

Investor Survey: Ofwat's PR09 Draft Determinations

Report by Indepen for Water UK

24 September 2009

Indepen is a strategy and economics consultancy. We work with clients facing the challenges of regulation, deregulation, competition and restructuring to create value in an uncertain world. We help them formulate strategy, shape public policy as well as assess and manage the associated regulatory and political risk.

Our work is built on our understanding and knowledge of regulators and government, business and investors, as well as other forms of enterprise. We use our knowledge to challenge constructively. Our thinking is based on the underlying economics and is independent, distinctive and rigorous.

We also work with boards on transforming organisations and their structures in support of strategy implementation. We provide them with the information they need to take confident decisions.

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Indepen Comment

Context

There are two important points about the context within which the survey took place.

The first is the positive view of Ofwat's regime that investors have expressed in each of the previous surveys beginning in 2003. They have consistently said that they value Ofwat's predictable and transparent approach to regulation. The most recent survey in the series, which was in March of this year, reported a shift in sentiment in the form of heightened perceptions of regulatory risk. The survey we are now reporting shows a further shift away from the previously held positive views, particularly among equity investors.

The second contextual point is the challenge presented to Ofwat by the volatility of economic and financial conditions. Investors show they are aware that it will be unusually tricky at the present time for Ofwat to make a balanced determination of price limits for five years. This survey shows divergent views of how well investors think Ofwat has risen to this challenge.

Comments

The results raise many issues worthy of comment. An important area, in our view, is the combination of the fact that investors did not expect the outcome they got and the related point of a perceived lack of transparency in the draft determinations. The results of the survey show that these matters are of particular concern to equity investors, although some debt respondents observed that debt finance was not entirely insulated from their effects.

The equity position is important for three reasons.

- Equity is essential to the incentive system of economic regulation.
- The sector has continuing obligations to invest massive sums in maintaining and enhancing services for consumers and the environment.
- From the draft determinations we see that Ofwat considers equity injections to be an important source of finance in the AMP 5 period¹.

¹ The DD says " ... we consider equity retention to be an important part of the way forward necessary to ease a financing constraint." Draft Determinations, section 5.6.3, page 115

Investor expectations

The survey shows that investors thought not only that the draft determinations were too tough but also that they were tougher than they had expected. In considering why investors' expectations were disappointed, there are two possibilities.

The first is that investors, particularly equity investors, were over-optimistic. As one debt respondent noted there was a degree of over-optimism among equity analysts before the draft determinations and acquisition valuations during the debt bubble would be consistent with over optimistic views of the returns to be had from the sector.

The other possibility is to do with Ofwat's communication which may have been defective or misleading or both.

Whatever the merits of these explanations, the survey shows that a large majority of investors now believe that companies will not or might not be able to earn returns at or above the cost of capital to the sector. If they are right, this would mean that investment in water companies could be value destroying.

All the equity respondents who answered Question 8e (on the change in the balance of risk since PR04) said that risk had shifted to equity and three quarters of them said that the sector was less attractive than before with over a quarter saying that they would not invest again in the sector.

Transparency

Investors were disappointed about the lack of transparency in the draft determinations. Over half of the equity and debt respondents, unprompted, expressed the view that rather than make its decisions on their merits Ofwat had set out with the intention that average bills would remain flat in real terms. Investors were surprised that Ofwat had not said in earlier consultations that this was its intention or explicitly in its draft determinations. Investors considered Ofwat had achieved its goal by making tough assumptions across the board, transferring risk to equity without a commensurate change in the WACC. Investors compared Ofwat's conduct this time unfavourably with that of PR04.

Additionally, several investors noted that information in the determinations was insufficient in that it was not possible to see how the price limits had been derived from the assumptions Ofwat had made. In addition, the relationship between Ofwat's draft determinations and the companies' business plans was not explained, in contrast with the position at PR04².

² At PR04, the draft and final determinations contained summaries for each company that showed those schemes that had been in the companies' business plans but were not funded in the determination. The current DD contains no such information.

