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22 May 2006

Mr P Fletcher CBE  
Chairman and Acting Chief Executive  
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Dear Philip

Thank you for providing the opportunity to comment on your consultation on Financing Networks. We have followed the structure of your paper for our responses.

**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?*

In response to the first part of this question, we believe that the financial ring fencing arrangements should apply to all monopoly businesses irrespective of the direct or ultimate ownership of the business.

The financial ring fencing arrangements require higher standards of discipline to operate within the regulated business than would otherwise be acceptable. This is particularly relevant to corporate governance measures and the actions of the board the directors.

The financial ring fencing arrangements also provide certain constraints in the activity and freedom of management and investors. These constraints do protect the assets and balance sheet of a regulatory business and include not only the restrictions on the use of assets but also the use of off-balance sheet commitments.

We believe that the financial ring fencing arrangements which have applied to some, but not all, of the companies in the water industry should be applicable to all companies, since the provision are all focused to regulatory asset protection and therefore customer protection.
In response to the second part of the question, we believe that the financial ring fence arrangements should not include cash lock up provisions. We believe that the financial ring fencing arrangements provide sufficient protection to the regulator and to customers. We believe that the market, through normal treasury arrangements, can adequately provide these protections either in similar form or surrogate form, for example in protection measures such as “net debt to RAV” covenants. Debt investors require these protections as the norm in even the most basic third party debt arrangement. Even in the few highly leveraged structures that have been created in the last six years, these protections have been incorporated in the overall creditor protection package and over this period these arrangements have proved robust. 

*How might the introduction of cash lock-up provisions affect existing financial structures including holding company debt?*

Were Ofwat minded to introduce these cash lock up provisions in the licence, then its effect on existing debt structures will be dependant on the strength of cash lock up provision being introduced relative to the covenants incorporated in existing financial structures.

Where the cash lock up provisions being proposed by the regulator are weaker than the covenant of existing financial structures then the introduction of these provisions are unlikely to have any effect and therefore be unnecessary regulation. Where the cash lock up provisions being proposed by regulator are stronger than the covenant of existing financial structures then again it is unlikely to affect existing debt arrangements at the operating company level but could certainly have detrimental implications for holding company debt facilities, which rely on the cash flows from the operating business to service the arrangement. This is likely to lead to an increase the cost of financing for these businesses.

*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?*

The current ring fencing provisions, in our opinion, are sufficient to allow the activities of the licensed undertaker to be fully separated from other group entities. Only in a “stressed” situation can this notion be proved. The financial distress of Enron provides an example of how the regulated business of Wessex Water was protected during the collapse of its parent company.

*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?*

We find it difficult to see how the separation of past and future capex will improve incentives for investment or lower the overall risk of regulated business in the short term. The approach should be thoroughly researched with focussed consultation and transitional arrangements and new regulatory methodologies developed.
Having said that, we can see merit in the principles of splitting the cost of capital and the RAV between past and future investment, in order to improve the transparency of the scale of allowed return for the respective elements, potentially reduce the overall cost of financing the RAV and therefore potentially to reduce customers bills.

We certainly would support further industry analysis in this area to explore whether these potential benefits could be realised.

**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?

During the PR04 process, Ofwat rectified a number of issues with respect to regulatory commitment to the RAV and equity funding that were apparent during the PR99 process. In particular the measures that Ofwat took in PR04 were:

1. to increase the allowed equity return from the low level allowed in PR99;
2. to provide considerable clarity to the calculation in the determination of the RAV from the brought forward position from the last review to the evolution of the value to the end of the determined price limit period.

The RAV has become a very important element of the economic regulation. To minimise regulatory uncertainty and risk, the regulator needs to be fully committed to the existence of RAV and the allowed regulatory return companies are able to earn on the RAV.

**Key issue for consideration (4) to (8).**
As an introduction to our response to the next 5 “key issues for consideration” we would like to state as a principle that we are opposed to the regulator relying on a market based mechanism (such as expecting companies to inject new equity into their business or enter into treasury arrangements where a proportion of debt is index linked) to solve what is fundamentally a regulatory problem.

The problem of financeability, in our opinion, arises due to a combination of three factors, the first two factors create the circumstance where the third factor then triggers the financeability issue. These 3 factors are:

1. The real rate of return regulation provides a cash return on investment to companies from customers that is in real terms as opposed to nominal terms;
2. The debt instruments issued by water companies are, more often than not, serviced in nominal fixed terms or nominal floating terms rather than index linked terms.
3. The large enhancement capex programmes facing mainly the water and sewerage companies which leads to rapid growth in the RAV. This growth in the RAV requires debt and/or equity funding. Unless shareholders tolerate a lower dividend yield in order to create equity formation in order to maintain a similar gearing (vs RAV) level (relative to a regulated business that has linked growth in the RAV and limited requirement for equity formation) an additional allowed return will be necessary.

