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23 May 2006

Dear Emma

Financing Networks

Please find attached a copy of the response from Welsh Water on the Financing Networks – Joint discussion paper by Ofwat and Ofgem.

We apologise that our response is slightly late.

Yours sincerely

PP. *Chris Jones*
Chris Jones
Finance Director

Cc
Martin Crouch
Director – Electricity Distribution Regulation
The Office of Gas and Electricity Markets

glas
Glas Cymru Cyfyngedig

We welcome correspondence in Welsh and English
Rydym yn croesawu gohebiaeth yn y Gymraeg neu yn Saesneg

FINANCING NETWORKS: A DISCUSSION PAPER

Response by Welsh Water

19th May 2006

Welsh Water welcomes the opportunity to respond to the discussion paper on Financing Networks produced by Ofwat and Ofgem in February 2006. The paper sets out the issues extremely well and formed the basis for a successful seminar on the subject in April 2006. For the water sector, this is the best time to be promoting discussion of these topics because there is a reasonably long period before the next price review. Welsh Water particularly welcomes the comments made by Ofwat at the seminar that any proposals to develop the existing methodologies would only be made after careful thought and extensive consultation, particularly with participants in the capital markets. This is essential if investor confidence in the sector is to be preserved.

Responses to the specific questions raised by Ofwat and Ofgem are included in an annex to this note. In addition, three underlying themes of particular importance are addressed below. In general, we have limited our comments to the implications for the water sector.

Underlying theme – the advantages of continuity

Welsh Water believes that the existing regulatory methodologies for the water sector in England and Wales have been extremely successful over the last 17 years. The careful development of these methodologies have led to a period in which substantial sums have been raised from the private capital markets to finance an unprecedented investment in the water and wastewater networks in England and Wales, whilst minimising the impact on customers' bills through improved operating and financing efficiency. The fact that all this has been achieved without any recourse to government subsidy or support is remarkable in an international context but, perhaps, is not fully appreciated in England and Wales.

The key regulatory principles that need to be followed in order to enable the continuation of this successful financing of the water sector are: consistency over time, consistency between companies, no retrospection and transparency. In addition, effective engagement with the capital markets is necessary, providing clear and consistent messages to investors. In other words, investors in a perceived relatively low risk sector such as water value above all a "no surprises" regulatory regime. At least one rating agency has commented to Welsh Water that the water regulatory regime in England and Wales is a major credit positive for the sector and is viewed as the equal of any other in the world.

In the period leading up to the 2004 Periodic Review, Ofwat were very effective in providing clear communication to the capital markets, such as early indications of the likely range for the allowed return on capital. As a result, substantial amounts of new capital have been raised on generally efficient terms, both to complete the funding of the AMP3 investment programme and to begin the funding of AMP4. Ideally, the capital markets would most like to see a continuation of this process of engagement in the run-up to the 2009 Periodic Review, with as much transparency and consistency

of methodology as possible. Of course, particular parameters may change in response to developments in the markets and methodologies may need to be developed, following extensive consideration and consultation. However, in general, a “no surprises” review is the best way to reduce the financing costs to the sector even further in future. In such a capital intensive sector, with every prospect of further substantial investment to come in AMP5 and beyond, financing efficiency is the key to delivering value for money to our customers in the future.

Against this positive background, Welsh Water is not persuaded that any of the proposals that have been put forward for major innovation and change in regulatory methodology are warranted. However theoretically elegant, it is not clear what fundamental practical problem they are seeking to solve. In these circumstances, Welsh Water believes that there should be a presumption against change, unless it can be demonstrated conclusively that there is a genuine deficiency with the existing methods. Continuity at future price reviews is the best way to minimise financing costs and, hence, customers’ bills in the long-term.

The “financeability issue”

In the 2004 water sector price review, the need for a “financeability adjustment” was determined primarily by the size of the capital investment programme for companies relative to the company’s RCV – in other words, the relative requirement for RCV growth over the period. Those companies experiencing the most rapid RCV growth will generally face the greatest strain on financial ratios and, hence, will have the greatest need for a financeability adjustment to ensure that they can raise their significant capital needs in practice.

In this context, the way to avoid the need for a financeability adjustment in practice is to ensure that the pace of capital investment in future does not place undue strain on companies and, in addition, is affordable for customers. Welsh Water would like to achieve a degree of consensus amongst its stakeholders over the next couple of years as to the affordable size of its AMP5 capital programme and the optimal prioritisation of that programme. In that way, it would hope to avoid the need for a “financeability adjustment” at the 2009 Price Review.

In the consultation paper, the question is raised as to whether there should be a consistent approach to “financeability adjustments” and “accelerated depreciation” in the water and electricity distribution sectors. Welsh Water’s recent experience suggests that “accelerated depreciation” is not an alternative to the “financeability adjustment”. Rather, because of its significant capital formation since privatisation, with regulatory capital value (RCV) growing from some £300 million to £3,000 million, the current cost depreciation allowed for in price limits is already likely to be materially higher than the level of capital maintenance on the recently created assets (MNI) leading to a temporary cash flow surplus for this item. However, because of the size of the funding requirement for ongoing investment in new assets, this cash flow surplus on depreciation is not sufficient to maintain financial ratios at levels acceptable to investors and so a further “financeability adjustment” has been required. These circumstances have not applied in the electricity distribution sector in recent years, which accounts for the fact that similar “financeability adjustments” have not been required in that sector to date.

