Ms E Cochrane
Head of Corporate Finance
Ofwat
7 Hill Street
Centre City Tower
Birmingham

Regulation

Your ref
Our ref
Name Jerry Cresswell
Phone 0118 373 8253
Fax 0118 373 8976
E-Mail jerry.cresswell@thameswater.co.uk

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THAMES WATER'S RESPONSE TO THE JOINT OFWAT/OFGEM DISCUSSION PAPER ON FINANCING NETWORKS

Dear Emma

Please find attached Thames Water's response to your joint discussion paper with Ofgem on 'Financing Networks'. I apologise for the delay in submitting it and hope it is not too late for you to consider the points we have made. As you know, we have been focusing on other matters recently and this meant that the Regulation Committee was not able to finally approve it.

Your paper covered some important aspects of the regime and we welcome the opportunity, ahead of consultation on PR09, to add our views to the debate.

Our response is in two parts. The first part is an open response and includes an introduction, principles underlying our response and a short summary of our response. The second part is confidential and contains our detailed response to the key issues for discussion identified in the discussion paper.

We believe there are some fundamentals which should be made explicit and form the basis of policy decisions. At the core of these are that

- customers will be best served by an industry which can plan and finance its activities within a long term sustainable framework and that

- decisions about how finance should be raised should be with the companies and the capital markets: the regulator should not assume that financing constraints can be eased by equity injections at below the full market cost or by reduced dividends.

These conditions will only be present if there is regulatory commitment to encouraging investment. This is an issue for the sector as a whole and it is of particular concern to Thames where, as you know, we face the prospect of a more substantial capital programme, possibly including major long term projects.

Thames Water Utilities Ltd

Clearwater Court
Vastern Road
Reading RG1 8DB

T 0118 373 8253
F 0118 373 8976
I www.thames-water.com

Registered in England and Wales
No. 2366661 Registered office
14 Cavendish Place, London W1G 9NU

We see the financeability debate in terms of financial sustainability, a key requirements for the water industry. Regulatory commitment to sustainable financing will become more important than ever, as we face the challenges of climate change and the water framework directive.

In our view, it will in due course be necessary for you to consider together the individual matters on which you have been and will be consulting and seeking views. Presumably, any conclusions on financeability will form part of an integrated and internally consistent package of changes to the regime and Ofwat will consult companies on the package in the course of preparation for the Periodic Review in 2009.

We would welcome an opportunity to discuss the issues raised in the paper and our response with your team. On a related topic we will of course continue to engage Ofwat on the specific issue of large projects.

We have sent a copy of our response to Ofgem.

Yours sincerely

Jerry Cresswell

Jerry Cresswell
Head of Regulation

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FINANCING NETWORKS DISCUSSION PAPER
TWUL RESPONSE – INTRODUCTION, PRINCIPLES AND SUMMARY

1. INTRODUCTION

1.1. We welcome the opportunity to respond to the joint Ofwat/Ofgem discussion paper on financing networks dated February 2006.

1.2. Our response has been informed by discussions with equity investors, lenders, commentators and credit rating agencies in order to gain a wider understanding of the views of key stakeholders in the sector. Our views as set out in this response have been informed by those discussions.

1.3. Some the points we make may apply to a greater or lesser extent to the energy sector but we make them in the context of the water industry.

1.4. It is important to note that this response reflects the views of Thames Water Utilities Limited and it should not be taken in any way to reflect the views of our ultimate parent company, RWE AG.

2. PRINCIPLES UNDERLYING OUR RESPONSE

2.1. The discussion paper covers a range of issues that are of fundamental importance to the success of the water sector. In summary the paper asks three main questions.

- Should regulators be concerned about increasing gearing in the sectors they regulate?
- Are there sufficient incentives for investment in regulated industries?
- If issues of financeability continue, how should they be dealt with?

2.2. We have made detailed responses to these questions but we believe that they imply a set of broader considerations to do with the development of the regime as a whole. These are of two kinds. The first has to do with the regime and what it was designed to do. The following may be statements with which few would argue but they are no less important for that and we need to be clearer about what they entail for how the regulatory regime works in detail. They are as follows.

- If the sector is to continue to be attractive to investors, Ofwat must continue to focus on its statutory duties to ensure that companies are able to meet their licence commitments and finance their functions. In our view, this requires Ofwat to do all it can to limit regulatory risk.
- If a broad range of investment sources is to be available to the companies, this will require long term regulatory commitment to match the long term nature of investment in the sector. This implies consistency of treatment that goes beyond the individual periods to which a set of price limits applies.
- The focus on investment is central to the objectives and conduct of the regulatory regime and the consequent ability of the sector to meet a wide range of economic, environmental and social objectives, reference to which is now explicit in the WSRA's statutory duties. This focus and the reasons for it

should be made transparent to stakeholders as well as investors so that the former understand the key role of the latter in meeting multiple objectives.

- Decisions on how to finance investment should remain with the companies.
- Ring fencing arrangements provide protection for the customers of the regulated businesses and subject to this protection not being weakened, decisions about capital structure, sources of capital and dividend policy should be left to the management of companies. This implies that assumptions about company financing made by Ofwat for the purposes of setting prices should be sufficiently general to avoid them being regarded as prescriptive and potentially leading to capital market distortions.

2.3. The second group contains points that may be more controversial about the trade offs that the regime has to acknowledge. The need to limit regulatory risk by maintaining commitment and the need to maintain and enhance the power of incentives for investment and improved performance, imply that the WSRA should

- ensure that the regime develops in a direction that makes it less intrusive, leaving decisions about inputs and how outputs are to be achieved to the companies
- acknowledge that, other things being equal, stronger incentives will mean that prices will be higher in the short term.

