WATER UK Response to OFWAT and OFGEM's Consultation on 'Financing Networks'

General comments

Water UK welcomes this consultation which we believe covers the key issues in financing water and sewerage networks that will need to be addressed for PR09.

These issues have important implications for all our stakeholders, not only investors, but ultimately for our customers and for the environment. A sustainable and stable financing framework is crucial to ensure investors remain willing to provide capital so that companies can deliver the investment that is essential to maintain and improve service and the quality of our environment.

The challenge is now more acute as companies – who have already delivered over £50bn investment in the last 15 years and seen levels of debt rise from very little to around 60% now, with several companies above 75% - face the prospect of continued high levels of investment for the foreseeable future.

The HMT/DTI report[1]– which prompted your consultation - highlighted issues around higher gearing. In particular that higher gearing may lead to an increased risk of multiple business failures, companies may cut back on investment to avoid financial distress and debt financing may lead to a lower risk/incentive regime with consequent implications for lower rates of efficiency improvement.

Higher gearing and continued high levels of investment are also likely to continue to put pressure on the balance sheets of companies, and the yardsticks by which investors judge their financial resilience. At the last price review Ofwat made financeability adjustments of £430m over and above the cost of capital, to ensure access to capital markets. This amounted to about 1% of additional revenue, paid for by customers. However, were companies to issue new equity instead of raising further debt to finance investment, the financeability issue could be resolved.

[1] 'The Drivers and Public Consequences of Increased Gearing: a Report by the Department of Trade and Industry and HM Treasury, DTI, October 2004'

These issues – the risks associated with higher gearing, and financeability - have rightly put the focus on considering whether regulators need proactively to encourage the retention of or indeed, increase the participation of, equity in the sector, and if so how. Several commentators have pointed to a lack of regulatory commitment over the longer term as a root cause of barriers to higher equity formation in the sector.

Financial diversity
Water UK believes that, whilst present levels of gearing are not of concern (as you conclude in sections 2 and 3) it would be wrong to be complacent: a universal trend to very high levels of gearing, particularly were market conditions to become less favourable than present (eg interest rates to rise significantly from their presently very low rates historically), could challenge these conclusions. Furthermore, the financeability gap is likely to continue to grow in the face of continued high investment. Hence, we continue to support the conclusions of the John Smith report[2], and implicit in the HMT/DTI report, that financial diversity – and an element of equity financing in the industry- currently remains a desirable objective. (Your questions 2, 3, 5 and 6 are relevant in this context).

The role of regulators in financing decisions
Nonetheless, going forward, Ofwat will need to be careful how it interprets increases in simple gearing ratios: it is clear that today, there is a blurring between 'debt' and 'equity' and rather, a spectrum of instruments.

Fundamentally, Water UK believes that it remains important for regulators to resist excessive intervention in financing decisions – and to retain as a core principle, that financial structure is primarily a matter for companies. Excessive intervention could stifle innovation and efficiency in financing decisions.

The importance of evidence-based regulation that respects the realities of the capital markets
We were also concerned with some views put forward (possibly in a cavalier spirit of devil's advocate) at your recent workshop on Financing Investment, that regulators should not perhaps be too concerned about potential credit downgradings, financial failure or special administration procedures having to be invoked.

Special administration procedures are clearly a backstop, but whilst they may be considered robust, if called upon there would undoubtedly be serious

[2] 'Structure of the Water Industry in England: does it remain fit for purpose?' John Smith and Duncan Hannan (November 2003)

consequences for public and investor confidence in the industry and its regulators. Likewise, credit downgradings are likely to result in a higher cost of debt.

All these damaging effects would be borne ultimately by customers (or even the taxpayer in extremis) as investors' perceptions of regulatory risk would sharply rise, and the cost of finance would rise. The effects might be seen either in higher bills, or lower investment. Ofwat will need to continue to exhibit its carefully balanced approach to setting price limits at PR09 and address questions about gearing and financeability based on sound evidence and analysis– not, as Philip Fletcher put it at your seminar, as a game of 'dare' with the capital markets.

