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Dear Keith

Financing Networks: Discussion Paper

With reference to your consultation published in February 2006, we welcome the early discussion of the issues raised in the paper. Having a wider sectoral review across utilities is helpful, but in reaching solutions for water Ofwat will need to be clear where sector specific considerations may need to take precedence.

Discussion of the issues in this area has been very open, with the discussion paper being followed by a well attended workshop in April. The timeliness of this gives an opportunity to Ofwat to develop the approach to be taken in this area well in advance of the methodology consultation for PR09, which will avoid any unnecessary uncertainty that may arise from delay.

Whilst the discussion paper raises questions in a number of areas, one key consideration omitted is the detail of the methodology to be used to set a cost of capital, this will need to be developed for the PR09 review.

The discussion paper poses a number of questions, the responses to which are detailed in Appendix A of this letter.

In summary we believe the key issues to be considered are the following:

- **Transparency:** The approach taken by Ofwat in 2004 price control review was successful in improving the level of transparency in the process required to reduce perceived 'regulatory risk'. There is a need to continue with this approach at the 2009 price review.
- **Consistency:** A consistent approach to financeability adjustments is required for PR09. Addressing financeability via a revenue uplift is the most appropriate method for the water industry as it has the least volatile impact on customer's bills.

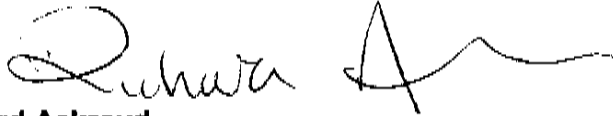


- We would caution any radical reform in the approach to financing, as this may unsettle the market, lead to unintended consequences and impact adversely on the profile of customers bills. The practicalities of a proposed split cost of capital would further complicate an already complex area with the possibility of more risk being passed onto customers.
- Considering how investment will be funded is a decision for the management of the business. Whilst the discussion paper raises a number of examples of how the regulator could be more prescriptive by using assumptions regarding index linked debt, and dividend policy, there is a need to avoid clouding management decisions with regulator decisions.
- To preserve and enhance the equity funding within a business, regulatory commitment to improve and enhance the incentives for out performance need to be given.

The discussion paper links to the concurrent consultation on the length of the price review period. We firmly believe that five years strikes the right balance between risk, reward and uncertainty. A long term regulatory commitment to process and approach is more effective in ensuring the long term sustainability of financing the industry.

Should you require any further information, please contact Susan Davy on 01274 692498 or by email to susan.davy@yorkshirewater.co.uk.

Yours sincerely



Richard Ackroyd
Director of Regulation and Investment

Appendix A

Responses to questions from the Financing Networks discussion paper:

Should financial ring fencing arrangements be extended to cover all monopoly businesses and modified so that all include cash lock up provisions? How might the introduction of cash lock up provisions affect existing financial structures including holding company debt?

A well managed company must be allowed to finance its activities as it feels appropriate; regulator 'step in' is therefore only for exceptional circumstances.

Financial ring fencing is currently included in almost all undertakers' licences; it has previously proved effective in protecting the customers of licensed water undertakers from the activities of their parent company. An example of this being Wessex Water and their ultimate parent company Enron. It is an appropriate mechanism for the protection of customers in the longer term.

As the discussion paper notes, currently where companies are geared, the market has prompted the use of covenants. The more highly geared companies have tighter covenants. Previous re structures in the industry, including the setting up of Dwr Cymru have not led to customers having to fund costs. The introduction of cash lock up provisions would not serve to further protect bond holders, nor customers.

Are the current ring fencing provisions sufficient to allow 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 cases of Wessex Water, and their ultimate parent company Enron, and establishing Dwr Cymru, has demonstrated that the current ring fencing provisions in place allow the licensed undertaker to be adequately separated from other group entities.

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?

Previous price control reviews have seen Ofwat adopt an approach to the setting of the cost of capital that reflects an 'overall' required return for a business. That said in this approach, the resulting cost of capital has reflected a separation of past and present investment. An assumed level of embedded debt was included in the calculation of the cost of capital at previous reviews.

The discussion paper focuses on a change in the approach to setting the cost of capital. A 'split' cost of capital is proposed, based upon funding existing investment in the regulatory asset value (RAV) from debt finance, and the operating and delivery of new investment with equity finance. Underpinning this approach is the premise that once investment has been added to the RAV it is relatively low risk and is suitable for debt finance. Managing the day to day operations and delivering new investment is higher risk and should therefore attract a higher return through the provision of equity finance. It argues that subsequently indexing the cost of capital would reduce the

regulatory risk caused by five yearly price reviews and deliver stability to the investor expectations.

We do not believe that a split cost of capital would benefit the water industry. Ultimately this approach would lead to the industry being structured towards debt, with all companies being relatively highly geared.

In the long run these structures would be more exposed to cost shocks and possible changes or disruption in the financial markets.

It is the overall cost of capital that is important, arguably the proposals put forward for a split cost of capital in the discussion paper could merely re allocate risk and not result in an overall reduction to the cost of capital – the uncertainty created by the split increasing perceived regulatory risk. If business and political risk remain 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. Indexing the cost of capital would increase the risk transfer to consumers, and increase the bills.