2.4. Taken together, these sets of considerations imply that the water regulation regime should change direction by moving closer to the price cap, economic incentive model of regulation and reverse the recent development of a more intrusive, rate of return type of regulation that saps incentives for investment and performance improvement.

2.5. A joint discussion paper on financing networks is informative and appropriate and we believe that other topics, for example regulation and sustainable development, would benefit from a joint approach. We look forward to the regulators promoting more instances of joined up regulation in their approaches to issues that span the sectors.

2.6. Presumably, the joint Ofwat/Ofgem discussion will lead to further consultations by the individual regulators and that in Ofwat's case this will be associated with the methodology for PR09. We recognise that there are differences between the sectors that might warrant differences in approach but, given the maturity of the two regimes, we would expect that differences in approach in future will be justified explicitly by reference to differences in relevant circumstances or regulatory objectives or both.

3. SUMMARY

3.1. This section summarises our response to the issues raised in the paper. Our detailed response to each of the key issues for discussion is in Annex 1 which is Company Confidential.

Issue (1) - Ring fencing

3.2. We concur with the theme of the paper that regulators should not be concerned by levels of gearing in the sectors. In water, the ring fencing arrangements coupled with company-specific debt covenants have provided protection for the regulated business and its customers. The existing safeguards have proved effective and we do not believe that there is a need to move to a more restrictive position. There is no need to introduce any cash lock up provision.

Issue (2) - Separation of past and future investment

3.3. We are not aware of any analysis or evidence that establishes the specific problems which Helm or Mayer are seeking to address or that looks at the costs, benefits and practicalities of implementing their proposals. We do not support implementation of these or other suggestions without the benefit of such analysis.

Issue (3) and Issue (5) - Incentives to invest and regulatory commitment

3.4. Ofwat has been successful in recent years in reducing regulatory risk. Any further reduction will be of considerable value to customers and we believe that the continuing need for new capital places a premium on the scope for doing more in this regard.

3.5. We support the idea, suggested by Helm, of alternative funding mechanisms to address the issues associated with major long-term capital projects that have different risk profiles to the existing business. We intend to commission a study to assess the implications of such projects for the regulatory regime.

3.6. Ofwat should ensure that companies can access a broad range of efficient investment sources and provide long term certainty and incentives for investment. We have set out in our detailed response a series of measures that Ofwat should consider would strengthen its commitment to the RCV and improve the incentives to invest.

Issue (4) - Index linked debt

3.7. We accept that, under its existing approach to financial structures when setting price limits, Ofwat might wish to make an assumption about ILD. We would be concerned, however, that any assumption made by Ofwat would in effect become a prescription especially since Ofwat's other assumptions about financing have become increasingly hypothetical for many companies. Consequently, we believe that certain safeguards, outlined in our detailed response, should apply.

Issue (6) – Dividends and financeability

3.8. Ofwat should not prescribe how a company should be financed and should avoid making modelling assumptions for dividends that could unsettle the capital markets. Management should be free to determine its own policy to ensure the most efficient mix of debt and equity funding (including retentions) for its own circumstances. Ofwat should not assume that the financeability gap could be closed by equity injection.

Issue (7) – Ratio definitions

3.9. It is essential that Ofwat continues to reflect the broad consensus of the ratings agencies in determining which ratios to apply in its financeability tests and the level at which the hurdles are set. It would not be appropriate for the regulator to substitute its own set of indicators.

Issue (8) – Financeability adjustments

3.10. The application of the regulatory regime leads to a timing difference between returns earned and payments made to lenders. This is exacerbated by rising levels of gearing and by increasing capital investment in the sector. The fundamental source of the difference is not known precisely and may be a combination of Ofwat's assessment of the cost of capital being too low and conventions in the capital markets that lead investors to require expected returns that are higher than would apply in an efficient market.

3.11. The balance of opinion appears to be that investors and the rating agencies pay less attention to future cash flows, presumably as a result of perceived regulatory risk. In our view, this is not conclusive but in any event, it is important to acknowledge that there will be a continuing need for financeability adjustments for the foreseeable future and that the adjustments must be must be NPV positive. The arguments supporting the latter are in paragraph 8.6 et seq of our detailed response.

3.12. The companies should not be put in a position of managing this mismatch, which is a by-product of the regime, by Ofwat assuming recourse to inefficient or unsustainable sources of finance either of debt or equity or by assuming artificial changes in their dividend policies. This suggests that uplifts are the appropriate response. We believe that Ofwat should consider recognizing uplifts as a legitimate component of the allowed rate of return in addition to looking at the approaches referred to in issue for discussion (8). As well as dealing with the financeability issue, it would also act as an indicator of regulatory commitment not to misappropriate future returns.

3.13. On a pragmatic level Ofwat should continue to test for financeability using a basket of ratios consistent with the market to ensure that companies can access efficient sources of debt. Under this approach, price limits should be set such that 'comfortable' investment grade ratios can be met, rather than 'minimum' requirements. In establishing financeability tests it is reasonable for Ofwat to make assumptions about the level of gearing[1] but it should be careful not to act in ways which effectively prescribe financing decisions. This would risk driving up the cost of capital.

3.14. Subject to paragraph 3.12, we believe that targeted NPV positive uplifts will be the most appropriate approach for the water sector in the foreseeable future, given the scale of expected investment and the need to retain investor confidence. NPV neutral approaches may become acceptable but only when financeability becomes a lesser consideration. We would not support adopting a nominal WACC without a sophisticated cost-benefit analysis

[1] ILD is more controversial and is covered in 3.7 above.