As for the trade offs inherent in the determinations, some equity investors took the view that the draft determinations reflected a significant change in the regulation of the sector. At Ofwat's request, the industry had presented detailed Strategic Direction Statements looking 25 years forwards. These had regard to the results of extensive customer and other research and stakeholder consultation and they had formed the basis of the companies' business plans. At the time it requested their creation and in its 2008 strategy document, Ofwat said that the Strategic Direction Statements would be part of the price review³. In fact, it is unclear whether and if so how the draft determinations have taken account of the Strategic Direction Statements and importantly what trade-offs Ofwat has made between long and short term outputs for consumers and the environment.

Conclusion

A substantial proportion of those interviewed expressed concern that the regime was no longer transparent and trustworthy in the way it had been formerly. This was prevalent among equity investors and not limited to those with illiquid positions.

Over half of the debt respondents continued to draw comfort from the Ofwat regime and said that the attractiveness of the sector was unchanged although over a third of these said it was less attractive. Some of them recognised that while Ofwat's tougher stance would directly affect the prospects for equity returns it could also have consequences for debt.

A potentially important consideration for public and regulatory policy not only towards the water sector but also towards UK infrastructure more broadly is that, whatever the final outcome of the 2009 Price Review, regulatory action is causing investors to reappraise the virtues of UK infrastructure as a home for their funds.

Without information on how it has reached its determinations and what trade offs Ofwat has made in doing so it is difficult to evaluate the draft determinations in a public policy sense or to see how anyone, customers, investors or the Competition Commission, can hold Ofwat to account for its decisions. It would be helpful if in its final determinations, Ofwat were to clarify the issues raised above and explain the trade offs it had made and what regard it had had to investors' opinions, including those reported here.

Acknowledgement

We thank all those who took part in the survey for their contributions.

³ "We also required each company to prepare a 25-year strategic direction statement as part of the 2009 price review." Ofwat's strategy – taking a forward look, April 2008, page 4

Summary

Objective

This document reports the results of the sixth survey of investors in the water sector in England & Wales. The objective of the survey was to report investors' views of Ofwat's draft determinations of price limits for 2010-2015, which it published on 23 July 2009.

The survey and this report

Water UK asked Indepen to survey investors and report their views on Ofwat's draft determinations. The Survey took the form of in-depth interviews during August and early September. We interviewed 14 equity and eight debt representatives and three rating agencies, 25 interviews in total.

We have set out the results of the survey relative to each of the questions. Where relevant, we have provided the results separately for the categories of respondent.

The following is a summary of the main findings.

Investors' overall views of the determinations

The survey shows that perceptions of the determinations differ as between equity and debt investors.

All but one of the equity respondents had a negative overall view of the draft determinations and they all said it was tougher than they had expected. The views of debt were mixed with roughly equal proportions expressing positive, neutral and negative views overall. Over half of debt investors said it was tougher than they had expected.

Over half of equity and debt responses (not including rating agencies) believed that rather than making its decisions on the merits according to the well-established building block approach Ofwat had set out to ensure that average bills would remain flat in real terms.

Among the rating agencies, one had said the determinations were ratings neutral whereas another had placed three water companies on negative credit watch.

Risks

About two thirds of equity respondents believed that the risks facing the sector had risen and many of them observed that Ofwat had not recognised this. On a related point, there were negative views about the determinations' risk mitigation mechanisms.

Prospects for out-performance

Half the equity investors thought that the companies would not be able to earn a return at or above the sector's actual cost of capital. Another third said that whereas some would be able to earn such returns others would not with the historical cost of their debt being the critical factor. The views of debt investors on the prospects for out-performance were more or less evenly balanced.

Attractiveness of the sector

Over three quarters of equity investors said that the sector was now less attractive stating that they would not invest again in the sector and that there were more attractive investments outside UK infrastructure. One large equity investor had sold a long held significant position. Those who thought the sector remained attractive noted the need for more mitigation measures and also the attractiveness of heavily discounted infrastructure assets in other parts of the world.

