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Dear Emma

Thank you for the opportunity of commenting on the joint discussion paper produced by Ofwat and Ofgem on the Financing of Networks. It is encouraging that a paper covering so many key issues that will need to be addressed for PR09 has been prepared early in the process. It is also timely to start considering these issues alongside the consultations on the length of the price review and the sustainable development duty. It is recognised that consistency of approach between the two regulators is desirable wherever possible, subject to some element of sector-specific consideration to take into account the nature of the different drivers.

The specific questions raised are considered below.

**Question1, 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?*

We believe the existing ring-fencing in water has proven to be a useful mechanism for protecting customers, as evidenced by the Enron/Wessex Water situation, and these standard provisions feature throughout the industry.

In the light of the proven success of the existing measures in precisely the type of situation they were designed to cover, it would appear unnecessary and possibly damaging to extend them. Further confidence is given by the covenant arrangements that are agreed by the highly-g geared companies as part of structured finance arrangements.

It is stated in the paper that Ofgem has introduced these lock-up provisions to be triggered when a company reaches the lowest level consistent with investment grade; the ongoing investment levels in water point to the need for efficient companies to be above that minimum level, to ensure continued access to the significant funding that is likely to be required into the foreseeable future. This again points away from the need for such lock-up arrangements in water and, indeed, their imposition could give confusing messages.

**Question 1, Part 2:**

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

Continued ....

We believe the ring-fencing provisions, which have been strengthened over time, are sufficient.

**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?*

The proposal raises some interesting issues but represents a significant increase in complexity over the existing approach, without any certainty that it can achieve its fundamental aim of increasing incentives for equity investment whilst also reducing risk and the overall cost of capital. The overall determinant of the cost of capital is business/regulatory/political risk and if this remains the same the mixture of debt and equity will not alter risk. Overall, the proposal envisages an increase in debt finance but if overall risk remains the same, higher equity returns will be expected on the lower portion of equity finance. The Helm proposal suggests additional long-term regulatory commitments such as periodic reviews focussing on opex, setting capex in a long-term framework, indexing returns on RCVs to market outcomes, etc; these ideas are valid suggestions, in terms of risk reduction in their own right, but do not require separation of assets.

The establishment of the transition from a new asset to an existing asset and, therefore, the change in its risk profile would make the system more complex. There is no real evidence that the enhanced return on new investment is necessary to stimulate investment. Constraints on the volume and pattern of investment that have occurred are arguably more significantly driven by other factors.

The proposal overall raises a number of interesting issues, particularly in terms of risk reduction, and these appear more central to the overall aim than the split cost of capital.

**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 best be rectified?*

In water, Regulatory Capital Values based on assumptions underlying price limits are published every year. The assumptions used in price limits are updated for changes in inflation annually. The methodology is now well understood, is used by the investment community as a proxy for the market value of the regulated business and has become an important part of our bond covenants.

RCV appears in the regulatory accounts but only as a note which follows the published numbers and the primary capital value used for the accounts continues to be MEA.

The annual publication and recent consistency of approach does give some certainty but, in the past, some indexation changes have caused confusion in tracking values through, particularly from the PR99 review.

One element that also gives a certain lack of clarity is that changes to RCVs relating to outperformance and logging-down are only agreed at the five-year reviews. There is no ongoing mechanism through annual return to agree material changes on ongoing items as they occur.

In terms of a lack of commitment to equity, there has been a trend to higher gearing which could be seen as a flight from equity or more reflects the tax efficient financing that debt currently offers. There is still evidence that equity investors are interested in water acquisitions. The trends need careful observation throughout the period.

**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 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?*

A simple answer would be that the level and mix of debt used in the regulatory funding model should be either that of the specific company or a level appropriate for a representative notional company. In that companies are raising index linked debt it would seem appropriate that a representative notional geared company will include an assumption of index linked debt.

This is however an interesting question because it fails to test the relationship between an appropriate mix of debt when setting price controls with the fact that funding for the cost of capital (a building block within the revenue requirement) is on a real basis. Taking PR04 as an example, there is clearly a cash flows mismatch between the 4.2% real funding in the revenue requirement and the assumption that debt is issued at a fixed cost of 6.7% (4.2% real plus 2.5% RPI). A real rate of return on an inflated RCV does create an ability to match these cash flows over a long time period but this does little to alleviate the immediate problem of receiving less from customers than is being paid out in interest on debt.