Your consultation does, however, ask a reasonable question as to whether regulators can adopt 'pragmatic' interpretations of financial ratios for the purposes of a financeability test. If this means, in effect, 'differently' from how capital markets interpret them, then we believe this would be pointless - and somewhat rash. Regulators need to adopt realistic financial ratios: ie the ones to which investors pay heed.

Nonetheless, it is clearly important for regulators to keep talking to investors, and to credit ratings agencies, to ensure confidence in the transparency and stability of the regulatory regime, and to ensure regulators fully understand the perceptions and constraints of the markets. If this leads to the development of alternative financial ratio tests that are consistent with companies accessing the credit markets - and agreed and accepted by the markets - then this might be worthwhile. It will be interesting to see the response you get from investors to your consultation on these points.

Financeability and consistency between regulators

The nature of the financeability test carried out be regulators – and the remedy - are clearly open to many permutations. Regulators have adopted a variety of approaches. We believe that whilst consistency between regulators is an important principle, sectoral differences also mean that one size does not always fit all. We think therefore that regulators do need to think more consistently about these issues, but also to demonstrate where they have taken a different approach to explain the sector specific circumstances that make that relevant.

For instance, in the water sector, the persistently high levels of capex since 1989 and expected into the future have meant financeability has become a more widespread and significant issue than, say, in electricity distribution. Furthermore, this factor, and the fact that depreciation is already relatively high in the water sector (compared with electricity), means that the option of accelerating depreciation to address financeability has minimal scope in water, as pointed out in the OXERA report. We think Ofgem needs to consider carefully whether persisting with this approach is sustainable in the long term, given that it raises questions about intergenerational equity between customers, and may also simply put off till tomorrow the financing problems being faced today.

Financeability and the sustainability of Ofwat's approach
The OXERA report concludes that the approach adopted by Ofwat for PR04 was appropriate and that 'no other approach would have been unambiguously better'. We agree however, with the consultants' further conclusion that looking forward to PR09 it is important to review this, particularly in light of possible developments in the capital markets.

For instance, it may be that perceived constraints on raising new equity, access to and the size of the index linked debt market, or investor perceptions of risk may shift, enabling some changes in approach. The OXERA report concludes that Ofwat should monitor and analyse these developments. Water UK's own Investor Survey may provide one vehicle for collecting evidence, and we look forward to co-operating with Ofwat's future work in this area.

The importance of transparency and stability in Ofwat's approach
After three price reviews it is clear that investors now have a good understanding of the current regulatory process and appear to have confidence in it – as indicated strongly at the recent Ofwat/Ofgem workshop. However, at PR04 a key exception noted by investors was the lack of transparency in the financeability adjustments. Investors and customers need to understand what is being done and why. We trust that Ofwat's monitoring of developments in markets and the explanation of its approach at PR09 will be significantly more transparent than at PR04.

Ofwat needs to be careful to avoid a complicated process or to change its approach for the sake of it, where that might risk denting the present confidence that has taken considerable effort by Ofwat and the industry to build up over the last few years. It is not many years since there was widespread concern about a lack of investor confidence in the sector and consensus that this reflected a perception of high regulatory and political risk. The industry and its customers need a regulatory process that continues on the path of stability and transparency established at PR04 and does not revert back into the unsettling – and ultimately costly for customers - pendulum swings of confidence from review to review. We see this as a crucial ingredient in creating a sense of regulatory commitment.

The split cost of capital

We believe it is important that your consultation lays to rest the, in our view, over-promoted and under-evaluated concept of the split cost of capital. This is presented as a panacea to retaining and raising new equity, reducing risk and the cost of capital and resolving the financeability issue.

Before commenting on this, we do appreciate the focus the debate has brought to thinking about risk and how it is allocated in the industry. We do also see merit in the idea of differentiating the cost of capital for significant stand-alone activities with different risk and, we would argue, entirely relevant for discrete large new schemes with considerable construction, demand and technology risk (see our response to your consultation on the 5 year period).

