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Dear Emma

Financing Networks: A discussion paper

With the anticipated continuing levels of capital investment we foresee that financeability will remain an important area for the PR09 price review and beyond. This view appears to be supported by the Ofwat water industry forward look 2010-2030 and is the view from the Oxera report into financeability. Therefore we believe that this discussion paper is timely and we welcome the opportunity to respond to it.

We have worked closely with Water UK in their detailed response. We do expand on a number of company specific issues below and highlight what we believe to be the key points from the Water UK response.

General comments

- *Downside assessment at periodic reviews.*

Ofwat has previously made central assumptions only and tested these against threshold ratios. However, Ofwat does not appear to carry out reasonable downside scenario sensitivity tests as the Rating Agencies do, when making its Determinations.

- *Financial ratios*

At PR04 the same level of financial ratios were used for Water Only Companies (WoCs) and Water & Sewerage Companies (WaSCs) in the assessment of financeability. This was a departure from previous approaches where higher ratio levels were assumed for WoCs. This lack of differentiation between WaSCs and WoCs is not consistent with the views of the Rating Agencies who 'for a given level of leverage would typically expect a WoC to be able to demonstrate superior coverages to a WaSC in order to achieve the same rating.'¹

¹ Moody's Industry Outlook: UK Water Sector, November 2004.

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- *WoC small company premium.*

At PR04 SEW provided considerable substantiation in relation to the need for a small company premium on the cost of capital based on the differing risk profile and the higher financing costs for WoCs. Ofwat recognised this issue in their underlying price determinations. However the uplifts for financeability were substantially higher for WaSCs and consequently the relative value of the small company premium allowances were eroded.

We are concerned that some of the proposals in the Ofwat/Ofgem document e.g. the Helm proposals on a split cost of capital may undermine Ofwat's approach to date regarding the small company premium on the cost of capital.

SEW specific issues

- *The impact of 'accelerated depreciation' on adjusted interest cover ratios*

The credit rating agencies use regulatory depreciation as a measure of the level of 'non-discretionary' capex required to maintain the regulated asset base at a constant value (in real terms) over the regulatory period.²

This concept has been translated into the adjusted interest cover financial ratio used by rating agencies and is contained explicitly within SEW's bond covenants.

$$\text{Adjusted interest cover} = \frac{\text{net cash from operations} - \text{regulatory depreciation}}{\text{senior debt interest paid}}$$

Consequently the proposal to accelerate depreciation would not give any improvement in this ratio in order to provide increased revenue for financeability of future capex programmes.

At PR04 SEW put considerable effort into substantiating its level of regulatory depreciation following the application of broad equivalence adjustments at PR99. We believe that reasonable regulatory certainty and transparency regarding the approach to depreciation has only relatively recently been achieved in the price setting process. This has given the sector, both companies and investors, greater confidence in the sustainable financing of capital maintenance. We do not believe that depreciation should be used as a tool to address financeability as this could interfere with its primary purpose of sustaining the asset base. SEW believes that divorcing the depreciation used in setting price limits from the economic life of the assets being funded will significantly reduce the transparency around the process.

² Moody's Special Comment: UK Water Sector, Key Ratios Used by Moody's in Assessing Companies' Credit Strength, March 2006.

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Specific discussion responses

This section responds to the specific discussion points raised in the Ofwat/Ofgem document.

- *Key issue for discussion (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?*

SEW already has ring fencing provisions in its Licence and considers that it is appropriate that this is applied consistently across water companies. However we do not believe that the Licence is the correct mechanism for applying cash lock-up provisions. The Ofwat/Ofgem paper already recognises that, where companies are highly geared, the market has already taken steps to introduce such provisions voluntarily within covenants.

Such amendments to the Licence could be perceived as a negative message for equity investors at a time when equity investment is to be encouraged.

- *Key issue for discussion (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?*

Dieter Helm's proposals have been a welcome input to the debate on incentives in investment. It is not clear however that the proposals to separate past and future capex and splitting the cost of capital will add to incentives for investment. There is little evidence that there has been a problem with capital investment in the water industry. The proposals are highly dependent on regulatory commitment which, although moving in the right direction, does not currently have a sufficient track record for such a radical change. In fact the incentives surrounding capital investment is currently constrained and asymmetric as a result of overspend capping within the RCV mechanism. It is possible that the Helm proposals, which are intended to reduce the overall cost of capital, will in fact have the opposite effect on equity investment.

We are not convinced with the Helm proposal that investment on existing assets is any less risky than new assets. Technology in the water industry has changed relatively little in recent periods. The significant capital value discount in the water companies also makes this proposal less clear in its impact on incentivising replacement of existing assets. The costs of replacing existing assets are a significant proportion of companies' investment programme and constitute a sizeable risk.

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Practically we can see difficulties in the implementation of this proposal relating to the definition of what is new capex, particularly where it relates to existing assets. A practical issue is how to determine changes in risk profiles as new assets become existing assets, over time.