This leads to a conclusion that the funding mechanism is driving the industry's appetite for index-linked debt as companies attempt to match short term (i.e. 5 years regulatory period) cash funding for interest with cash interest paid on debt. I.e. cash received from a real return on RCV is equal to cash paid on index linked debt.

It could be that this cash imbalance has in the past been funded from raising additional debt, but as gearing has increased, and associated lower credit ratings have developed, there is more emphasis on matching cash flows within specific building blocks of the revenue requirement.

Access is available to all companies in the form of direct market issues of debt, special purpose vehicles operated by banks, or derivatives. Demand may however be greater from higher geared companies as they may need to put a greater emphasis on matching cash flows.

Index linked debt is an effective inflation hedge but is subject to RCV risk. As index linked debt increases by inflation then an appropriate increase in RCV is required to support the carrying value of the debt, whereas fixed rate debt creates future debt headroom against an inflated RCV. Consequently, a 100% index linked funded company that overspends on capex, or is subject to an RCV log down, could rapidly find itself in financial difficulty.

Demand for corporate index linked debt (or equivalent) is strong at present, but this is unlikely to be a reasonable basis on which to predict the future. Spreads of index linked debt continue to be higher than those of fixed or floating rate debt, and if supply increases at a greater rate than demand then prices will increase.

**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 foundation of the approach to the last price reviews has been to use notional gearing for setting prices. The theory has been to set an overall cost of capital and apply it to notional structures so that the additional investment required could come from debt or equity. There was a recognition at PR09 that debt at present was significantly cheaper, but relying wholly

on debt would lead companies to a potentially brittle structure. There appears to be no good reason to depart from this concept; although only United Utilities has raised fresh equity through rights issues, Northumbrian Water achieved a full listing and all the private equity deals have had an equity component.

An approach which allows for the tax implications of an increased proportion of equity in companies' balance sheets does not fit easily with an overall notional approach or the current tax treatment of the highly-g geared companies.

The situation needs monitoring throughout this current period but there is a danger in a hybrid approach which loses its logic. If the mixed approach of some debt and some equity is to be preserved, the price setting formula must be established carefully to incentivise the access to both.

**Question 6:**

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

A more flexible approach by Ofwat in modelling dividends infers that assumed dividend levels would be lower but progressive based on the expectation of future growth. This does not tie in with the objective of encouraging future equity participation, as the nature of the water and sewerage sector is based on yield characteristics with dependable income and limited growth.

**Question 7:**

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

It is important that Ofwat employ a consistent approach to the definition of ratios used by the credit rating agencies. Ofwat did take into account the overall level and trend of ratios and this is important but specific ratios and their levels may be important in different circumstances. MIS has consistently emphasised the importance of the adjusted interest cover ratio as the single most important factor being the ability to service debt payments, assuming all capital expenditure is funded by accounting charges. This concept appears difficult to argue with.

Moving the majority of the ratings to BBB would be a significant risk for companies and their customers, in the light of the continued need to access funds for investment programmes that show no signs of dropping off.

Headroom for cost shocks would start to disappear and the impact of one company falling below investment grade would rebound across the sector.

**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?*

a) Revenue Uplift

The required revenue uplift is the most identifiable and simple of the options to understand. Ideally, it should be PV neutral because it is essentially a timing issue not caused by the cost of capital being wrong. It is very important to ensure it is retained in the business and does not form part of any dividend. The difficulty outlined in the discussion paper of paying this sum

back with the prospect of persistent high levels of capex in this AMP period and beyond is acknowledged. Various options for future treatment of this uplift need to be explored before the next review.

b) Accelerated Depreciation

We believe accelerated depreciation has the potential to distort the cost between generations as it divorces the depreciation used in price setting from the economic life of the assets. Depreciation does not seem to be the logical tool for addressing financeability and has a greater potential to lose the clarity of the situation than the revenue uplift.

c) Nominal Cost of Capital

Subject to the issues raised in answer to Question 4, this would lead to a front-loading of returns and large initial increases in bills. The very significant downward effects that this would have on ratios later in the period is not seen as a sustainable way ahead.

If you have any queries on the points raised above, please do not hesitate to contact me.

Yours sincerely

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Corporate Strategy Director