Again the view of debt was more mixed with about two thirds believing the sector remained attractive and one third that it had become less attractive.

Technical issues about the determinations

Over three quarters of equity and debt investors who expressed a view said that Ofwat's treatment of capex was too tough.

Ofwat had introduced some new approaches at this review, the most significant of which was Capital Incentive Scheme (CIS). Although investors welcomed the CIS in principle they could not understand and did not welcome Ofwat's application of the Scheme which they said was over complicated and was in effect an opaque way of reducing prospective returns on capital.

Several investors noted that information in the determination was insufficient in that it was not possible to see how the price limits had been derived from the assumptions Ofwat had made. Nor was the relationship clear between the determinations and the companies' business plans.

Salient views on the financing elements of the determination were as follows.

- Ofwat's WACC assumption was low – over 90% of equity and over 60% of debt respondents
- While Ofwat's cost of debt number was thought to be reasonable, its cost of equity was low, and did not reflect the risk of investing in the sector.
- Ofwat had not justified changes from the previous review, including its new WACC number and its decision to remove the small company premium for equity
- There were inconsistencies between the financial parameters within the draft determinations (variously referring to the relationships between the WACC, gearing and credit rating on the one hand and WACC, RAV growth and dividend yield on the other). Specifically Ofwat appeared to be inconsistent in its assumed credit rating when considering the cost of capital and financeability.

1 Introduction

1.1 Background

Ofwat published 'Future water and sewerage charges 2010-15: Draft determinations' on 23 July 2009. Water UK asked Indepen to survey investors in the sector and report their views of the draft determinations (DD).

1.2 Approach

The survey was sponsored by Water UK and guided by a Steering Group including representatives of the companies, Ofwat and Water UK. The project was led by Matthew Parr who was supported by John Hargreaves and Tom Walker.

The Steering Group opted for a survey consisting of some 25 in-depth interviews which we conducted between 4 August and 3 September. The respondents were selected in discussion with the Steering Group to reflect the range of investors, advisors and analysts that deal with the sector. A list of the institutions and individuals to whom we spoke is in Appendix A. The numbers were as follows.

- 14 equity – representing infrastructure funds, fund managers, advisors and analysts
- Eight debt – representing bondholders, lenders, advisors and analysts
- Three representing the rating agencies.

Most of the interviews were face to face with a small number of telephone interviews where we were not able to meet and one respondent submitted a written response. There was a single set of questions for all the interviews, which we had agreed with the Steering Group and provided to each respondent in advance. Our approach was to ask the questions and then discuss the issues without prompting.

Coverage of the issues was not complete in all interviews. This was for a number of reasons.

- Some of the questions were not relevant to some of the respondents
- The interests and knowledge of the respondents meant that we did not always cover all of the questions in equal depth or sometimes at all
- Most of the interviews lasted for about one hour but some were constrained by other commitments of the respondents.

This has implications for the interpretation of the results, for example the category of response "No view given" does not necessarily mean that a respondent had no view.

This report summarises the answers to each of the questions. Where it seems relevant we have reported the results separately for the different types of respondent. The rating agencies often said they were not in a position to answer specific questions and their role was to rate the sector rather than comment on it. We have excluded them from the charts.

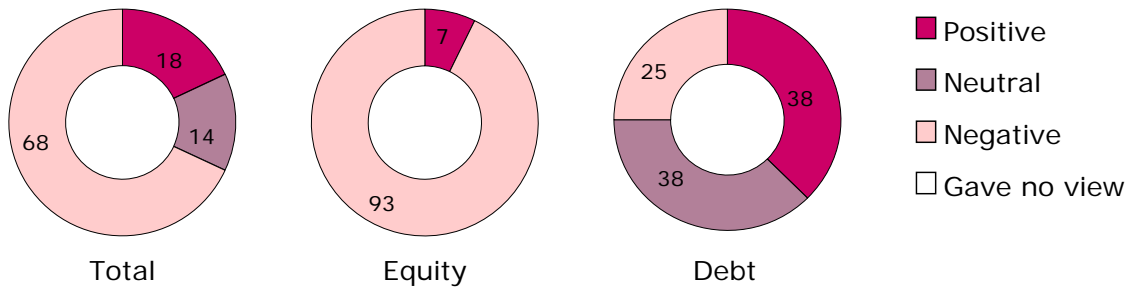
2 Summary of responses

The summary follows the structure we used in the interviews and has the following headings.