In our opinion, the combination of the first two factors creates an inherent vulnerability in the economic regulatory system of water companies where cash can quite easily be constrained. An arbitrary reduction in the allowed level of depreciation could equally give rise to a problem with financeability.
Since Ofwat, in their methodology to model and test for financeability, ignore the current gearing of companies and adopt a "notional gearing" which is consistent with the gearing assumed in the allowed cost of capital, we believe that the level of actual gearing of a company is not a direct trigger for the financeability problem. We therefore disagree with analysis that suggests that the financeability problem is only apparent amongst the higher geared companies.

**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 are strongly opposed to the suggestion that regulators should assume that a proportion of a company's debt is index-linked when setting price controls. It is very dangerous for the regulator to assume that all companies can access index linked debt either directly from the capital/debt markets or indirectly through the swap market. Real obstacles exist which makes it difficult, if not impossible, for companies to hold index linked debt. These obstacles are:-

i) for companies that have to report, or for companies that are part of a group which needs to report, their financial statements in accordance with IFRS accounting rules, then the existence of most types of index linked instruments provides the potential for extreme and volatile movements in the profit and loss account and reserves;
ii) for companies where the board of directors have deliberately considered and decided to adopt a treasury policy which does not include index linked debt, then altering that policy may not be easily accomplished.

An additional key weakness to this solution is that there is no guarantee to the availability of index linked products in the future, or the existence of counterparties or investors in the future who are willing to transact in the index linked market on terms commensurate with Ofwat's assumptions.

**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?

We do not believe that the existing regulatory regime denies the facilitation of equity injections. It is the level of allowed equity return within the allowed cost of capital which is critical in determining investor appetite to participate in an equity injection as well as a stable and predictable regulatory regime.

**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?
On the face of it, it would seem reasonable for regulators to be more flexible in their approach to modelling dividends as a method for stabilising gearing. However, this then may generate some odd and bizarre results. For example, if a company had to deliver a large enhancement capex programme then this “flexibility in modelling dividends to stabilise gearing” may lead to the company distributing no dividend just so that equity is formed. Paying equity holders a below normal dividend in circumstances where a company is delivering a large enhancement capex programme would be counter intuitive since this company would at the time of delivering the capex programme be facing high business risks and more business risks than a company with a small capex programme to deliver. During this period shareholders are unlikely to be prepared to accept a lower cash return.

We therefore feel that the regulator’s approach to modelling dividends should primarily allow the equity holder to receive an appropriate level of cash return commensurate to the risks borne by the shareholders.

**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?

We believe that the regulator should continue to adopt a package of ratios to test for financeability.

It is important that the regulator continues to apply consistency with:

i. the credit worthiness assumed in the allowed cost of capital and
ii. the credit worthiness assumed to create the benchmark credit ratios to test for financeability.

This consistency is also relevant for water only companies where the allowed cost of capital includes a small company premium. Ofwat, in PR04 created an inconsistency in this area by applying the same benchmark credit ratios, which were consistent with the allowed base cost of capital excluding the small company premium, to those companies that were awarded the small company premium. We urge Ofwat to restore the consistency in approach to small companies which existed earlier at PR99.

**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?

Of the regulatory solutions available we are strongly opposed to an NPV neutral solution since this would require either:

- regulatory manipulation of depreciation in order to achieve acceleration of depreciation or
- a measure whereby the appointed business held as a “loan” the financeability payments which at some point in the future the business would have to refund to customers.

Both these solutions would create large uncertainty and regulatory risk.
We see two key weaknesses to accelerated depreciation:

1. This solution may not be a sustainable solution. Ultimately this solution relies on monetising the RAV in order to finance new investment. The reason why we believe this solution is unsustainable is that this would deny future financing of maintenance expenditure through allowed depreciation only because it had previously been applied earlier to enhancement capex. This could then potentially cause its own financeability problem.

2. This solution may create an impairment problem and an impairment charge in the profit and loss account and reserves. This could be applicable to companies whose net assets were close to the value of RAV less net debt. The impairment issue might then arise if allowed depreciation was increased to such a level that the allowed depreciation was greater than the sum of the historic cost depreciation plus the indexation on the RAV. Impairment of the company’s net assets could then have profound implication on the company’s ability to raise debt and service dividends.

A key weakness to the suggestion that a financeability uplift could be treated as a loan from customers to the appointed business is that there can be no certainty that the company could repay this debt to customers. Whilst the large scale enhancement capex programmes are still being predicted into the future and there is no visible down turn predicted, the solution of a loan would provide enormous uncertainty to creditors who find it hard to understand the repayment term of this debt.

Of the three proposed solutions, we support the first proposal being the revenue uplift. This reasons for supporting this solution are:-

- Simple and achieves the desired outcome
- It provides a fair solution to customers since this revenue uplift would only apply to those companies that required it as a result of triggering the financeability ratios.

We hope these comments are useful to your deliberations and we look forward to receiving your further views on this important topic.

Yours sincerely

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