At risk capital – the importance of a “level playing field”

A further general concern that has been raised by some commentators is that investors may not properly perceive the risks of investing in particular utilities, especially highly geared utilities. The thought is that investors might incorrectly believe that, in some manner, the regulator would ultimately intervene to protect the value of their investment, if the company concerned were to get into financial difficulty.

Welsh Water is in frequent contact with many capital market participants and has never come across such a misunderstanding of the fundamentals of the UK regulatory systems. Investors recognise that all private capital invested in UK water companies is “at risk” (whether equity, bonds or various “intermediate” forms) and that it is the job of investors to price that risk accordingly. Various options also exist, such as monoline guarantees and credit default swaps, to help them manage such risk further, if they so desire.

The key regulatory requirement to maintain this state of affairs is that Ofwat needs to continue to apply its publicly stated “level playing field”. This means that all water companies are treated equally and, crucially, price controls are set, not on the basis of the actual capital structure of an individual regulated water company, but rather on the basis of a common, notional balance sheet. In this way, it is clear to investors that Ofwat will make no allowance for the actual financial circumstances of a company and, should that company get into trouble, then it will not receive any preferential treatment. The special administration regime exists to protect customers’ interests in such circumstances.

Such “level playing field” principles should also continue to be applied to the other assumptions made by Ofwat for the modelling of companies’ financial positions and “financeability adjustments” – such as assumed dividend yields, assumed dividend growth and debt structures.

The following section addresses the key issues raised in section 8 of the discussion paper.

Annex – Section 8: Issues for discussion

Key issue 1 – should financial ring fencing arrangements be extended to cover all monopoly businesses?

Welsh Water believes that it is important that investors remain clear that their capital is “at risk” and that the regulatory system does not exist to protect their particular financial interests. Regulators should therefore be wary of taking additional powers to intervene in the financial policies of regulated utilities, such as dividend lock-ups, because the taking of such powers could leave the regulator open to challenge by investors if either the use of (or the failure to use) those powers resulted in loss to investors.

Key issue 2 – separation of past and future capital investment?

As explained in Welsh Water’s main response to the consultation paper, Welsh Water does not believe that any fundamental change to the regulatory regime is either justified or likely to be beneficial to customers. Consistency and transparency are likely to lead to lower financing costs and, hence, lower bills to customers in the long-term.

Key issue 3 – lack of regulatory commitment?

Again, the clear communication of a consistent methodology to investors is the best way to enhance “regulatory commitment” as perceived by investors.

Key issue 4 – should regulators assume a proportion of index-linked debt?

This may be a reasonable assumption, depending on the conditions in the capital markets at the time. If so, then the assumption should be applied equally to all water companies. It should also be noted that the assumption of index-linked debt may have only limited implications for issues concerning “financeability”. In practice, rating agencies would be expected to react to the presence of an increased level of index-linked debt in a company’s balance sheet by adjusting their target levels of interest cover accordingly.

Key issue 5 – changes to facilitate equity injections?

All regulated water companies have to generate equity in their balance sheets in order to maintain acceptable levels of gearing in the face of a net capital investment programme. This is the case even for Welsh Water, where “customer reserves” take the role of equity in its balance sheet. Thus, it is not clear whether equity injections per se need to be encouraged, as opposed to the use of financial assumptions which enable the generation of the required additional equity through whatever route – including the retention of profits. Any proposed method and assumptions to enable equity to be created in the hypothetical balance sheets used for price setting purposes would be applied equally to all companies following the “level playing field” principle.

Key issue 6 – more flexibility in the approach to modelling dividends?

Such an approach might be justified in light of market conditions at the time but, as with the assumption of index-linked debt, changing one assumed financing parameter is likely to impact on others, such as the required cost of capital or target levels for key financial indicators. Again, a “level playing field” should be applied.

Key issue 7 – should regulators adopt the financial ratios used by credit rating agencies? Would there be significant difficulties if a majority of companies were rated BBB?

Regulators must continue to adopt the key financial ratios used by rating agencies in practice as the purpose of the exercise is to ensure that companies would be able to finance their activities in the real capital markets if they were adopting the regulator’s hypothetical balance sheet. The scope, definition, target levels and trends of key financial ratios are all important.

Welsh Water does not believe that a BBB credit rating would be acceptable as the norm for the sector. In part, this is because perceptions have been created amongst utility investors in the past that a regulator was targeting a lower level of rating for the sector, which had a very detrimental impact on investor confidence and their required risk premium to invest. In addition, a general BBB rating, although it might have been acceptable in the very benign market conditions of the recent past, could leave the sector exposed to financing difficulties in the event of adverse market conditions in future and would definitely result in a higher financing cost to the sector, which would be bad for customers’ bills.

Key issue 8 – the remaining issues of financeability.

The issues of “financeability” and accelerated depreciation have already been discussed in Welsh Water’s main response.

Because capital investment requirements of water and electricity distribution have been very different in the past, it should not be expected that there would be a single, optimal approach to financeability across the sectors. In particular, given the likelihood of a continued substantial net investment programme in water, any change of method that led to an advancement of revenue from later periods to “fix” a financeability problem in a current regulatory period would only be expected to exacerbate financeability difficulties in the future.