution to the problem, it suffers from severe disadvantages arising from the transition to this method, namely large price rises to customers and the impact on perceived risk in the industry. We would not support this.

17. Other solutions broadly involve revenue adjustment or reprofiling which may be either NPV neutral or positive. NPV-neutral approaches should avoid customers bearing additional costs over the long-term, i.e. there is no increase in the cost of capital. However, NPV-neutral approaches might not be sensible because bringing forward revenues will exacerbate financeability problems at subsequent price reviews and increase uncertainty.

18. Our response to question 8 below addresses this in more detail.

How will Ofwat deal with the uplifts allowed in 2004?

19. We welcome the comments made by Philip Fletcher at the seminar, indicating that there was no intention by Ofwat to claw back adjustments made at PR04. Ofwat should continue to reinforce this message. Such statements are useful in maintaining the confidence of investors.

20. However, it is reasonable to assume that Ofwat will examine companies' dividend policies with a view to assessing whether or not there has been any over-distribution.

Clarity on how regulators intend to judge whether previous financeability adjustments have been distributed would be welcome.

Responses to specific questions raised by the consultation

Should financial ring-fencing arrangements be extended to cover all monopoly businesses and modified so that they all include cash lock-up provisions? How might the introduction of cash lock-up provisions affect existing financial structures including holding company debt? Are current ring-fencing provisions sufficient to allow the activities of a licensed undertaker to be fully separated from other group entities? If not, what additional ring-fencing provisions might be appropriate and what might be the costs and benefits of these?

21. We do not see a case for the extension of cash lock-up conditions to all utility companies for three reasons. Firstly, existing ring-fencing conditions appear to have worked adequately. The Enron/Wessex case demonstrated that ring-fencing provisions have already proved more than capable of protecting the customers of licence holders from holding company insolvency. The package of existing measures therefore seems adequate.

22. Secondly, cash lock-up protection has emerged where companies have adopted structured finance arrangements. One of the benefits of AWS' financial restructuring was to enable us to demonstrate compliance with existing ring-fencing conditions more robustly. Cash lock-up is an important feature of the creditor protections put in place in this structure. Cash lock-up is triggered not by credit ratings but by breaching specific levels of key financial ratios or the operational standards that must be maintained throughout the business. These factors are both measurable and under management's control and thus provide a real incentive for a disciplined financial approach.

23. We believe such protections should emerge to manage risk as part of financing strategies of financially efficient companies. We do not believe it is for Ofwat to impose them for example by setting up alternative triggers which second guess actual arrangements.

24. Thirdly, Ofgem's approach relies upon the judgement of the rating agencies to trigger the cash lock-up. We do not believe this is appropriate for the water industry. Provisions are triggered when issuer credit ratings fall below investment grade or are on the lowest rating consistent with investment grade and on some form of negative watch or outlook is announced. Agency credit ratings are not always transparently derived, consistent over time or between the different agencies.

Would the separation of past and future capital investment improve the incentives for investment, lower the overall risk of regulated businesses and reduce the cost of finance? Are there any practical implications?

25. Dieter Helm's proposals are an interesting contribution to the debate over financeability and the treatment of risk in the business more generally. We believe there is a great deal of merit in considering such fresh thinking about risk allocation across the industry.

26. However, as we understand them from the consultation paper the proposals seem to be complex, and we are doubtful about how setting of three separate costs of capital (on "old" RCV, "new" RCV and capital delivery/operations) will be seen by investors who, unless the proposals result in an actual separation of the regulated entity into its underlying components (one which operates and builds infrastructure, and one which owns the built infrastructure represented by the RCV), will still be interested in the returns available to them from a single cashflow. We are not confident that such an approach would aid certainty and transparency and therefore reduce risk in the regulated entity. Other practical issues arise such as how to handle the transfer of newly built assets to the RCV. It is also unclear how risks should properly be allocated. Should unexpected costs arise which relate to a "failure" of assets that form part of the RCV, it does not seem immediately obvious that there will be a clear answer as to where the risks should fall.

27. On the other hand, there is some potential to treat major capital schemes in a way that distinguishes them from the "run of the mill" investment undertaken by companies. Large schemes have different risk profiles and it is possible to see benefit in treating them differently, perhaps with a scheme specific cost of capital (perhaps indexed), which is committed to over the period of construction. It is easier to see how practical issues might be overcome, perhaps via Special Purpose Vehicles.

28. It was pointed out at the 27th April seminar that the proposals would tend to increase rather than reduce the current level of gearing in the industry. Whatever public policy consequences of high gearing are potentially of concern (e.g. the potential risks to customers and taxpayers, and the consequences for the continuing delivery of essential services) would presumably be exacerbated. A counter to this is that the gearing can be high at lower overall risk when risk is more clearly allocated. However, we are not convinced that it would be straightforward to ensure the necessary clarity.

