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By e-mail

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NS/JF

Dear Emma

FINANCING NETWORKS - A DISCUSSION PAPER

Background

The Ofwat and Ofgem consultation paper is a comprehensive review of the financing issues facing regulators as they begin to prepare for the next round of price determinations. Portsmouth Water is pleased to participate in these discussions and this response has been prepared after attendance at the Water UK City Conference and Ofwat/Ofgem workshop held on 27 April 2006. This response will comment on views expressed at these events as well as the questions raised in the document. In addition, the Company has used the Oxera report produced for Water UK¹ and has sought advice from NERA.

The paper was written against the background of the Final Determination of prices for the Water Industry in 2004 after a process which was considered by most commentators to have gone well. Ofwat worked very hard to explain to investors the regulatory process and the decisions taken, and was rewarded with a positive reaction to the process and the final outcome. This is contrasted with PR99, which resulted in a flight of equity and significant restructuring of the Industry. We believe, the Industry, investors and its customers need a regulatory process that continues on the path of stability and transparency established at PR04 and does not revert back into the unsettling - and ultimately costly for customers - pendulum swings of confidence from review to review. We see this as a crucial ingredient in creating a sense of regulatory commitment.

General Comment

Given the success of the PR04 review, our overall view of Financing Networks is that the regulator, having worked so hard to restore investor confidence, should think very carefully before making too many changes to the Financing process which might create uncertainty, leading to a higher cost of capital. Regulators should resist the temptation to solve problems that are not there, and we believe that the only criticism or observation of the PR04 process by Investors was that the scale of financeability adjustment was a surprise to the Investment community. This could be addressed through greater clarity of how the financeability tests are to be applied to reduce the regulatory discretion in the process. That is not to say that regulators should not seek to minimise the size of financeability adjustments by assuming that companies are efficient in raising finance, but they should avoid fundamental changes to the regulatory regime such as setting prices consistent with ratings of BBB, or the introduction of little understood economic techniques such as the 'split cost of capital'.

¹ *Testing for Financeability: an assessment - report prepared by Oxera for Water UK*

Small Companies

The consultation paper does not specifically deal with the appropriate ratio for ensuring the financeability of small companies. Ofwat's 2004 price determination did not allow for higher financial ratios for the Water Only Companies (WOC's) in comparison to Water and Sewerage Companies (WASC's). This contrasted with Ofwat's price determination in 1999 where Ofwat tested the price determination against differential levels of financial ratio constraints for WASC's and WOC's on the basis of differential risk.

At the final determination Ofwat suggested that higher thresholds were not required because of the twin effects of allowing a small company premium and the smaller capital programmes were required relative to their size (WOC's RCV). In our view there is little logic for Ofwat, on the one hand, to allow for a higher cost of debt to reflect higher credit risks but then, on the other hand, not to allow for higher financial ratio constraints: if credit risks of small companies are higher for any assumed level of gearing, then the Company will require higher ratings to achieve any particular credit rating.

In a NERA report published in 2003, evidence was presented to suggest that financial ratio constraints faced by WOC's are higher than those faced by WASC's in order for these companies to achieve a single A credit rating and access the debt capital markets in an efficient manner. Furthermore, Moody's rating agency statements in 2004², released prior to the final determination, confirm this view:

"In assessing the credit quality of the WOC's, Moody's has generally factored in a higher level of operational risk compared with the WASC's. Because of their much smaller size, but to varying degrees depending on the specific characteristics of their operations, the WOC's may exhibit higher asset or revenue concentration risk and be generally more exposed to cost shocks, cost overruns on individual projects or other negative events that may affect a larger portion of assets, revenues or costs that would normally be the case for their larger peers. Accordingly, for a given level of leverage, Moody's would typically expect a WOC to be able to demonstrate superior coverages to a WASC in order to achieve the same rating."

We are not sure that the approach to the small company premium and financeability taken by Ofwat at PR04 for small companies was consistent. The role of financial ratios in setting prices is to act as a *consistency check* in order to ensure that the allowed rate of return (and other building block assumptions) deliver a financial profile that is acceptable to the capital markets. It is clearly appropriate to ensure that higher (credit and other) risks faced by WOC's are reflected through a higher allowed rate of return and higher financial ratio constraints. This is not double counting but, rather, it ensures that the regulatory package is fully internally consistent.

A further issue of consistency concerns the small company equity premium. Since Ofwat's allowance for a small company equity premium is due to illiquidity costs (and not explicitly higher risk), it does not represent an additional return to shareholders but compensation for higher costs. It follows that Ofwat's financial modelling should use the same post tax cost of equity for both WOC's and WASC's in order to ensure that financial ratios and financial indicators are adequate after all costs have been taken into account. The small company equity premium should then be added to the allowed rate of return after financial ratios have been confirmed to be acceptable. This way, illiquidity costs are treated in the same way as taxes, operating costs, etc.