It seems that the increased regulatory complexity of this proposal could outweigh the benefits of increased transparency to investors that is intended.

- *Key issue for discussion (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?*

The improvement in transparency at PR04 from previous reviews was welcomed by SEW and indeed by all key stakeholders. In particular the early statement by Ofwat relating to a floor for the cost of capital, and the 'comfortable' investment grade assumption have improved confidence in equity investors. However none of these assumptions are explicitly built into the price review process leaving uncertainty as to commitment in future review processes. The small company premium was an example at the PR04 review where it was uncertain whether a premium on the cost of capital would be recognised. The need for different financial ratios between WaSCs and WoCs was recognised at PR99 but not at PR04.

One other area is clarity and transparency around the RCV. SEW entered into lengthy correspondence with Ofwat during the 2004 Price Review in an effort to resolve discrepancies between RCVs published in RD letters and the RCV subsequently being used in financial modelling. We are aware that this was also an area of confusion within the financial sector during the PR04 process.

- *Key issue for consideration (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?*

We recognise that holding a proportion of Index Linked (IL) debt is a reasonable strategy for companies to pursue. However we believe Ofwat should continue to monitor the market carefully and exercise caution before making assumptions relating to this form of debt when setting prices. The costs associated with raising this debt are relatively high and there remains uncertainty regarding the capacity in the market for IL debt. It should also be noted that companies with swap related IL debt, under FRS 25 & 26, are vulnerable to large swings in financing costs due to the sensitivity of the fair value of the interest swap to RPI indexation. This is likely to be a consideration for companies taking out this type of financial instrument.

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It should be noted that while IL debt may improve earnings and interest cover ratios it does not improve gearing and debt coverage ratios. We are aware that at least one of the rating agencies does not recognise the benefits of IL debt in their analysis of the interest cover ratios, substituting in its place conventional debt. Before Ofwat includes any element of IL debt in the price determination it would need to be clear that the rating agencies would properly reflect this within their ratings.

- *Key Issue for discussion (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?*

Our response is similar to that in (3) above. Longer-term regulatory commitment within a long term transparent framework is seen as the area which would improve the appetite for equity injections. This is particularly applicable not just to the base cost of capital but also the small company premium.

- *Key Issue for discussion (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?*

This proposal appears to be counter-intuitive to encouraging equity investment and would be a regressive step from the current regime. It is difficult to precisely understand what is meant by 'flexible' however it can be assumed that this means lower dividends in the short term, possibly coupled with an expectation of higher dividends at a later date. The attraction of water company and infrastructure investment in general is the steady yield characteristics of these assets, with limited focus on growth potential.

Ofwat's water industry forward look showed continuing high levels of capex for the next two regulatory periods and only then a minor tailing off of expenditure. This profile would appear to indicate that significant 'flexibility' would be required, making the impact of this proposal more significant than in a lower expenditure environment.

- *Key Issue for discussion (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?*

From our perspective it is vital that Ofwat's view of financeability and 'comfortable' investment grade is aligned with that of the rating agencies. Any change in regulatory assumptions which could lead to a lowering of credit ratings would be of significant concern to SEW. Ofwat is aware of the difference in risk profile perceived by the rating agencies and investment community between WoCs and WaSCs in this area.

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- *Key Issue for discussion (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?*

SEW does not consider that there is sufficient evidence on the proposed approaches to suggest with confidence any alternative approach to that at PR04. The market for IL debt issues can be monitored further and there may be benefit in reviewing the financeability ratios with rating agencies.

SEW concurs with the conclusion of the Oxera report that revenue uplift was the best of the available options.

As mentioned previously we have concerns over the proposal for accelerated depreciation and do not believe that the primary purpose of sustaining the asset base should be modified as a 'workaround' to address financeability.

Moving to a nominal WACC would be a significant change to the regulatory regime and would be a departure from the majority of UK regulated industries (only telecoms has adopted a nominal approach). Oxera highlights that the resultant one-off increases to customers' bills would be significant and would exceed those of the financeability uplifts to date.

We trust that our comments help to inform the appropriate framework for financeability at PR09 and beyond, that will ensure investors remain willing to provide capital to enable SEW and the rest of the industry to deliver the continuing high investment programme. This would appear to require a continued balanced approach to setting prices avoiding unnecessary intervention in, or "second guessing" of the capital markets, which in turn could result in an undesirable shift of risk between different stakeholders, increase uncertainty and ultimately place upward pressure on the cost of finance.

We note the careful selection of words that this is a "discussion paper" and not a consultation, having been driven by the recommendations of the HMT and DTI report. Whilst it is timely and important to be "discussing" these issues, we look forward to participating in an equally timely consultation process in order that conclusions can be appropriately drawn in good time to inform the PR09 process and avoid any unnecessary uncertainty or ambiguity in that process.

Yours sincerely,

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