However, the split cost of capital is not about this- it is applied to the generality of a water company’s business and as such has serious flaws. These are that:

- it leads to higher average gearing, and a small sliver of equity
- it can only reduce risk if it is accompanied by increased regulatory
- commitment (this need not be dependent on having a split cost of capital)
- if new investment, on going into the RAB, then receives a lower return, investors will make up for this by demanding a higher return upfront, so any cost of capital gain is illusory
- the concept flies in the face of simpler regulation: as testament to this, despite having been outlined at length in numerous papers and at numerous conferences (including most recently your own Financing Networks workshop), Q and A at these occasions indicate that investors and other stakeholders remain confused by what is actually being suggested.

Given these serious doubts we recommend this idea is not pursued further and that Ofwat concentrates on real options for adapting the regime that will make a significant difference to promoting a sustainable industry. We also think that it is useful to continue to explore and to gain a greater understanding of risk in the industry.

The level of capex

As widely recognised, and noted in the discussion above, high levels of investment are likely to remain in water in the foreseeable future. There is however a fundamental question about the appropriate level of investment in the future, and uncertainties remain about the full impact of new EU directives on the water sector. Whilst this is not a question for this consultation, it is important not to lose sight of the fact that it is both the level of investment – and the degree of regulatory risk around that – and not only how it is financed, that will impact on customers bills. Furthermore, we believe that the impact on financeability should be a consideration in assessing the appropriate phasing of future investment.

Next steps

Water UK welcomes that the consultation is very open at this stage and that there will be further opportunities for Ofwat to develop its approach in discussion and possibly joint research with stakeholders. Water UK stands ready to participate as appropriate. Nonetheless, we urge Ofwat to pin down some key features of the approach as early as possible to avoid unnecessary uncertainty and impact on investor confidence in the run up to PR09.

The annex to this letter contains our detailed response to your specific consultation questions.

Yours sincerely

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Economic Regulation Adviser

ANNEX: FINANCING NETWORKS – WATER UK’S RESPONSE TO OFWAT/OFGEM’S CONSULTATION QUESTIONS

Question 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?

Water UK believes that financial ring fencing is an important mechanism for protecting the customers of regulated monopolies. The current arrangements in water have been put to the test in the case of Enron/Wessex Water (as noted in your consultation) and found to be effective in protecting the customers of the licensed water undertaker from the activities of its parent company.

There remains a degree of inconsistency between the standard licence provisions on ring fencing between water companies and we understand Ofwat’s desire for a more standardised licence. However, this will be a matter for the individual companies concerned.

We do not believe the introduction of cash lock up provisions is either necessary or desirable. Indeed it would represent belt-and-braces for highly geared companies (against the spirit of better regulation), whilst it could deter equity investors (going against the broad consensus that it remains desirable to retain financial diversity in the sector).

- First, as noted above, standard provisions have proved sufficient eg Wessex/Enron.
- Secondly, as your paper notes, for highly geared companies, the market has anyway prompted such provisions to be voluntarily included within covenants – in light of this market provision, regulation would be excessive. By contrast, the introduction of cash lock-up provisions – increasing regulatory control over returns paid out to shareholders - could actually send a negative signal to equity investors. This is an important consideration in light of the desirability of retaining financial diversity in the sector – as noted in our general comments.
- Thirdly, you point out that Ofgem has introduced these provisions to be triggered when a company reaches the lowest level consistent with investment grade: however, in the case of water, where Ofwat has sought to ensure efficient companies maintain credit ratings ‘comfortably’ within investment grade, this should be avoided.

Cash lock-up provisions would be seen as increased sub-ordination of holding company debt to credit investors at the regulated entity and hence would be likely to make it more expensive – although, core debt pricing could come down if ratings were to rise.

We believe the current ring fencing provisions are sufficient to allow the activities of the licensed undertaker to be fully separated from other group entities.

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?

This question relates to the proposals for a 'split cost of capital' being promoted by Dieter Helm.

First our interpretation of the Helm proposal is presented, since the proposal, despite numerous presentations, remains a high level concept, with a lack of clarity as to exactly what is being proposed.