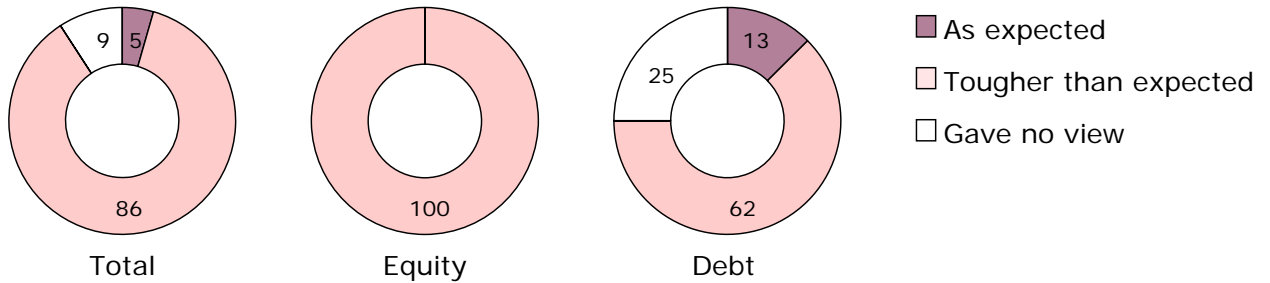
- Overall views of the determination
- Financial aspects
- Treatment of general economic conditions
- Other aspects of the determination.

2.1 Overall views of the determination

Q1. In overall terms, what do you think about the draft determinations?



Q2. Is it as you expected?



Total

The majority (68%) of responses were negative in overall terms about the draft determinations with 14% neutral and 18% positive. Debt participants were more positive than equity.

The vast majority of respondents (86%) said the draft determinations were tougher than they had expected, only 5% thought they were as expected.

Equity

Only one of the 14 equity investors had a positive view of the draft determinations, saying

"Challenging but not outrageous. Globally the UK is still the benchmark for regulation. A concern from a long term investor perspective is that good performers are not rewarded relative to bad."

13 had a negative overall view of the DD. Of these, eight said they thought Ofwat had decided the draft determinations to ensure it would result in level prices.

"Clever, politically driven determinations. Not an evidence-based DD but decided on the basis of no bill increases for customers."

Other negative comments, each made by one respondent, included

"Difficult for companies to out-perform the DD, even the leading companies."

"The DD fails to recognise good performers"

"Ofwat's judgement on all elements, with few exceptions, was at the tough end."

"Overall result was unbalanced with a particularly painful outcome for recent acquirers and infrastructure funds."

"Regulators should be neutral to capital providers but Ofwat's tone has changed."

"Nothing left to deal with shocks in a time of greater volatility."

"Harsh at any time but very harsh in the circumstances."

All 14 equity respondents said that the DD was tougher than they had expected.

"Expected it to be tougher than last time but not this tough."

"Individual parts tough but not unreasonable - taken together though it is unexpectedly harsh."

Debt

Three of the eight expressed a positive overall view of the DD. One of these said

"The determination looks fairly sensible. Ofwat has done as it said it would do."

Three were neutral about it, for example

"Harsher than expected but liveable with."

"Expectations of some equity analysts had been unrealistic."

Two debt respondents were negative about the DD. One of them said

"It is clawing back the outperformance of last period. This is inappropriate."

