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Dear Emma

## **Financing Networks – response to Ofwat’s consultation**

We welcome consideration being given to this issue well in advance of the next price review. There is a considerable benefit in joint studies of this nature when considering issues which are common to regulated industries.

In general we support keeping regulation *simple*. However, the implications for customers, and for other companies in the sector, are too great for the regulator simply to set the cost of capital and leave financing issues for the markets to resolve. It is important that regulators take a view on issues of financial structure and financeability. Hence we support *smarter* regulation.

We would welcome the opportunity to be involved in further consultation before the next price review. Trends in financial markets will need to be watched closely to collect further evidence on the right approaches to adopt. Ofwat has already done much to increase confidence in financial markets.

We do not believe that all the issues can be resolved immediately, but our initial views on the questions which you have raised are set out below. However, before setting out our responses to your questions we provide a summary of our views and then discuss the whole issue of incentives for equity and the impact of higher gearing.

## Summary

### **i. Incentives for equity and the impact of gearing**

Higher gearing may impose costs on customers and on the sector, and this aspect seems to be somewhat played down in the paper. Costs of financial distress cannot be isolated to the company affected. Therefore it is appropriate for a regulator to be concerned about financial structures and to encourage equity participation, e.g. by adjusting the assumed cost of capital with gearing.

### **ii. Ring-fencing issues**

Cash lock-up provisions would discourage equity participation in the sector and increase the cost of equity.

### **iii. Split cost of capital proposal**

We agree that it is appropriate to consider how to attract equity finance, and whether this would be cheaper than debt finance with associated financeability adjustments. However, we consider that the split cost of capital proposal would not achieve its objectives, and could actually increase the cost of capital.

### **iv. Regulatory commitment**

Market behaviour indicates that there is some perception of a lack of regulatory commitment. Formalising the Regulatory Capital Value (RCV) mechanisms in the Licence, and introducing a symmetry of approach to “overspends” and “underspends”, in relation to the assumed capital programme, would help to remove this perception.

### **v. Index-linked gilts**

It is sensible to assume some index-linked debt in making financial projections, but it should not be assumed to be as freely available, and on as favourable terms, as in current market conditions.

### **vi. Raising funds from equity**

There is scope for raising funds from equity, and equity participation can be encouraged by reducing perceptions of regulatory risk. Assuming a reduction in dividends would reduce investors’ confidence in the sector and increase the cost of equity.

### **vii. The approach to financial ratios**

Ensuring that there is confidence in the regulatory framework is the best way of influencing the financial ratios expected by the market, rather than attempting to take a different view from the market.

### **viii. NPV-neutrality of financeability adjustments**

In view of the continuing large capital programme, we do not think that making financeability adjustments NPV-neutral is a practical proposition.

## **Incentives for equity and the impact of gearing**

As noted in your consultation, this joint Ofgem / Ofwat work on financing networks originated from DTI and HM Treasury expressing concern about increasing gearing, and suggesting that new ideas should be sought for encouraging equity to remain in the water sector. We consider that these issues are a significant area of concern and are not fully dealt with in the paper. The appropriate conditions for companies to undertake rights issues, and the treatment of different capital structures will need further consideration over the period leading up to the price review, and are likely to need changes to regulatory mechanisms.

As noted in your paper, high gearing has not yet caused any companies to be in financial distress, or restricted ability to raise additional finance. This has, however, been a relatively benign period, with low inflation and low real interest rates, and easy access to debt markets. The effects of high gearing will not be fully tested until there are unfavourable economic conditions.

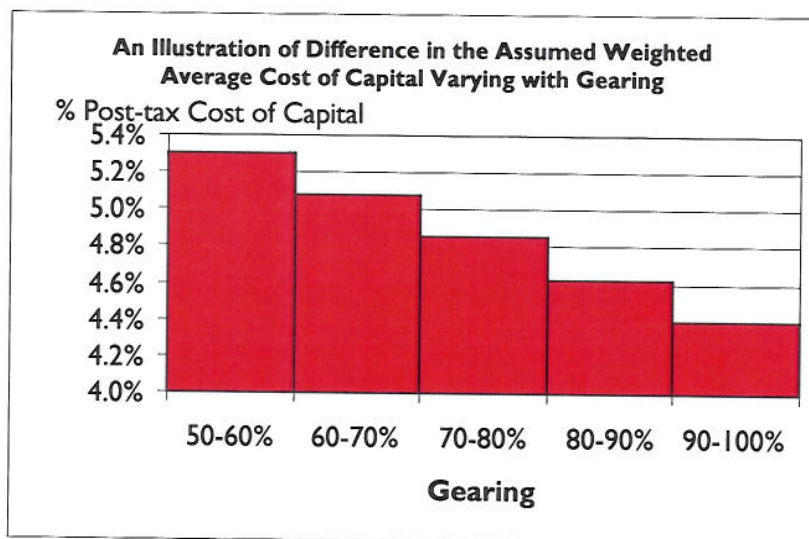
Our modelling shows that under unfavourable economic conditions, similar to those which have been experienced in the last twenty years, a highly-g geared company would have financial ratios well below those needed for investment grade status. In such unfavourable conditions, access to debt markets becomes more difficult, and raising additional finance or refinancing would be problematic. At the end of current debt terms, highly-g geared companies may not be able to refinance existing debt at the favourable rates obtained when they geared up.