Summary of Helm proposal: It is suggested that capex should be separated into old assets (those in the RAV) and new investment and the cost of capital split to reflect the different risk perceived to be attached to each (lower/higher respectively). This would enable investors with an appetite for risk (equity) to gravitate to new investment, and those with lower appetite for risk (debt) to focus more sharply on the assumed lower risk existing asset base. Greater transparency of risk and returns would enable improved risk management, and enable greater commitment to be given by regulators to returns on each (in particular on existing assets). Dieter Helm has conceded that the result would be higher overall gearing, but thinks risk would be reduced overall, leading to a lower cost of capital, whilst securing a continuing role for equity investors in spurring efficiency and absorbing risk 'where it matters'.

First, Water UK welcomes the stimulus this proposal has given to the debate around risk allocation and how to secure more efficient financing – especially how to secure equity finance - going forward. We regret that the proposal has not been presented more clearly, as it has evidently created considerable confusion amongst the audience of stakeholders (as has been clear at Water UK's city conference and your own seminar). We think this confusion should signal a warning to regulators, who should be concerned with methods of regulation that are as transparent and simple as possible.

Secondly, we are dubious that separating past and future capex (and splitting the cost of capital) would improve incentives for investment.

- It is not clear that under-investment has been an issue for water, where there has been a history of successful delivery of significant investment since privatisation. But, if there has been under-investment eg in capital maintenance or sewer flooding, this has not been because of the cost of capital, but due to a lack of prioritisation compared with environmental investment;

- The incentive for companies to invest beyond the agreed capital programme is, in our view, constrained by the mechanism of RAV capping[3] not by whether or not the cost of capital is split.

Nonetheless, we believe there is merit in considering new ways of financing very large, discrete projects – eg a large new reservoir, the Thames Tideway etc. Such projects may exhibit higher than typical risk, and to ensure access to capital at reasonable rates, may require treatment through a separate regulatory contract. Such a contract may need to give stronger regulatory commitment over the longer term as well as a higher cost of capital. Terminal 5 represents an example.

However, for the bulk of water and sewerage investment we doubt the assertion (and would be interested to see evidence) that there is a considerable risk differential between new and existing assets, or even if there is, that it is necessarily in the direction which Helm assumes. Furthermore, management of the asset base and new investment are activities that are often very similar and intertwined – indeed, going forward there is a concern increasingly for 'total asset management', looking for opportunities to benefit from synergies between maintenance and enhancement requirements, and to consider opex-capex trade-offs more efficiently. Helm's proposals seem to run counter to this quest, which is, in our view, fundamental to delivering the overall 'value' that Ofwat seeks (as set out in your consultation on sustainable development). For instance,

- given the evidence of companies having been able to meet and even outperform the regulator's efficiency assumptions on capital expenditure, it would not seem that there is considerable risk of cost overrun in water projects – whilst Helm considers construction risk as a major source of risk for new assets;

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- if problems arise unexpectedly that require replacement of an ‘existing’ asset, then the cost of replacement will generally be as high as with a ‘new’ asset – and higher than suggested by the RAV, because of the capital value discount;

Thirdly, we think the real issue that is at the heart of this proposal, is not whether it addresses ‘under-investment’ in some sense. Rather, on Helm’s premise that debt investors are less likely than equity investors to want to invest, the question he is ultimately exploring is whether the proposal can increase incentives for *equity* investment in particular whilst also reducing risk and the overall cost of capital (including financeability allowances). This is a useful question, although we reject his premise, for which, as your analysis shows, there is no evidence.

However, on the question of encouraging equity, since Helm has conceded that the proposal would lead to an increase in debt financing and gearing, it would appear to fail on its starting blocks.

We do not think that the separation of past and future capex would lower the overall risk of regulated businesses. The business risk is the business risk. Overall risk could only be reduced if a) splitting the cost of capital reveals risk to be lower than what was previously perceived to be the case and/or if b) there is an accompanying increase in regulatory commitment. We believe that the proposal, far from increasing transparency about risks, would actually increase complexity and perceived risk. As to commitment, the prospects for enhancing regulatory commitment do not depend on having a split cost of capital.