Looking forwards to PR09, it is imperative that Ofwat recognise the need for the financial ratio constraints for the WOC's to be based on objective evidence.

Response to Specific Questions posed

- 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? 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?*

We believe that the ring fencing provisions currently in use in the Water Industry and adopted for almost all companies is a useful mechanism for protecting the interest of customers and proved very effective in the case of Enron. There is a very strong case for extending such provisions to cover all monopoly businesses, **but they should not include lock up provisions.**

² Moody's (November 2004) "UK Water Sector Stable Rating Outlook Factors Broadly Neutral Credit Impact of Draft Determinations for 2005-10: A Pragmatic Review from a Pragmatic Regulator"

Firstly there is a concern with the message this would sent to equity investors, and the potential impact on customers' bills. Any reduction in risk to customers would be at the expense of greater risk to equity investors and therefore increase the cost of capital - which would run counter to wider concerns to retain the confidence and participation of equity investors.

Furthermore, as the paper notes, where companies are highly geared, lenders have already provided such provisions within covenants. Regulators are not in the best position to determine what the appropriate lock up might be and could cause confusion if the ratios are different from loan covenants. Overall we do not believe that any benefit would outweigh the costs of this proposal.

With respect to the second part of the question, the current ring fencing provisions as they apply to most companies (including Portsmouth Water) are sufficient to allow the licensed undertaker to be fully separated from a group entity. There is no evidence that this is perceived to be a problem, and this would be an unnecessary change in regulation and could only add to uncertainty for investors.

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?*

This question is referring to the split cost of capital proposed by Dieter Helm. We have several difficulties with this approach not least of which is that most commentators have difficulties in undertaking how it would work. At the recent seminar organised by Ofwat and Ofgem, it was clear that few people fully grasped the principle (clear from the response of Dieter Helm's to points being made). Perhaps more telling, at the Water UK City Conference a representative of a major investment bank sitting on the platform, when asked a question about the principle said he did not understand the concept. We do not believe there is logic to the argument that embedded RCV carried any less risk than new expenditure. It could be argued that as the cost of replacing the asset base is much greater than is reflected in the RCV, the risk is greater than for new capital which is fully recovered. The main source of risk is regulatory risk which is not associated with any type of asset.

A case could be made for a high cost of capital for large long term projects as outlined in our response to Ofwat's consultation on the length of the price review.

Overall, however, the introduction of the split cost of capital would create a good deal of uncertainty for investors and should not be implemented in the manner suggested by Helm.

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?*

We are not aware of any evidence of a lack of commitment to the regulatory asset values, or that this is perceived to be a problem for investors.

Following Ofwat's decision to publish the RAV's for water it has become a corner stone of the valuation of companies by Investors and its principle is built into Loan documents and covenants. The publications of RAV's in water has therefore, we believe, been a key element in building Investor confidence in the water industry. As a result of this, we believe a failure to commit to or honour the current RAV principle would badly damage investor confidence and should be avoided.

Regulatory commitment to the RAV could be enhanced further, by addressing the present asymmetric treatment of capex over and underspends. Overspends are effectively capped, and underspends are automatically treated as efficiency. Hence there is limited incentive for discretionary investment - even where this is in customers' interests. This mechanism is not likely to be seen in a positive light by equity investors.

As noted earlier, we recognise that Ofwat has made considerable efforts since 1999 to regain the confidence of equity investors. Investors would appear to have a more positive view of the Water Sector, share prices are strong and as noted in paragraph 93 of Financing Networks, transactions have taken place at premiums to RAV's. However the evidence claimed in paragraph 93 could be overstated and it is important not to read too much into these developments because:

- New equity buyers have mainly been private equity or investment funds looking for secure long term high returns to match pension fund liabilities. This has not to date increased the share of equity in the market: indeed, these newcomers have further geared up balance sheets. The impending sale of Thames may reveal more information about investor incentives and confidence.
- To some extent, market premia to RAV values should be expected at the start of the periodic review cycle, because investors may place a high value on the certainty of cash flows (over the next 5 years). Conversely, at the end of the cycle when cash flows were becoming open to more uncertainty, these premia may expect to diminish, or even reverse.
- Added to this, present economic conditions - in particular historically exceptionally low interest rates - have undoubtedly buoyed investors' perceptions of prospects. If investors have seen some upside since PRO4's conclusions, there are clear risks ahead, in terms of continued exceptionally high energy costs, and the spectre of possible increases in interest rates, worldwide. Companies have also yet to demonstrate how far any outperformance of Ofwat's, in our view, demanding efficiency assumptions may be possible.

These arguments were put most succinctly by a representative of Morgan Stanley at the recent Water UK seminar.