However well-constructed the arrangements for special administration are, it would be impossible to avoid financial difficulties having an impact on customers. The distraction of management focus can be expected to have an impact on service, and there would be an impact on financing costs for the company and for the sector. If financial distress from economic conditions were combined with a drought, with restrictions on use having an effect on income, there could be a major impact on the financial viability of the industry. Debt providers could be expected to take all possible actions, including potentially legal action against a regulator, to ensure that they did not incur losses. For this reason, it is not appropriate for a regulator to be concerned only with setting the cost of capital, and leave the market to determine the capital structure of a company / companies.

Financial distress among one or more companies is likely to have an effect on the terms on which the whole sector can raise finance, which would result in higher bills for customers. There is, therefore, a strong case for encouraging maintenance of a significant proportion of equity in the sector. Encouraging equity to remain in the sector is discussed further in answering the specific questions raised, but one issue which needs to be considered is whether the cost of capital should vary with levels of gearing.

We recognise that basing tax on company-specific gearing has some impact in this direction, but it would be possible to go further, for example by making the post-tax cost of capital dependent upon gearing. There is already a regulatory precedent for varying the cost of capital with structure, in the small-company premium. In both cases, the variation in cost of capital encourages a particular industry structure to be preserved. We consider, however, that there is a much stronger case for varying the cost of capital with gearing than there is for a small-company premium, where the evidence for higher financing costs is not clear-cut.

If the range for the cost of capital were similar to that between small and large companies, then an illustrative spread of cost of capital with gearing is shown below. We recognise that in a competitive market the cost of capital does not diminish continuously with gearing in this way, since higher returns required by equity, and the potential costs of financial distress, offset the lower cost of debt relative to equity. However, in a regulated sector, higher gearing can transfer risk to customers, as discussed above. Therefore there is a strong case for varying the assumed cost of capital with gearing as illustrated in the chart below.



Higher gearing may impose costs on customers and on the sector. Costs of financial distress cannot be isolated to the company affected. Therefore it is appropriate for a regulator to be concerned about financial structures and to encourage equity participation.

### **Ring-fencing issues**

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?*

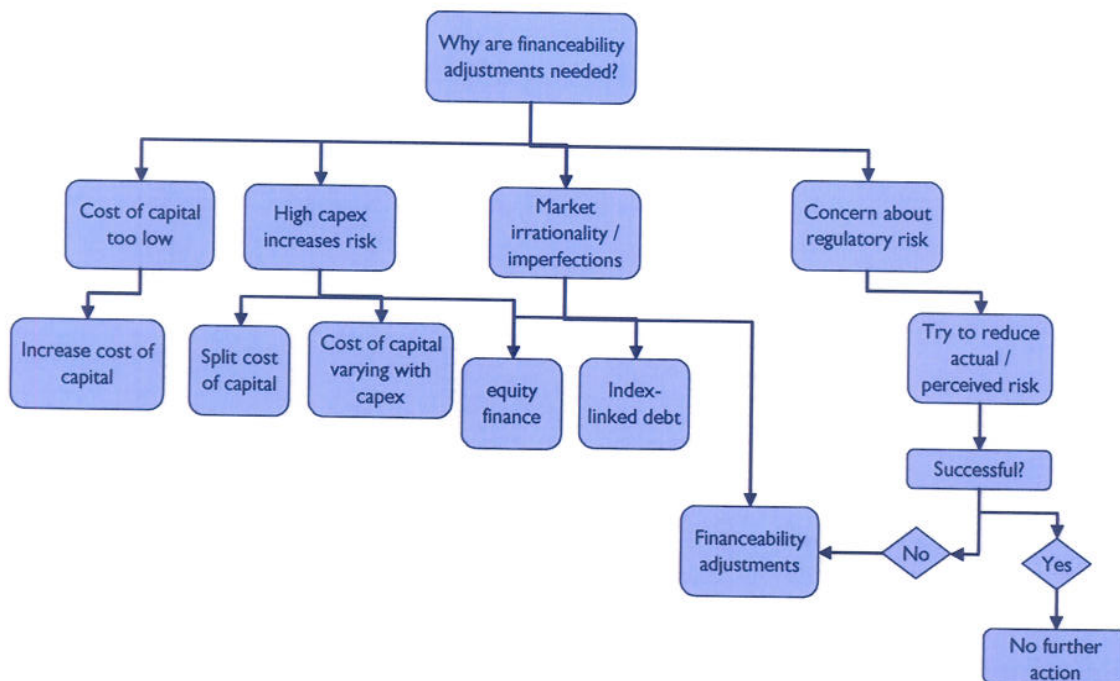
*Are the current ring fencing provisions sufficient to allow the activities of the licensed undertaker to be fully separated from other group entities?  
If not, what additional ring fencing provisions might be appropriate and what might be the costs and benefits of these?*