Consequently we do not believe the split cost of capital would lead to a lower overall cost of capital. If business/regulatory/political risk remains the same, then any increase in debt financing at lower rates would be offset by higher expected equity returns on the lower portion of equity finance.

Neither will it help reduce any financeability gap. The OXERA report points out that the premium rate on new assets would apply only to a relatively small part of the asset base, whilst the rate on existing assets would presumably need to be lower (reflecting its lower risk) – hence the net impact on revenues would be small. To eliminate any financeability gap, the premium rate would have to be set at an unrealistically high level (above any reflection of a risk differential) It might be argued that this would not be necessary, because the higher cost of equity reflecting the higher risk of new investment would mean equity would be attracted to the sector so as to reduce financeability. But as the proposal would have increased gearing in the first place, the financeability gap would be likely to be higher.

Finally, there are significant practical issues with this proposal. For example, when is it decided when a new asset would become an existing asset, and no longer receives the higher rate of return? Investors may perceive there to be greater uncertainty over their investment in the long term, and demand a further premium for this.

Even if it worked, the proposal – which would represent a step change in the regulatory framework - would also bring an increase in complexity and reduction in transparency. Given the highly prized stability and transparency in the regulatory regime that has been achieved by Ofwat in recent years, this would be a significantly retrograde step.

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 be best rectified?

Evidence of lack of regulatory commitment to RAVs and equity
The RAV is the most significant source of value for investors in the regulated water sector, and it is crucial that regulatory risk around this value is minimised. However, because regulators cannot commit their successors, and because prices are currently reset every 5 years, there is inherently regulatory risk around the RAV.

There is however, no material evidence in our view of a *recent* lack of regulatory commitment to RAVs in water. Indeed, Ofwat has increased confidence around the RAV by annually publishing the numbers. Consequently at PR04, the value of the RAV was not a significant issue, compared with at previous reviews. However, less commitment has been evident in electricity. To some extent poor experience in one sector may unhelpfully colour investors' views of regulatory commitment per se. Ofgem's move to publishing RAVs is to be welcomed.

We also recognise that Ofwat has made considerable efforts since 1999 – when it is arguable that the subsequent sharp increase in gearing reflected a flight of equity prompted by a perception of lack of regulatory commitment – to gain the confidence of equity investors, and has taken some steps, if not explicitly to encourage equity, then to reduce the relative advantages from gearing up – as noted in your paper.

Investors – including equity investors – do seem to have a more positive view of the water sector now, as illustrated in Water UK's last investor survey, which found that the perception of political and regulatory risk had diminished. There has been some appetite for water assets by equity investors and share prices are strong. It is important not to read too much into these developments however. For instance,

- New equity buyers have mainly been private equity or investment funds looking for secure long term high returns to match pension fund liabilities. This has not to date increased the share of equity in the market: indeed, these newcomers have further geared up balance sheets. The impending sale of Thames may reveal more information about investor incentives and confidence.

- To some extent, market premia to RAV values should be expected at the start of the periodic review cycle, because investors may place a high value on the certainty of cash flows (over the next 5 years). Conversely, at the end of the cycle when cash flows were become open to more uncertainty, these premia may expect to diminish, or even reverse.

- Added to this, present economic conditions – in particular historically exceptionally low interest rates – have undoubtedly buoyed investors' perceptions of prospects. If investors have seen some upside since PR04's conclusions, there are clear risks ahead, in terms of continued exceptionally high energy costs, and the spectre of possible increases in interest rates, worldwide. Companies have also yet to demonstrate how far any outperformance of Ofwat's, in our view, demanding efficiency assumptions may be possible.

Furthermore, there has been only one rights issue in water in recent years (United Utilities) – (and only two in the utilities, the other being BT). OXERA's presentation at our City conference showed that the use of rights issues in the UK utilities sector falls significantly behind that in other sectors and abroad, pointing out that this does raise questions as to whether there are particular market failures – such as for instance a failure of regulatory commitment. Indeed, in OXERA's report on financeability adjustments, they argue that the need for financeability may itself be a manifestation of this barrier to rights issues.