- 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?*

Portsmouth Water already has a considerable amount of index-linked debt as I believe do most other water companies. Whilst we believe that funding decisions should be left with the companies, we recognise that the assumption of index-linked debt in the price setting process offers a potential solution to the scale of financeability payment. We would therefore accept in principle that it is reasonable for Ofwat to consider making an assumption of some index-linked debt in setting price controls, but with some caveats:

- Ofwat should avoid excessive intrusion into the financing decision of companies
- the level of index-linked debt assumed should be at the lower end of the range currently adopted by companies or should be based on a proportion of the funding for net new capital expenditure. An assumption of too high a figure may force a significant step change in finance for some companies and trigger a high demand for such debt
- Ofwat should monitor evidence on the size and depth of the current market for index-linked debt
- the cost of raising index-linked debt is at present favourable, as a result of demand from pension funds, but may not remain so. Companies may also face significant re-financing costs if they had to restructure their balance sheets significantly to include index-linked debt. Such additional transaction costs would need to be factored in by Ofwat to the cost of capital. Whether index-linked debt assumptions would turn out to be a cheaper solution to resolving financeability than the present approach would be an important consideration

- 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?*

'Financing Networks' deals with the issue of incentives for equity on the basis that equity funding of new net capex would reduce the need for financeability adjustments. There is also the potential problem in the future that if companies continue to be cash negative and this continues to be financed by debt, then the gearing level of the Industry will rise and at some point this may not be sustainable, forcing a requirement for the 'return' of equity.

The regulator should not assume in the modelling for a price determination that companies are able to raise equity, as history and evidence suggest there are significant barriers to this. Evidence was presented by Oxera at the Water UK City Conference.

Equity participation in the water sector might be encouraged by greater initiatives to outperform for the Industry.

Regulators should avoid approaches to encouraging equity which effectively assumes that different companies are allowed a different rate of return, and should certainly avoid any mechanism which might appear to be influencing finance decisions.

- 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?***

Portsmouth Water does not believe that a "more flexible approach to dividends" would be a reasonable approach to take. Investors acquire water utility stocks for the yield and a relatively dependable income stream not yield rather than growth. It is difficult to see how such a move could encourage equity participation.

- 7) ***Should regulators adopt pragmatic definitions of ratios used by the credit rating 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?***

The Company believes that Ofwat should employ a pragmatic, but consistent approach to the definitions of ratios used by the credit rating agencies. Ofwat should attempt to be consistent in testing against the ratios, but should still recognise that in certain circumstances the breach of a specific ratio could be important. For example, a company which breached three ratios by say 0.01 of a percentage point probably should not receive a financeability, whereas a breach of one ratio by say 0.2 of percentage point would be significant and worthy of financeability uplift.

If the majority of ratings were BBB, there would be significant risks for companies and their customers. There must be some doubt that the same range of low cost finance would be open to customers and whether there would be the same demand for water company debt. This may lead to an increase in the amount of credit wrapped debt which would in itself increase costs. There would be little headroom for cost shocks and there would be a considerable risk of one company falling below investment grade. In this event the impact on confidence in the sector could be serious. This would rebound on customers either in the form of prices to reflect the higher cost of debt, or in the form of stalled investment.

- 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?***

Portsmouth Water believes that the approach to financeability taken by Ofwat at the last price review was the most appropriate, a view shared by Oxera in its report for Water UK. We fear that any change may damage investor confidence and none of the alternatives mentioned provide any real improvement. On the alternative options we have the following specific views:

- *nominal cost of capital* - this would require a major change to the regulatory approach and would increase prices for customers. It creates unnecessary uncertainty and its negative impact would be out of proportion to any problems caused by financeability
- *accelerated depreciation* - we do not consider this appropriate either within or between price periods. As the Ofwat consultation notes, (para 179) the approach 'can divorce the depreciation used in setting price limits from the economic life of the assets being funded and raised questions of intergenerational equity.' Furthermore, as the Oxera report has identified, where financeability is expected to be an ongoing issue due to persistent high levels of capex, it can simply mount up for the future a worse financing problem than today. Accelerated depreciation profiles are also closely related to the use of a revenue advancement mechanism as a way to solve short term cash flow problems. Any revenue advance mechanism simply represents a loan from customers. The additional revenue should not be booked as revenue, and hence a contribution to profit. Instead, the additional inflow of funds from customers is a loan, which should be recorded as incoming cashflow and which is offset by a growing liability (the obligation to repay the loan). Such an option can only be effective if the financial markets don't notice the off-balance-sheet liability, which may be true in the short term but unlikely to be true in the long term.

- *revenue advancement* - we believe that the problems that Ofwat raise in paras 176 to 178 are potentially significant, particularly in the context of persistent high levels of capex not just for the next AMP period but beyond - in this situation, there would be significant regulatory risk around when the advance would need to be repaid

Overall, we believe the approach made by Ofwat at PR04 is the most appropriate method of dealing with financeability.

Yours sincerely

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