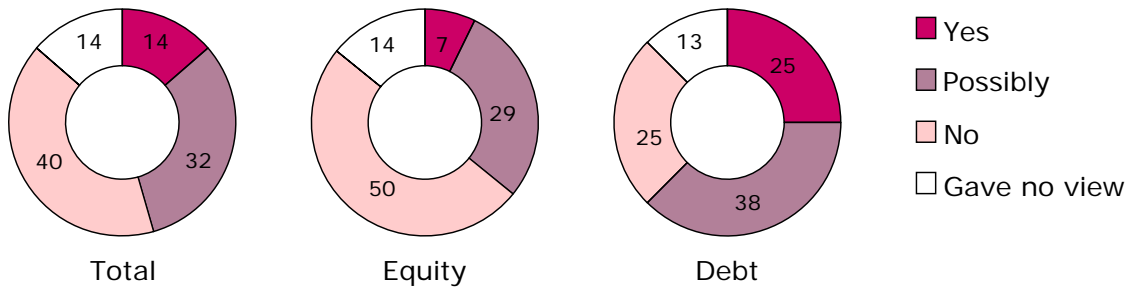
Four believed that the DD worked back from the answer of level prices.

In terms of their expectations, five said the DD was tougher than expected and one that it was as expected. Two gave no view.

Rating agencies

One observed that the DD was ratings neutral although another had put two quoted WaSCs and one WoC on negative credit watch. One gave no view on the basis that as a rating agency its job was to analyse and rate not take a view on the DD.

Q3. Will the determination mean that the companies will be able to earn a return equal to or greater than the sector (actual) cost of capital?



Total

Only 14% said that companies would be able to earn a return equal to or greater than the sector (actual) cost of capital. Twice as many equity as debt respondents were of this opinion.

Equity

There was a range of responses with seven (50% of the equity respondents) saying that the companies would not be able to earn a return equal to or greater than the actual cost of capital.

Four said either that it was possible that they would (one response) or that some would and some would not (three responses). Some noted that the individual companies' debt positions, in terms of when they had raised debt historically and when they would have to do so in future, would affect their outcome.

"Those that have locked in debt might manage: those that haven't will not."

One gave a marginal yes.

"Probably just. The cost of equity is too low but some might outperform the cost of debt and gearing assumptions."

Two gave no view.

Debt

Debt respondents were more evenly distributed in their view of whether companies would be able to earn a return equal to or greater than the actual cost of capital with

- Two out of eight saying yes
- Three saying possibly, some will some won't
 - "Performance dictated as much by when they need to raise money as anything"*
 - "Historic cost of debt will determine outperformance"*
- Two saying no
- One giving no view.

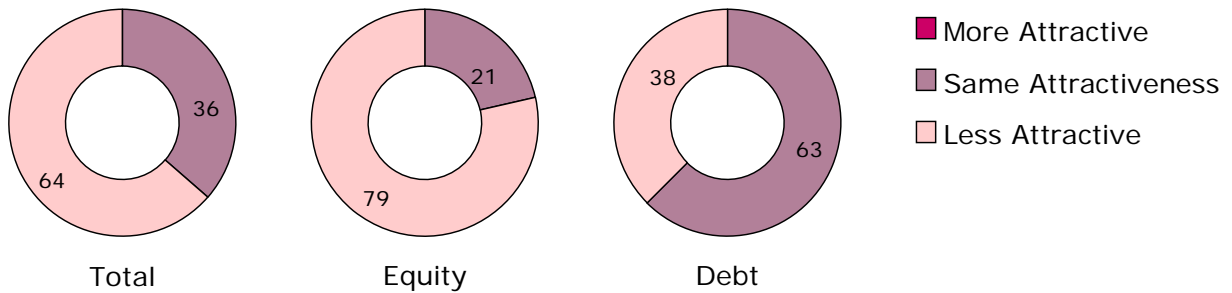
Ratings agencies

One said companies would.

"As the DD was ratings neutral the companies should be able to earn a return greater than the actual cost of capital."

The other two gave no view.

Q4. How have the draft determinations affected the attractiveness of the sector to you as an investor?



Total

Almost two-thirds said the sector was now less attractive with the remainder saying its attractiveness was unchanged.