In sum, the positive mood of the capital markets towards water is to be welcomed, but the turnaround in view should not be taken for granted.

Investor sentiment is a volatile commodity and can be easily shaken. The evidence on rights issues is not persuasive that the conditions exist for widespread use of equity issuance. The most that can be said is that the few remaining traditionally mixed finance companies have in the last few years been able to sustain their equity base.

Improvements to commitment to RAVs and equity
In terms of improvements to commitment, as your paper notes, and is widely recognised, there have already been considerable improvements in the transparency of regulation, leading to a greater sense of stability in the water sector. It is to be hoped that the recent move to a Board structure at Ofwat will also increase continuity, and a sense of commitment, over time.

However, regulatory risk over the long term does remain. We have argued separately however, that the solution does not obviously lie in a longer period for price reviews, but that setting the price review in a more strategic longer term context could add to the perception of regulatory commitment over the long term (see our response to your recent consultation: Setting price limits for water: is 5 years right?).

Regulatory commitment to the RAV could be enhanced further, by addressing the present asymmetric treatment of capex over- and underspends. Overspends are effectively capped, and underspends are automatically treated as efficiency. Hence there is limited incentive for discretionary investment – even where this is in customers' interests. This mechanism is not likely to be seen in a positive light by equity investors.

A further way that regulatory commitment to RAVs can be enhanced, would be for RAVs to be included in the licence, and for the regulator to commit, also in the licence, to principles strictly limiting and defining the circumstances under which past RAV decisions might be revisited.

In terms of commitment to investors, such changes are likely to be welcome both to equity and debt investors. Customer benefits would follow in terms of containing the cost of finance, and encouraging companies to go beyond regulatory requirements in terms of investing for customers.

Separately (in our consultation paper on Future Regulation) we have argued for greater incentives for innovation and the adoption of riskier but potentially lower cost long term solutions. We also suggest that Ofwat and the EA should consider how to enhance the scope for efficiency, perhaps by pulling back from too rigid regulation of scheme delivery, to a greater focus on outcomes. To the extent that equity investors may be more attracted to such changes, these moves could further support the retention of equity in the water sector, as well as injecting greater dynamism into the industry, to the benefit of lower bills and a better mix of outputs for customers.

Beyond this, we reiterate that Ofwat should refrain from excessive intervention in financing decisions per se and retain a cautious and evidence-based approach to promoting one or other financial structure.

In question 5 below, we consider the need for specific incentives to encourage rights issues.

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 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?

Water UK recognises that the use of index-linked debt by companies offers a potential solution to the financeability issue, since in principle it addresses directly one of the main causes: the mismatch in cash flows that arises because, under the present price cap methodology, companies receive revenues that are index-linked but remunerate debt investors in nominal terms. This gives rise to a need for additional borrowing to finance the shortfall.

However, we note that this is only one of the causes: upward pressure on cash ratios arises also from large capex programmes creating negative cash flow; and may reflect that investors perceive greater risk to returns than allowed for in the regulator's assumptions (eg in the cost of capital). Index-linked debt would not address these issues.

Also, whilst ILD may improve earnings and interest cover ratios it does not improve gearing and debt coverage ratios. It also appears that only some forms of ILD borrowings improve cash ratios that rating agencies are concerned with. Index linked leases and derivative arrangements require inflation to be paid away each year. Further, the credit ratings agencies currently treat ILD quite differently for the purposes of calculating financial ratios.

Nonetheless we accept that in principle it is reasonable for Ofwat to consider making a regulatory assumption about a degree of index-linked debt in companies' balance sheets. However, and in addition to the points noted above, we perceive several significant difficulties, so that Ofwat will need to be cautious in any assumptions it makes.