We recognise the need for ring-fencing arrangements, and accept the case for current licence provisions to be extended to all companies. However, we are not convinced that these arrangements need to be extended. The current provisions have worked effectively where a parent company has got into difficulties, as, for example, in the case of Enron ownership of Wessex Water. Cash lock-up provisions would not affect highly-g geared companies, which already have such provisions in place. They could, however, send the wrong message to equity investors, in terms of the level of regulatory control on returns to shareholders, at a time when it is desirable to increase, or at least maintain, equity participation in the sector.

Cash lock-up provisions would discourage equity participation in the sector and increase the cost of equity.

### Financing issues

In reviewing financing issues, it is useful to list the potential reasons for financeability adjustments being necessary. The appropriate way to address financeability issues is likely to vary with the reasons for the adjustments. These reasons, and how they affect the appropriate options to consider, are set out in the flow chart below.



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?*

The proposals as discussed in the paper do not appear to achieve their desired objective, in that if expenditure receives the lower return when completed, investors would not receive, overall, an equity return on the investment. It would be possible to devise an arrangement which did achieve the objective, but we consider that there may be issues in principle against such an arrangement:

- The case for the split cost of capital proposal is made on the assumption that companies with larger enhancement programmes are exposed to greater risk. This is not matched by water industry experience to date – larger programmes have given companies the opportunity for more outperformance. The greatest risks have been in terms of having to incur expenditure that was not planned as part of the Periodic Review process – examples are additional spending following the 1995 drought; Thames’ mains replacement expenditure to control leakage in AMP3; and, in the current AMP period, rising electricity prices.
- It is true that a single large project probably has considerable risk e.g. the West Coast Main Line. There is generally more scope for things to go wrong on a large project than to come in under forecast. However, that has not been the nature of the water industry programme to date, and it is, in general, unlikely to be the case in the future. The capital programme consists of relatively small, diverse projects. Where parts of a business can be clearly separated, and there is a different level of risk, there is a case for a separate cost of capital. This might apply to the Thames Tideway project, a new reservoir, or the construction of a national grid. It does not apply, however, to water programmes in general.
- The proposal includes the suggestion that there should be a return on operating costs to reflect risk, but it is not obvious how such a return would be set, and this adds a further level of complexity to the process.
- With a uniform cost of capital, the return on the existing capital base is protected because the overall cost of capital has to be set sufficiently high for companies to be able to raise additional finance. With a split cost of capital, the return on the existing base would not have to match investor expectations, providing the marginal cost of capital was sufficiently high.
  - This would not be in the interests of existing investors.
  - It would not be in the general interest either, as “new” capital eventually becomes “existing” capital. The long-term return on an investment would be more uncertain, because the cost of capital on existing assets would be less certain. This would be likely to raise the marginal cost of capital on new borrowing, because investors would want to get a quick return. It would be possible to attempt to overcome

this by linking the cost of capital to market indicators, but such a mechanistic approach may not be desirable.

- As noted in the consultation paper, the proposals would lead to increased gearing, since the enhancement programme in progress is only a small part of the capital base, so appear likely to increase financeability issues rather than reduce them. It is also not clear what the mechanism is for replacing debt with equity once a project is completed.

