mid kent water

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May 19, 2006

Dear Emma,

Re: Financing Networks: A discussion paper

We welcome this consultation as the need to ensure that the Water Industry is able to adequately and efficiently raise new finance will continue to be a fundamental issue facing all companies. It is almost certain that future capital plans will continue to require companies to raise additional finance. Certainly, Mid Kent envisage the need for very significant capital expenditure (over £100m) on supply demand schemes, particularly the development of the Broad Oak Reservoir during AMP5 (2010/11 to 2014/15) and AMP6 (2015/16 to 2019/20) which will require additional finance to be raised. This is likely to equate to an increase of almost 40% in the regulatory asset value of the company.

The Company believes that the approach to the cost of capital adopted by Ofwat at the last Periodic Review, (which involved setting an Industry wide figure with a small Company Premium for the water only companies combined with financeability adjustments when key financial ratios were not achieved) was appropriate and well communicated, and adequately fulfilled OFWAT's obligation to ensure that efficient Companies can finance their function.

Our responses to the specific questions raised in the consultation are included below. However, we believe that the covenants associated with our debt finance and the need to maintain our credit rating both to comply with Licence Condidtion F and satisfy our lenders provide the controls and discipline for our management to adopt a prudent strategy that does not expose the organization to unnecessary risk and enables finance to be raised effectively.

Yours sincerely,

Jo Stimpson
Finance Director

Specific questions raised in the discussion paper:

Question 1, part 1: 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?

Introduction of ring fencing reduces risk for lenders and therefore should enable funds to be borrowed more cheaply ultimately benefiting customers. The regulator is able to provide additional reassurance to lenders through ability to monitor and control companies more effectively than lenders. Therefore it is reasonable to extend ring fencing arrangements to all monopoly businesses.

Covenants included by lenders mean that cash lock-up provisions are set by the market. If the introduction of cash lock-up provisions by the Regulator mirrors the market or are less onerous, then they are superfluous. If set tighter than market this could inhibit fresh equity and lower share prices as lower dividends may be anticipated. Additionally, cash lock-up provisions could interfere with company management decisions. Overall therefore we believe additional cash lock-up provisions are unnecessary.

Question 1 part 2: Are the current ring fencing provisions sufficient to allow the activities of the 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?

Current ring fencing provisions included in Water Company Licences are sufficient to ensure that there is adequate separation between the regulated and non-regulated activities. The covenants included by lenders and the reviews conducted by the credit rating agencies provide additional constraints to ensure that only appropriate activities are carried out by licensed undertakers.

For the water industry the current RAG 5 reporting requirements on the transactions between the regulated business and the associated businesses which are audited each year by our Statutory Auditors and subject to periodic investigation by Ofwat are adequate. It is difficult to believe that additional compliance would provide any further assurance but would result in additional costs to the organization.

Question 2: 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 if such an approach was adopted?

It is not clear how this approach would operate. Certainly, this is not the way the capital markets work. The Regulator needs to incentivise organisations to finance efficiently, that is to attempt to outperform the regulatory cost of capital assumptions. Any method needs to ensure that funding will continue to be made available for new investment. The market does not differentiate between existing and future investment but provides finance where returns balance risk associated with investment.

Question 3: Is there any evidence of a lack of regulatory commitment to regulatory asset values or equity funding and if so how might this be best rectified?

In the case of small companies, such as Mid Kent, there has been significant interest and availability of Private Equity Finance when these companies have been put up for sale. Generally, these deals have been accompanied by new owners taking on additional debt resulting in increased gearing. Ofwat has reviewed and consulted on each of these acquisitions.

Network organisations provide relatively predictable returns which enable higher levels of gearing. It is apparent that Ofwat have a concern about the potential systematic failure of a highly geared Industry. However, it is not clear how Ofwat can encourage further equity. Simply offering a higher cost of capital would not necessarily encourage additional equity issue. For small companies such as Mid Kent, there is an inherent problem with the cost of issuing new equity and the likely size of any new issue is unlikely to be attractive as a public issue.

Equity could be increased by retaining dividends. However, given that the attraction of water companies to many equity investors is a low risk business with a steady and reliable dividend, this would not suit many shareholders. In fact if there was a perception that future dividends could be more volatile the sector could become less attractive to equity investors.

Question 4.: 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? Are there longer-term implications for the companies' financial stability of adopting a significant proportion of index-linked debt? What is the demand for corporate index-linked debt and are there constraints on investors' portfolios? Would it be more expensive?

It may be reasonable for Ofwat to assume that a proportion of debt is index-linked as most companies include it within their debt portfolio. This would have to depend on the potential availability of index-linked debt in the market. The cost of this should be covered in the overall cost of capital. At present there is sufficient capacity for Mid Kent to raise all its new debt in the index-linked market. The product is well suited to the water industry as the annual indexation of debt mirrors the annual uplift of the Regulatory Asset Value allowing more investment to be funded from operating cash flows than debt with a nominal interest rate.

Existing Mid Kent indexed debt has a thirty year maturity, however new products with forty year maturities are being introduced to the market. As a portfolio of indexed debt is built up the risk associated with having to refinance will be reduced. At present index linked debt is an attractive option to companies. The long term nature of the water industry means that there is a good match between the length of asset lives and the maturity length of the debt. The confidence in the regulatory system in England & Wales and the performance of the management to maintain satisfactory credit ratings means at present there is adequate demand for the provision of index linked debt. Given that many pension funds are increasing their exposure to bonds to achieve a better match to their liabilities it is probable that this demand will continue.

