Mr Keith Mason
Director of Regulatory Finance and Competition
Office of Water Services
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Direct line: 01225 526344
Direct fax: 01225 528009
Email: keith.harris@wessexwater.co.uk

19 May 2006

Dear Mr Mason

Financing Networks: A discussion paper

Thank you for letting me speak at the joint seminar you held with OFGEM. I thought I would recap on the points I made as Wessex Water's contribution to this debate.

Why may financeability adjustments be necessary?

Disagreement between the Regulators and the financial markets over the cost of capital ?
The cost of capital is determined by the financial markets. In theory if the Regulators reflect this in the price control there should be no need to make any further adjustments. The fact that financeability adjustments were needed in 2004 could reflect a mismatch of views.

Clearly with companies trading at premiums to their capital values, and given the relatively benign state of the capital markets, this theory is a little difficult to justify in relation to the 2004 price control. But it does not take away the point, at least in principle.

We must also be mindful that setting the cost of capital too low in 1999 was a major factor in encouraging companies to gear up their balance sheets which, of course, is a reason why financeability adjustments were necessary in 2004.

The market is not wholly focussed on the cost of capital
Whilst theory may suggest that all that should matter is the cost of capital, the real world is different. Investors, fixed income or equity, all want different things from their investments. Moveover, investors and rating agencies have their own ways of evaluating their investment criteria. These criteria often change.

If we wish there to be a blend of investors then Regulators must set price limits in a way which broadly encourages investment from the wide spectrum of the capital markets. It is then for companies to construct capital and financing structures which meets the investment needs of the markets.

The market does not understand or trust the industry and its regulators

Given the effort that regulators and companies have taken over the years to explain the regulatory process, it would be hard to say that the markets no longer understand utilities. That does not mean to say that we can take this understanding for granted. It falls to all participants in these industries to be consistent and transparent.

However there remains an issue of trust and, possibly, regulatory commitment. Markets are acutely aware of the political nature of utilities. It is probably unreasonable to expect this to change. However, it is vital that political and regulatory risk is minimised if we are to keep the cost of capital down. We believe there are 2 important factors in doing this:

- Companies deliver on their regulatory contracts and continually improve service to customers,
- The financial performance of companies should, as far as possible, be a matter between the regulators, the companies and their investors. Sadly, open discussion of performance is misused by the media to the long term detriment of consumers as it unsettles the financial markets and acts to blunt incentives to outperform.

Price limits are set in real terms whilst financial instruments are often nominal

Issuing nominally denominated debt against real terms price limits does create a strain on certain of the financial ratios set by the Rating Agencies. But this is a matter largely for companies. Financial markets allow companies to issue index linked debt or to use swap instruments to achieve the same. The difficulty is the depth of these markets. Also, index linked debts may improve earnings and interest ratios but it worsens gearing. It would be wrong, at present, for regulators to assume too much index linked finance in company's balance sheets when testing for financeability.

The scale and pace of the capital investment programme

If the scale and or pace of the investment programme were slower then financeability adjustments are much less likely to be necessary.

In many ways it is appropriate that the scale and pace of improvements are matters for government and consumer representatives. But these groups must understand the true cost of their decisions. If the cost of the investment programme increases because of its scale and pace then this cost should fall to customers and not to investors.

The role of Debt, Equity and the Board

We do not see debt and equity as pure alternatives to each other. They are not black and white, rather they form part of a continuum of financial instruments each with slightly different risk and reward characteristics. It is self evident that instruments which are closer to the equity end of the spectrum accept greater risks and take greater rewards.

All investors must bear the risk of imprudent financial and operational management. However, we do not believe that all investors should bear all risks. In particular, where managements have been prudent, but exogenous shocks have occurred, we question the wisdom of passing on the consequence of this to fixed income investors. To do so may, at the very least, increase their perception of risk and hence the cost of capital. At worst it could discourage investment.

The role of “equity” is to deal with shocks and to benefit from outperformance. As such, optimal equity formation should be encouraged. To that end, we do not believe that proposals for additional ring fencing are helpful. We consider that the most significant difference between financial ring fenced and conventional structures is the use of cash-traps. Were these to be imposed as part of the regulatory ring fence then one of the major reasons not to gear up is removed.

There is no need for additional ring-fencing provided the corporate governance structure of network businesses is appropriate. This requires strong and independent non executive Directors with a clear remit to protect the long term interests of the business.

We would, of course, be happy to discuss these or other points with you in more detail should you so wish.

Yours sincerely

Keith Harris
Director of Finance and Policy