29. Perhaps most fundamentally, setting a split cost of capital would appear to go against the broad principal that it should be for companies, not regulators, to manage their own financial structure. AWS' capital structure is perhaps among the closest to what Helm is envisaging among the regulated water companies. Creditors are protected by detailed provisions which control the allocation of risk to them. However, this model has emerged because we believe that this represents an efficient capital structure and see clear benefits for the business. There is no consensus across the industry that this is appropriate in all circumstances. If such consensus emerged there might be more justification for a split cost of capital. At the present time, however, we consider that adopting such a mechanism would lead to higher rather than lower regulatory risk.

Is there any evidence of a lack of regulatory commitment to regulatory asset values or equity funding and if so how might this be rectified?

30. At the broad level we see no evidence of lack of commitment by regulators to regulatory asset values or to the need for equity funding. Ofwat in particular has been keen to ensure stakeholders understand its commitment to the current model and to increase the transparency with which it is applied.

31. However, the commitment that any regulator can give is inherently limited because whatever is said, a regulator is unable to bind its successors. In practice, the only way of demonstrating commitment on the part of successive regulators is via a consistent and lengthening track record of transparency. From the water industry perspective, despite the good work of the last few years the track record is still not that long.

Should regulators assume that a proportion of debt is index-linked when setting price controls? Is access to the index-linked debt markets (or related instruments) available to all companies regardless of their specific financial/corporate structure? What is the demand for corporate index-linked debt and are there constraints on investors' portfolios? Would it be more expensive?

32. In principle we do not believe that it is for regulators to determine the capital structures of companies ex ante.

33. Although regulators do have to make assumptions about companies' capital structures, assuming all companies issue some index-linked debt constitutes a significant change. Having said that it seems reasonable for regulators to make such an assumption if it is apparent that this is what in practice most or all efficient companies are doing.

34. It is important to note that the proportion of debt that is index-linked debt is limited. Firstly, it is reasonable to suppose that for a specific company there is an optimal level of such debt, which depends on the specific circumstances of the company and its approach to financing. However, one factor that would tend to limit the proportion of IL debt is the attention that equity investors pay to the historical profit & loss account rather than focusing on cashflows. Accretion of the index-linked liability in periods of higher inflation could significantly reduce reported earnings and would hence affect equity investors' perceptions of risk.

35. A more fundamental limit is that imposed by the market for such debt itself. While innovative approaches such as AWS' "Freshwater" issuance have in effect widened the market, it should be recognised that corporate index linked debt is a very small part of bond market. Ongoing demand for such instruments, for example from pension funds seeking to match assets to liabilities, would suggest the market could grow but at present it is still relatively thin. Therefore a great deal of caution should be exercised in setting an assumed proportion of IL debt. Currently over a third of AWS debt is index-linked either directly or via "synthetics" and swaps. However, in our judgement there would need to be a step-change in market depth for it to be reasonable to assume that all companies had a similar level of debt. Some companies with very large RCVs have relatively little such debt. We would prefer a cautious and transitional approach in making such assumptions.

Are there any changes to the regulatory regime that would be required in order to facilitate equity injections? What would the implications for highly geared companies?

Would it be reasonable for regulators to be more flexible in their approach to modelling dividends as a method for stabilising gearing and easing financing constraints? Would such an approach require changes to the regulatory regime to increase certainty and if so what sort of changes would be most appropriate?

36. We fully support the over-riding principal (which regulators have accepted) that it is for companies not regulators to determine the capital structure. On this basis we would in general oppose the introduction of any further measures to encourage specific capital structures. However we do see merit in adjustments to the regime which would increase the degree of transparency and "fairness" in the regime, particularly in relation to adjustments to the RCV.

37. Regulators need to make reasonable assumptions but in doing so they need to be cognisant of the capital markets' likely response to these assumptions. The capital markets tend to react negatively to new equity issues, including rights issues, and to dividend cuts. Any indication that the regulator assumes such activity would probably increase the cost of equity.

38. Investors hold utility stocks in their portfolios because of their specific characteristics: high yield, and low but stable inflation-linked growth. Ofwat's assumptions about future dividend yield and growth have to date reflected these characteristics. In future such assumptions should continue to have regard to market fundamentals. Assuming significantly lower yields would inevitably colour investors' attitudes towards such stocks and would likely lead to lower demand for them and higher costs of equity.

39. Higher costs of equity relative to the cost of debt would tend to provide an incentive for companies to adopt more highly geared structures.

40. Notwithstanding the above we believe that regulators have some power to lower the cost of equity and hence encourage equity formation. Transparency and consistency of approach over time are important. Of particular relevance to equity investors is clarity of rules surrounding changes to the RCV and removing any perception that such rules penalise investment made in good faith. Ofwat's practice of limiting increases to RCV for various elements of expenditure made during the periodic review is one example where we believe current regulatory practice could be improved without diminishing the incentive for companies to avoid unnecessary expenditure.

41. One specific question is: if a notional gearing assumption is retained, then how should it be set in future? We believe that the assumption should be updated in the light of what has been allowed for capital investment rather than reset back to an arbitrary level in each periodic review.