Reliance on index-linked debt is predicated on the assumption that retail price index will continued to be used at future price reviews to index the RAV and there will not be a switch to using an alternative measure such as the consumer price index.

Question 5 : Are there any changes that would be required to the regulatory regime in order to facilitate equity injections? What would be the implications for the highly geared companies?

The cost of raising equity is a barrier for fresh equity to the water sector. Also the cost of debt is lower and hence offers existing equity owners a greater opportunity for out performance. For smaller companies, the size of potential equity issues is not particularly attractive for equity providers and the management of investor relations is potentially onerous. New equity for the WOCs has generally come through takeovers. Recently there has been little new equity for the WASCs other than the United Utilities rights issue. Current trends indicate that rational Companies will increase gearing towards the highest level available before a constraint is imposed by debt providers through covenants.

Ofwat could encourage fresh equity by specifically allowing cost of equity issues in price limits. However, it is not clear what level of certainty that equity would be issued could be given by a Company in advance of well developed plans and / or approval by shareholders.

Question 6 : Would it be reasonable for regulators to be more flexible in their approach to modelling dividends as a method for stabilising gearing and easing any financing constraints? Would such an approach require changes to the regulatory regime in order to increase certainty and if so what sort of changes would be most appropriate?

Dividend retention is a cheap way of increasing equity and lowering gearing, but investors do not like dividend cuts. Such a move would require adequate communication about and subsequent demonstration of future dividends to maintain investor confidence.

Q7 Should regulators adopt pragmatic definitions of ratios used by the credit ratings agencies? Is the specific level of any particular ratios critical to credit worthiness? Is it the overall level and trend of ratios that is important? Would there be significant difficulties for companies if the majority of ratings were BBB?

Inevitably the market, through the credit agencies will dictate the appropriate financial ratios for companies to achieve satisfactory credit grading. Mid Kent understand that the credit rating agencies take a pragmatic view over a range of financial ratios but have in the past indicated that FFO/Net Debt is considered critical.

We understand that the ratings agencies do place significant importance on the trends in ratios and are not dogmatic about specific levels of the ratios but will accept that on occasions if a ratio is marginally below their target levels, if the management is able to demonstrate future ratio recovery, credit grade levels may not be affected.

Mid Kent believes that water companies listed on the stock market need to have a higher credit rating than BBB and that a reduction to this level could create problems raising future debt and may result in covenant issues.

Question 8: If there are remaining issues of financeability what are the advantages and disadvantages of a) revenue uplift and should this be PV neutral b) accelerated depreciation c) profiling returns on a nominal basis?

We believe that the approach adopted by Ofwat at the last periodic review which included financeability adjustments was appropriate. It is likely, given the scale of future capital programs that such adjustments will be required in the future.

With regard to the three suggested methods:

Revenue uplift

This approach was adopted by Ofwat at the 2005 Determination and overcame issues for Companies that had unsatisfactory financial ratio's to maintain satisfactory credit rating. The majority of the Water & Sewerage Companies and some of the Water Only Companies were given financeabilty adjustments. The extent of financeability adjustments at this Periodic Review could be interpreted that the overall cost of capital should have been set at a higher level than the 5.1% post tax figure used by Ofwat.

Mid Kent understand that the revenue uplift adjustments were not anticipated to be reversed and hence were not NPV neutral. In principal it would not be unreasonable for the overall NPV impact on customer bills, to make such adjustments NPV neutral. This could be achieved by either a reduction in the Regulatory Asset Value or by reducing revenues in a future determination by an amount that is NPV neutral However, it is likely in the foreseeable future that Companies such as Mid Kent, with a significant future capital program would not be able to achieve satisfactory financial ratios if such adjustments were made.

Accelerated depreciation

In many ways this is a financeability adjustment in a different guise. It is likely that there will be a mismatch between the depreciation charge adopted by a company and that allowed in a determination. In addition the Regulatory Asset Value of the Company will be reduced which could lead to future issues regarding the ratio of the level of net debt to regulatory capital value and future financeabilty difficulties as the level of revenue allowed at future reviews will be reduced through both a lower depreciation charge and lower return on regulatory asset value. Mid Kent take the view that accelerated depreciation is an expedient way of achieving a financeability adjustment but does not give adequate transparency.

Profiling returns on a nominal basis

This would result in a fundamental change in the method of calculation of prices for the Water Industry. There is likely to be a significant initial increase in prices although the overall net present value of future revenues is unlikely to be changed. However, as the RAV would not be indexed by RPI, it would mirror a historical cost type valuation with additions at cost. A nominal return on such a RAV is consistent with traditional borrowing but not index-linked borrowing or equity.

Mid Kent believe that if a change from the current method of indexing the RAV by RPI and applying a real rate of return to using a nominal base for returns is considered a separate detailed consultation focusing on this subject should be carried out, including an impact assessment.

Overall whatever the method adopted the objective of achieving an outcome which enables Companies to finance their borrowing requirements to meet their capital program efficiently does not alter. The alternative solutions should produce a similar outcome for price profiles. The issue then reverts back to whether a price determination is going to allow Companies to meet their financing needs and whether the balance of risk between customers and investors is appropriate.