Are there any practical implications if such an approach was adopted?

Whilst there may be a case for separating the funding of large discreet projects, we believe that the approach to the split cost of capital would pose practical problems.

There are inherent problems in an approach that seeks to separate 'existing assets' from delivering new assets and operations.

The existing asset base consists of a number of differing asset classes with differing asset lives. Excluding the investment required for quality obligations, the majority of new investment consists of replacing or maintaining existing assets. Furthermore, much of the new quality investment actually takes the form of upgrades to existing assets often undertaken in association with maintenance investment on the same assets. Trying to allocate differing risk profiles to these assets would prove very difficult.

The assumption of when an asset becomes 'new' over the regulatory period and moves to the asset base would pose practical difficulties, and would add complexity over the current regulatory approach.

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?

Whilst adjustments to the regulatory capital value (RCV) have not been an issue in the last review, there is a need to ensure clarity and consistency with any approach adopted.

The RCV is 'capped' in the water industry; the amount of investment that a company can have recognised in the RCV is limited to the investment outlined in the price determination. The rules around inclusion of investment within the RCV need to be clearer and more transparent than they are at present to ensure regulatory commitment. Changes to mechanisms that impact on the RCV post price control reviews are unsettling and lead to evidence of the lack of regulatory commitment.

Whilst the discussion paper raises the historical issue of the 'flight of equity' after the PR99 review, subsequently due to the PR04 review increasing the level of regulatory

transparency, and having comfortable investment grade assumptions, equity investor confidence has improved at PR04.

An important point to note is that there is a requirement from the regulator to be consistent in the approach adopted, and maintain the confidence of the equity investors.

In addition to commitment to the regulatory process, enhancing traditional equity funding could be achieved via enhanced incentives for out performance, and maintain the approach of a balanced notional balance sheet.

To ensure regulatory commitment to equity funding then the incentives for out performance – via enhanced returns or retained earnings need to be improved.

Should regulators assume that a proportion of debt is index linked when setting price controls? Is access to the index linked debt markets 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 investor's portfolios? Would it be more expensive?

The regulator needs to set clear defined boundaries between what decisions are made by the regulator and what decision are made by management. Making assumptions into the future may reduce the flexibility afforded to companies of choosing the most appropriate type of financial instrument.

Whilst currently it may be efficiently possible to raise index linked debt, the bond market is not as big as the equity market and only a subset of this is index linked. It is therefore questionable as to the limit of this market. Additionally, in order to access the more favourable rates, the structure of the bonds may be complex to establish. Virtually all recent index linked financing in the water sector has relied upon, in one form or another, monoline insurance companies providing credit insurance against the utility's default. The depth of this funding mechanism is restricted by the risk appetite of these monoline insurers.

Ultimately there are inter generational issues with raising this type of debt. The future costs of the index linked debt being borne by future generations of consumers, which is undesirable as a general proposition.

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?

We do not think it is appropriate for the regulator to be more flexible in the approach to modelling dividends. Such an approach would be counter intuitive to the objective of encouraging future equity participation.

Should regulators adopt pragmatic definitions of ratios used by the credit ratings agencies? Is the specific level of any particular ratio critical to credit worthiness? Is it the overall level of and trend of ratios that is important? Would there be any significant difficulties for companies if the majority of ratings were BBB?

We believe it would be appropriate for Ofwat to be transparent about the ratios used to address the financeability issues in the industry.

It is important that Ofwat should employ a consistent but pragmatic approach to the definitions of ratios used by the credit rating agencies.

If the majority of ratings were BBB, there would be significant risk for companies and their customers. At a credit rating of BBB, companies would be left with little headroom for cost shocks. This would impact on sector confidence and ultimately raise the cost of investment, impacting on the level of customer bills.

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?

The approach taken to practically addressing financeability should be consistent and transparent. At PR04 Ofwat dealt with the issue of financeability via a revenue uplift. For the reasons set out below, we believe this to be the best approach to be adopted at future reviews. In theory there is no reason why a revenue uplift should not be PV neutral, however, that would be on the assumption that the situation would reverse itself in the current or subsequent periods. At the PR04 review there was no indication that the financeability adjustment would be reversed in future periods. Changing the approach latterly would result in uncertainty and lack of consistency.

- Revenue uplift : A report prepared by Oxera concludes that this is the best of the available options; ideally it should be PV neutral because the problem is essentially a timing one, not a problem of the cost of capital being wrong, but this issue is complicated by the expectancy of persistent future high levels of capex in the water industry. Although we recognise that other sectors have adopted alternative approaches, we consider that the circumstances of the water sector are significantly distinct to render those alternatives inappropriate for water, as noted below.
- Accelerated depreciation: We do not consider this appropriate either within or between price periods. We do not believe that depreciation should be used as a tool to address financeability as this could interfere with its primary purpose of sustaining the asset base. Furthermore, with increased capital expenditure and levels of depreciation, the impact on customer's bills in the future would be significant.
- Nominal cost of capital: this option would require a change in the regulatory approach to water, and one that would see a very large one off increases in present customers' bills. We consider this would not be in customers' interests.