- the issue of principle: that Ofwat needs to avoid being drawn into excessive intrusion into, even dictating of, companies' financing decisions;
- practicalities: for instance, we estimate[4] the share of index linked debt in companies' total debt currently ranges from almost 0% to 100%. Even assuming, for the purpose of a financeability test, a weighted industry average figure for ILD in companies' balance sheets could impose a significant step change in financing upon some companies.
- the size and depth of the market: currently the market for corporate ILD is limited, and our research indicates that the bulk of ILD used by water companies involves the use of credit wrapping. The capacity of the monoline insurance market for this purpose is small and immature– it would be inappropriate to assume that this market could supply the bulk of the large financing requirements of the industry going forward – although it is reasonable for Ofwat to monitor how the market develops.
- impact on financial stability: some companies are achieving a considerable portion of their ILD issuance by means of nominal debt accompanied by inflation swaps, as your consultation paper notes in para 149: this means that this route does bring with it increased volatility in reported earnings, which companies do consider can limit their appetite for it.
- cost: the cost of raising ILD is at present favourable, as a result of demand from pension funds, but may not remain so. Companies may also face significant re-financing costs if they had to restructure their balance sheets significantly to include ILD. Such additional transaction costs would need to be factored in by Ofwat to the cost of capital. Whether ILD assumptions would turn out to be a cheaper solution to resolving financeability than the present approach would be an important consideration.

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?

There is some overlap here with the issues raised earlier in questions 2 and 3. Here we consider the specific question of how the regulator might encourage equity injections (if it were assumed to be appropriate).

The main rationale for the question lies in the debate about how to deal with financeability. Ofwat's estimation of the financeability gap was based on the assumption that companies would raise all new finance via debt. However, if companies were to raise the finance instead through new equity, eg through a

[4] from a sample of 14 companies

rights issue or cutting dividends (the latter point dealt with in question 6 below), then this would pre-empt a gap arising.

We note first of all that simply assuming in the modelling that companies can and will raise new equity (for all or some proportion of the required finance) will not guarantee that it will happen – or that if it does it will be cheaper than the option of raising debt and paying a financeability uplift. Indeed the evidence, outlined in the OXERA report, suggests that there could be significant barriers to this.

Equity formation might be encouraged by the suggestions made earlier in question 3. But it would also be hard for regulators to rely on this delivering equity formation so that financeability adjustments could be avoided. More specific measures to encourage rights issues might include raising the cost of equity, adding a premium to the cost of equity (including the costs of making rights issues, and as Ofwat suggests, the higher tax costs associated with equity) for those with higher equity proportions.

Ofwat should have regard to the following principles if considering such options, which would be a significant departure into explicit encouragement of specific capital structures.

In brief, (i) any social benefits from promoting equity formation should be greater than the transactions costs (or incentive cost) AND (ii) the social benefit, net of transactions costs, must be greater than the differential cost of raising equity and the cost of debt (including financeability payments). If there are no perceived social benefits and the aim is just to avoid financeability payments, then the cost of raising new equity plus the transactions costs should be less than the cost of debt plus financeability. Also, any incentive for equity should be paid only to those companies with equity above the regulatory target, as otherwise, if it were added into the generic cost of capital, it might simply encourage further gearing up as the rewards would be greater.

However, incentivising equity would explicitly move the regulator into a regime of different costs of capital for different types of company. Nonetheless, Water UK recognises that, arguably, there is a precedent with the small company premium.. Likewise we have separately argued that it may be necessary to provide for a different mechanism for the financing of large discrete projects. Thus 'one size fits all' may become progressively outmoded. Any significant reversal of the principle of regulators being 'hands-off' as regards financing decisions should however require strong justification.

Question 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?

Water UK is clear that ‘greater flexibility in the approach to dividends’ would not be a reasonable step to take. A more flexible approach by Ofwat in modelling dividends' infers that assumed dividend levels could be lower but progressive, based on the expectation of future dividend growth. However, investors buy utility shares for their yield not growth characteristics (as Ofwat notes in para 158) – particularly being seen to have relatively dependable income streams. Equity investors would therefore find the sector less attractive, which would be a result running counter to the objective of sustaining future equity participation.