The arguments above suggest that risk may not really be higher with a larger enhancement programme. However, the market requirement for financeability adjustments shows that the market may require a higher return with higher capex. Therefore, even if the actual risk is not really higher, this is the perception of the market, which regulators, of course, need to recognise. However, if perception does not match reality, it may be possible to influence the market, and perceptions may change. Ensuring the regulatory regime is clear, reliable and predictable, and development of a longer-term framework, will contribute to changing perceptions.

In these circumstances, it is better to have a flexible approach, to match the market conditions of the time, than to change the regulatory price-setting process. Therefore financeability adjustments are a better approach than the split cost of capital proposal, which would be unlikely to achieve its objective of reducing the cost of capital.

We agree that it is appropriate to consider how to attract equity finance, and whether this would be cheaper than debt finance with financeability adjustments. However, we consider that the split cost of capital proposal would not achieve its objectives, and would be likely to increase the cost of capital.

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?*

There are a number of specific areas where there is evidence of a lack of regulatory commitment:

- For the purposes of RCV calculation, the assessment of overspends at a service rather than company level was applied retrospectively, as it was not signalled in advance before being applied at the 1999 determination.
- The current methodology provides for the company to retain the benefit of capex underspends for six years, with the underspend then being deducted from the regulatory asset value (RAV). However, no adjustment is made to the RAV for overspends. The failure to get any return on investment, even when clearly required and efficiently implemented, as with expenditure

after the 1995 drought, presents a significant risk. We consider that a symmetrical approach to underspends and overspends would remove a significant and unjustified risk. A company having to bear the cost of overspends for five years would be a sufficient deterrent to prevent any unwarranted expenditure.

- The “glide-path”, converging returns to the cost of capital over ten years, was set in 1994 but eliminated at the price review in 1999. This change may well have been justified, but it did represent a lack of commitment to equity returns which had previously been set.
- The “roller coaster” of capex, with dips around the time of price reviews, partly results from companies being unwilling to commit to investment until the determination has been made. This may indicate that companies do not have full confidence in appropriate capex programmes and returns being set. A longer-term framework for water industry planning would help to address this; this is discussed further in our response to the consultation on the period for setting price limits. As discussed in our response, we feel that developing such a long-term framework is more important than reviewing the period for which prices are set.

The market requirement for financeability adjustments suggests there is a market perception of regulatory risk. The Investor Survey in 2003 showed regulatory risk as the biggest risk, with 60% of respondents thinking that regulatory risk, defined as the risk of adverse regulatory decisions, is high or very high. It would be desirable to attempt to remove these perceptions.

We do not support the idea raised in the paper of increasing regulatory commitment by fixing the cost of capital and depreciation over the life of an asset being financed. This has some of the disadvantages of the split cost of capital proposal. It could, however, be appropriate for some large projects.

We do, however, support developments which would show stronger commitment to maintaining adequate returns. Regulators have considerable discretion, because methodologies are not generally enshrined in law or in the Licence. One possible approach would be to incorporate RAVs, and the mechanisms for their adjustment, into the Licence. This could include the process for adjustment from determination to actual spend, indexation, and the adjustments for capital maintenance charges.

Market behaviour indicates that there is some perception of lack of regulatory commitment. Formalising the RAV mechanisms in the Licence, and introducing a symmetry of approach to overspends and underspends, would help to remove this perception.

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 would be reasonable in principle to assume that a proportion of debt is index-linked. We do not consider it appropriate to consider companies' specific ability to raise finance, as Ofwat should not need to support inefficient structures. On present terms, index-linked debt would not be more expensive, but it usually has been higher-cost. It would be sensible, to assume some limitations on the size of the market for index-linked debt, as there is a small potential pool of issuers, and not to assume that terms will remain as favourable as those presently available.

It also needs to be borne in mind that index-linked debt does not improve all ratios, and that rating agencies will not necessarily recognise the benefits of index-linked debt in interest cover ratios. Before using an assumption about index-linked debt in the assessment of financeability there would need to be clarity that the Rating Agencies would reflect this within their rating assessment.

If raising index-linked debt does remove concerns about financeability, then this is evidence of imperfections in the market, in that index-linked debt does not really remove any risk. The same net cash flows could be achieved by borrowing on nominal terms and increasing borrowing each year, to cover the difference between real and nominal interest rates. All index-linked debt does is eliminate the need for additional borrowing. If there are real underlying concerns about risk or the regulatory regime, ultimately assuming some debt is index-linked will not remove the problem.

