

SOUTH WEST WATER LIMITED – FINANCING NETWORKS RESPONSE

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Dear Emma

FINANCING NETWORKS

I am pleased to attach South West Water's response to the Financing Networks consultation paper. Please give me a call if you have any queries concerning the points made.

Yours sincerely

Keith
Keith Richards
Head of Regulation

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?***

- Investor confidence in water stocks is in part due to the way in which Ofwat has selectively applied appropriate ring fencing conditions to each company, based on company specific factors including ownership and gearing. Evidence to date shows that existing arrangements work well and are adequate. Any universal extension of ring fencing, including cash lock-in provisions for conventionally geared companies, may be expected to contribute to a rise in the cost of equity with no measurable benefit to customers.
- Existing regulatory accounting guidelines have been effective in ensuring that licensed activities are separated from other Group entities. To completely exclude the licensed undertaker from involvement in non-regulated activities that are complimentary to the core business would create inefficiency and (at the margin) higher charges to customers.

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 approach would introduce an unwelcome additional complexity to water regulation. It may be appropriate to allocate risk in this way for very large capital projects; but with a few exceptions, most water companies now have a larger number of small investment projects to implement; programmes of work, with maintenance taking an ever-increasing share of the total capex. With integrated investment programmes, the potentially superficial allocation of risk between replacing existing assets and adding new assets, usually at the same physical site, is unlikely to provide meaningful information for investors.
- When considering this approach for large projects, there is an interesting parallel in the PFI business where PFI's are often refinanced after construction - the initial equity investors capitalise the enhanced returns for accepting risk during the construction phase and the project is then subsequently funded at a lower rate of return by debt providers. However, it is important to note from this model that the capital value financed at a lower cost is "grossed up" from the project capital expenditure ie it is not possible to refinance the equity with lower cost debt without recognising a capital uplift at the point of refinancing. Applying this approach to a RAV based utility would imply that while a lower rate of return might apply to the existing RAV, the notional value of capex would need to be uplifted to provide an appropriate equity return post construction.

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

- There is no current evidence of a lack of commitment, following the restoration of investor confidence in the lead-up to PR04 through increased transparency and signalling of the price setting methodologies, including the application of financeability adjustments. Ofwat must take a similar approach for PR09, with additional steps to improve the long-term planning horizon for future investment and price setting.

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 investor portfolios? Would it be more expensive?***

- Whilst acknowledging that Ofwat should not totally dismiss the propensity that companies may have to raise a proportion of new debt in the index linked market, considerable care should be applied in modelling the resultant impact on key financial ratios. Whereas index-linked bonds include an accreting principal, other forms of index linked exposure, such as index linked leases and derivative arrangements require inflation to be paid away each year and would not therefore improve the cash interest cover ratios used by rating agencies. We also understand that at least one of the major rating agencies does not currently recognise the cash ratio effect of index linked borrowing.
- The use of index linked debt at levels at much above 15% of RCV may cause potentially significant volatility of profit before tax which would affect equity investor perception.

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 role of Ofwat should be to set an allowed cost of capital based on optimal gearing assumptions. It must then be up to companies, as part of an efficient financing incentive, to judge the degree of equity retention or new equity injection, as determined by market conditions.

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?***

- Nothing is more damaging to investor confidence than a dividend cut or deferment, however well signalled or explained. The attraction of water stocks is their yield characteristics. However relatively certain the regulatory environment, investors would not be easily assuaged by the 'promise' of future growth.

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?***

- A degree of pragmatism is necessary, as there are clear differences between rating agencies in how their assessments are derived. However, Ofwat should as far as possible apply a consistent set of rules in assessing the financeability of each company, so that the process is broadly transparent.

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?***

- A revenue uplift to satisfy key financial ratios, as applied by Ofwat at PR04, has the advantage of simplicity in application, and thus avoids further adjustment to the components of the price setting methodology. The issue of PV neutrality can only be addressed if reversal is seen as a realistic prospect in the following price-setting period; not a likely proposition for water companies, given the expected environmental improvement programme to be financed over the next fifteen years.
- Accelerated depreciation as a means of providing additional revenue should be avoided, as this would weaken the price-setting methodology by imposing a disconnect between the true economic life of a company's assets and their amortisation.
- Any switch to profiling returns on a nominal basis would require a dramatic once-off price adjustment that is unlikely to ever be acceptable to customers.