It should also be noted that Ofwat has already adopted a degree of flexibility in relation to dividends through the assumption of 2% growth built into the financial modelling at PR04. There would thus seem limited additional scope to assume more of the cost of equity is recovered through dividend growth rather than yield.

Question 7: Should regulators adopt pragmatic definitions of ratios used by the credit ratings 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?

It is important that Ofwat should employ a consistent but pragmatic approach to the definitions of ratios used by the credit rating agencies, based on the fullest appreciation by the agencies as to the specific qualities and characteristics of the regulated water and sewerage sector. Specific ratios and their levels may be important in different circumstances, so whilst the overall level and trend of ratios would generally be the appropriate primary focus, Ofwat should retain a pragmatic approach having regard to specific ratios as appropriate.

We would be concerned however were Ofwat to suggest that by ‘pragmatic definitions’ this means, in effect, ‘different’ from the definitions used by capital markets. This would be pointless, and somewhat rash. Regulators need to adopt realistic financial ratios: ie the ones to which investors pay heed.

If the majority of ratings were BBB, there would be significant risk for companies and their customers. Although at BBB, it may be unlikely that companies would face restricted access to finance at reasonable rates, they would be left with little headroom for cost shocks and there would be a considerable risk of one company falling below investment grade. In this event the impact on confidence in the sector could be serious. This would rebound on customers either in the form of prices to reflect the higher cost of debt, or in the form of stalled investment.

Water UK also believes that in choosing its package of indicators, Ofwat should ensure internal consistency with its assumptions on cost of capital and gearing. For instance, given that Ofwat recognises that small companies are entitled to a premium on the cost of capital to reflect higher credit risks at any given level of gearing, then equally, those companies will require higher ratings to achieve any particular credit rating. The financeability test should recognise this.

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?

Water UK agrees that these options should be considered *after* duly considering the role for equity injections, assumptions on index-linked debt, and reviewing the ratios and levels to form the financeability test. On all of these there is a need to monitor market developments, as evidence is not yet sufficient to suggest, with confidence, an alternative approach to that adopted at PR04 – as concluded in the OXERA report. On dividends we remain sceptical that the approach can be changed if equity is to be sustained, whilst on the split cost of capital, we do not consider that this offers a solution to the financeability issue (again, as per the OXERA report).

The industry looks forward to working with Ofwat to develop a shared understanding of market developments and the role for these three options.

Turning to the remaining regulatory options for dealing with residual issues of financeability: nominal cost of capital, present value (PV) neutral approaches, revenue uplift.

a) Nominal cost of capital: as the OXERA report explains, this option would require a sea change in the regulatory approach to water, and one that would see very large increases in present customers’ bills . We conclude, along with OXERA, that this would not be in customers’ interests.

b) PV neutral options: to the extent that the financeability problem arises due to the timing mismatch as a result of using a real cost of capital, Water UK agrees there is good reason to consider present value neutral solutions. We consider revenue advancement and accelerated depreciation. Although we recognise that other sectors have adopted alternative approaches, we note that the circumstances of the water sector are significantly distinct to render those alternatives inappropriate for water, as noted in our introduction and below. OXERA also concludes that the scope for these approaches whilst worthwhile to consider, is likely to be more marginal than in electricity.

c) Revenue advancement: we believe that the problems that Ofwat raise in paras 176 to 178 are potentially significant, particularly in the context of persistent high levels of capex not just for the next AMP period but beyond - in this situation, there would be significant regulatory risk around when the advance would need to be repaid.

d) accelerated depreciation: we do not consider this appropriate either within or between price periods. As the Ofwat consultation notes, (para 179) the approach 'can divorce the depreciation used in setting price limits from the economic life of the assets being funded and raises questions of intergenerational equity.' Furthermore, as the OXERA report has identified, where financeability is expected to be an ongoing issue due to persistent high levels of capex, it can simply mount up for the future a worse financing problem than today.

e) Revenue uplift (the Ofwat approach at PR04): OXERA concludes that, having exhausted other options for dealing with financeability, this remains the most appropriate regulatory approach for Ofwat to adopt. We note that financeability adjustments made at PR09 amounted to just 1% of total revenue.