<p>It is sensible to assume some index-linked debt in making financial projections, but it should not be assumed to be as freely available, and on as favourable terms, as in current market conditions.</p>
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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 experience of Northumbrian Water shows that it is possible for a company to return to the market to raise equity, after equity has not been available for some time.

If equity is to be raised, then care must be taken to avoid any actions which cause concern about future returns. For this reason, we have reservations about the suggestion in Question 6 below, raising the possibility of reduced dividends, with higher growth.

It is clearly appropriate to consider whether raising money from equity is cheaper than debt finance with financeability adjustments. There is evidence from the United Utilities rights issue of the terms on which additional equity can be raised. Analysis of the issue suggested that it required an overall uplift of the cost of capital of 0.3% to 1.2% (0.7% to 2.7% increase in cost of equity); on this basis, it is possible that a rights issue would be cheaper than raising debt, if financeability adjustments are required as a result of increasing debt.

As discussed in our response to Question 3, we consider that reducing perceptions of regulatory risk would assist in raising equity. Mechanisms to increase certainty should include commitment to outputs for longer than the five-year period. There should also be a symmetrical approach to capex underspends and overspends, bringing water regulation into line with the approach generally adopted to utility regulation. This would remove an issue which could be a significant deterrent to attracting new equity into the industry.

Perceptions of regulatory risk will also be by ensuring that there are no conflicts between quality regulators' expectations and output assumptions in price-setting, and that there are clear mechanisms for dealing with changes in required outputs. Ensuring the legitimacy of the overall regime, in terms of providing a reasonable balance between stakeholders, and ensuring that the improvement programme reflects consumers' willingness to pay, will also reinforce confidence in the framework.

There is scope for raising funds from equity, and equity participation can be encouraged by reducing perceptions of regulatory risk.
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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?*

For the reasons set out in the response to Question 7, we feel that any assumption involving reduced dividends would risk increasing uncertainty among equity investors. There was a strong adverse reaction to the reduction in dividends by South West Water following the 1999 price review. Water shares are seen as a reliable source of income, and reduced dividends would remove this reliability, and so increase the cost of equity.

Assuming a reduction in dividends would reduce investors' confidence in the sector and increase the cost of equity.

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?*

We agree that it is the overall level and trend of ratios which is important. However, attempting to take a different view of ratios from that of the rating agencies would be perceived as a very risky approach. Rating agencies do not have a mechanistic approach based on financial ratios, but take a view on the company and the sector, including the regulatory framework. Therefore it is important that there is confidence in a clear and predictable framework.

A "pragmatic approach" would indicate a lack of clarity, which would increase uncertainty in the markets, and ultimately increase the cost of capital. If a regulator feels that the market requires stronger ratios than are necessary for a sound financial position, it should attempt to influence the market view, rather than taking a different view.

Only making financeability adjustments if projections showed a company dropping below investment grade status would be a risky approach. If the majority of companies had BBB ratings, then this would increase to some extent the cost of borrowing. In addition, most importantly, it would leave very little room for cost shocks, such as rising electricity prices or higher interest rates, without companies falling below investment grade status.

Ensuring that there is confidence in the regulatory framework is the best way of influencing the financial ratios expected by the market, rather than attempting to take a different view from the market.

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?*

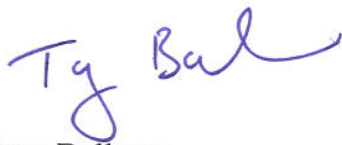
In principle there is a case for making any financeability adjustments PV-neutral. However, it is likely that there will be a continuing large capital programme in the water industry, with further financeability adjustments. This means that when prices can eventually be set to recover the adjustments, the payments back will be large. The lower returns that would then be earned might undermine

confidence of financial markets. Therefore PV-neutrality might not be a practical proposition.

In relation to the suggestion of profiling returns on a nominal basis, this would require a significant one-off increase in prices when the change was made, which we do not think would be desirable. Reprofiting depreciation would not improve all the financial ratios which are used to assess financeability, but would be a better option than profiling returns on a nominal basis.

In view of the continuing large capital programme, we do not think that making financeability adjustments NPV-neutral is a practical proposition.

Yours sincerely

A handwritten signature in blue ink that reads "Tony Ballance". The signature is written in a cursive style with a large 'T' and 'B'.

Dr Tony Ballance  
Director of Regulation and Competition