42. In this context regulators should perhaps pay more attention to movement in companies' gearing over time rather than its absolute level, and what this says about the sustainability and appropriateness of the approach to financing. A notional gearing level is an implicit assumption that a portion of capital investment is financed by retention of earnings over the price review period. Over-distribution of available

cashflows to equity holders with the consequence that capital investment is all debt-financed should be of concern and would be revealed by a creep up in the level of gearing. A high level of gearing does not itself indicate over-distribution if this level is maintained.

Should regulators adopt pragmatic definitions of ratios used by the credit rating agencies? Is the level of any specific ratios critical to creditworthiness? Is overall level and trend of ratios that is important? Would there be significant difficulties for companies if the majority of ratings were BBB?

43. We are encouraged by Ofwat's requirement for companies to maintain investment grade credit ratings. Although we consider that regulators should draw their own conclusions about financeability, in doing so there is no alternative but for regulators to have regard to actual ratings. It is the actual ratings issued by the agencies that drive financeability concerns. Credit rating agencies have therefore inevitably acquired a regulatory function via their assessment of companies' creditworthiness. The agencies' lack of accountability for regulatory outcomes makes this an uncomfortable situation for all parties but one that is likely to persist.

44. It is also important to note that the agencies are not consistent either among themselves, or over time, with regard to which specific ratios are considered to be most important. This suggests that while regulators should draw their own conclusions they need to understand how their decisions are likely to affect all the ratios used by agencies and hence take a balanced view of impact on credit ratings. More dialogue to improve mutual understanding between regulators and rating agencies would be beneficial. We believe that regulators should endeavour to be clear about the reasoning for decisions while accepting that it is not desirable to adopt too mechanical an approach.

45. The levels of ratios that Ofwat used to test for financeability at PR04 aimed to maintain companies "comfortably within investment grade". It would be possible to apply a more stringent test (i.e. ratios consistent with issuer ratings at or just above investment grade) but these would remove an element of headroom across the industry and increase regulatory risk. If this were to result in actual ratings at the BBB or equivalent level, it would be difficult to imagine that actual costs of capital would not increase across the industry even if finance were to continue to be available.

If there are remaining issues of financeability what are the advantages and disadvantages of (a) revenue uplift (and should this be NPV neutral) (b) accelerated depreciation (c) profiling returns on a nominal basis?

46. In general we support the conclusions set out in Oxera's report for Water UK. We believe that Ofwat needs to retain the option to use a mechanism similar to that used at PR04, which calculates revenue uplifts based on a notional balance sheet. Modifications should be explored, particularly around the assumptions relating to gearing, use of index-linked debt and level of dividend payments but as we discuss above any such assumptions need to be made cautiously.

47. We agree there might be a role for re-profiling of revenues within and across periodic reviews. However, the limitations of this must be recognised. We do not believe that it alone will necessarily be sufficient to address financeabilty issues particularly when there are large ongoing capital programmes. Any substantial re-profiling of revenues will likely have adverse consequences for financeability in the future.

48. Mechanisms for making financeability adjustments NPV neutral (such as capitalisation and deduction from RCV) rely on the need to make future downward adjustments to RCV or revenues in the light of financeability constraints at the time. These will tend to increase uncertainty and risk if it is not clear how they are to be applied. Future reductions in RCV will also tend to increase financial and operational gearing, which could impact both financeability and perceived risk in the industry.

49. We do not favour acceleration of depreciation as a method for addressing financeability, particularly for the water industry. There appears to be no theoretical basis to link the need to change the profile of revenues with the depreciation charge or assumed asset lives. We note that in the water industry depreciation allowances are not in any case set at a level which will recover the RCV over an assumed asset life – rather they are based broadly on what expenditure is actually required to maintain the asset base in its current state in perpetuity (explicitly for infrastructure assets but also implicitly for non-infrastructure assets). These allowances are relatively high and if they were higher would not be cost-reflective. Current customers would be paying too much for the assets that are being consumed.

50. There are also practical consequences: rating agencies are not consistent in their assessment of interest cover ratios. Higher depreciation charges would accentuate the inconsistency.

51. In general we would prefer any revenue re-profiling mechanism to be via an entirely separate and transparent mechanism but believe that caution should be exercised in view of potential impact on future financeability and risk.

52. We do not believe moving to a nominal cost of capital is realistic. Although this is potentially an obvious and permanent solution to the "mismatch" problem, it suffers from severe disadvantages arising from the transition to this method, namely large price rises to customers. We would not support this.

53. Some have argued that financeability issues could be resolved if the cost of capital were set high enough to avoid them: i.e. get the cost of capital "right" and then leave financeability to the market. This would seem to involve a higher cost of capital for all companies compared to the current arrangements, which would disbenefit consumers generally. As we have argued above we believe a better approach is for the regulators to test for financeability concerns on a company-specific basis. Even if this testing is based on notional capital structures it is a more tailored and targeted way of addressing the issue.