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Dear

FINANCING NETWORKS – A DISCUSSION PAPER

Three Valleys welcomes the joint Ofwat/Ofgem discussion paper on financing networks because incentives to invest in the sector must be retained if we are to maintain and improve services for our customers. The paper is a useful spur to improve the price setting methodology in time for the next water price review.

Three Valleys operates with a lower than average ratio of debt to equity and to some extent shares the concerns highlighted in the DTI/HM Treasury paper *'The Drivers and Public Consequences of Increased Gearing'*. It believes there is a continuing role for equity finance in the industry, particularly because this is more closely aligned to incentive based regulation which has proved to work well in generating benefits for customers. For these reasons Three Valleys advocates improvements to the current price setting methodologies to support equity finance, rather than some of the wider reforms suggested, such as split cost of capital or adjustment to depreciation lives.

If the approach to financeability is to be changed at the next water price review, the proposals need to be sufficiently well-formed that they can be consulted on in the price review framework and methodology papers, which we anticipate would be published in the autumn of 2007.

Financeability Adjustments in the Water Sector at PR04

At the last price review, Ofwat set price limits that included about £400m of revenue adjustments considered necessary to allow each company's regulatory balance sheet to meet regulatory financeability criteria. In practice this means that each company's allowed rate of return is different.

The main drawbacks with the PR04 approach were:

- The same regulatory financial ratios were used for water-only companies as for water and sewerage companies, contrary to the good market evidence from ratings agencies that supports the use of tighter ratios for WoCs

- Financeability adjustments and the small company premium have become confused and indistinct because the financeability tests were carried out after addition of the small company premium to allowed revenues. It is important to preserve distinctiveness because financeability adjustments intend that the regulatory balance sheet is consistent with 'investment grade', to attract investor interest, whereas the small company premium rewards the additional transactions costs and risks of investment in 'investment grade' small companies.

- The approach to modelling dividends was changed from the 1999 price review. Whilst assuming a cost of equity of 8%, Ofwat's cash modelling assumed dividends of only 6%, with 2% growth, so deferred the receipt of cash returns to equity investors beyond the price review period.

- The overall tightness of the determination brings little prospect of meaningful equity creation through retained earnings.

- There was insufficient weight given to the financial ratios important to equity investors as compared to debt investors

- It introduced further complexity to the price setting process

- It was counter-intuitive – owing to PR04 financeability adjustments, some large water and sewerage companies which enjoy greater access to capital markets, have higher allowed returns than smaller companies with more limited access to finance

Split Cost of Capital

Although the thinking behind the split cost of capital is to improve incentives through adjusting the risk and reward mechanism, on balance we do not support it. As we understand it, the split cost of capital suffers the following drawbacks:

- Adds to the dis-incentive to equity finance as equity risk capital becomes necessary for only operations and asset delivery

- Requires higher up front returns for new investment to compensate investors for lower allowed returns in subsequent periods, so may not reduce the long term allowed cost of capital

- Increases the complexity of regulation

- Would seem to require long term regulatory commitment to the rate of return that will be earned on existing assets

Given these disadvantages we recommend that the split cost of capital idea is not pursued for PR09

Adjusting Depreciation

We do not support the idea of bringing forwards allowed depreciation to support cash flows for financeability purposes.

Adjusting depreciation would weaken the cost reflective link between water prices and the economic costs of wear and tear of water assets and creates a discontinuity with accounting approaches. There are also difficulties with intergenerational fairness as the technique would force today's customers to pay not only for the assets they are consuming today, but also the costs of assets that will be consumed in future periods.

Summary

The financeability approach used at PR04 suffers from drawbacks, which would need to be resolved before PR09, if a similar approach is to be used, in particular:

- Solve price limits using tighter ratios for WoCs, in line with capital market evidence

- Add the small company premium for WoCs after financeability adjustments to preserve the distinctiveness of the small company premium

- Improve the incentives towards participation of equity finance in the industry

There are significant disadvantages to the split cost of capital approach and to adjusting allowed depreciation to accommodate financeability concerns and we recommend that these approaches are ruled out for PR09.

Yours sincerely,

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Economist