Equity

11 (79%) said the sector was less attractive than before. Of these

- Four said they would not invest again in the sector
- Six referred to more attractive investments outside UK infrastructure
- One had sold a sizeable, long held investment in a quoted WaSC.

Some of their comments were as follows.

"The regulator should be clear about the new policy - selling the future for short term benefits – so it can be held accountable for the decision it has made."

"The regulator is a source and not a mitigator of risk."

"We will not invest again in UK infrastructure. There is a witch hunt for investors and Ofwat is determined to push down returns."

"Step increase in risk - the Pendulum has over-swung away from equity."

"Huge number of cheap companies need equity at the moment."

In answer to the question, only three equity respondents (21%) said the sector remained as attractive although their comments in discussion were not wholly positive, for example

"Sector is at a tipping point and will only be okay with more mitigations."

"This question is important given much world infrastructure is heavily discounted."

Debt

In contrast, five (63%) debt respondents said the attractiveness of the sector was unchanged. Their comments included

"The DD did not impact the cost of debt to the sector – this is set by the rating agencies"

"Still a safe, well regulated defensive sector"

"The attractiveness of the sector for debt has not been affected much by the DD. It is perhaps unattractive to equity even (when) acquired at 100% RAV"

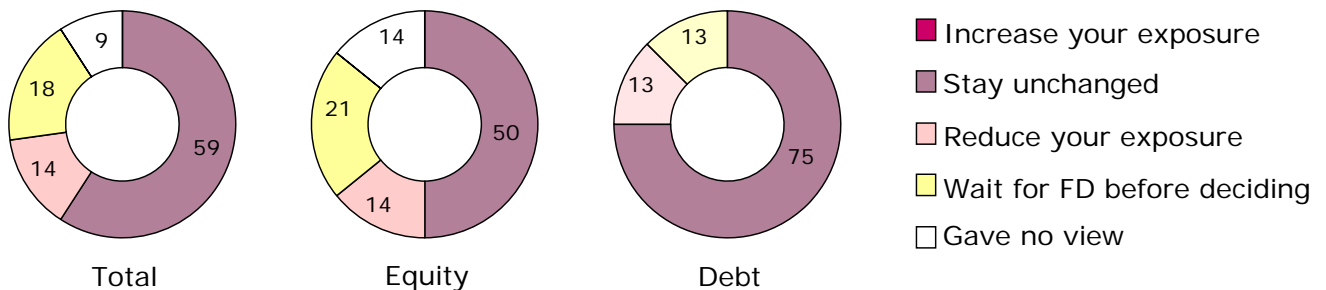
Two of these referred to potential risks from the competition agenda.

Three said the sector was less attractive.

"If the DD was like the FD, in combination with the other risks, we would sell BBB+ and reduce our exposure. In a BBB+ world our appetite for the sector would be less."

"The DD has caused angst and concern at senior credit committee level about the sector and also the DNO sector. They now see a higher degree of risk than they had previously thought. Against the record of low risk and regulatory stability they see this as a real change. This could have an impact on the cost and availability of debt finance."

- Q5. Relative to your current holdings, are you likely to
- Increase your exposure?
 - Stay unchanged?
 - Reduce your exposure?
 - Wait for the FD before deciding?
 - Other (specify)?



Over half of the respondents (59%) said they would not change their current exposure to the sector. Around a third said they would either reduce their exposure or wait for the final determinations. None said they would increase their exposure.

Of the seven equity investors (50%) who said their holdings would remain unchanged, five referred to the fact that their investments were illiquid. The two that said they would reduce their exposure were both investors in the quoted companies.

The majority of the debt investors (75%) said their holdings would remain unchanged and one indicated a reduction in exposure to the sector.

Q6. Are there any elements of the determination that you would wish to see changed in the final determination?

- a. Which aspects?
- b. What changes (quantified)?
- c. Why?

The answers to this question all related to topics covered by other more specific questions and have been included in the responses to these. In summary the following issues were raised

- The cost of capital
- Cost assumptions
- Risk and risk mitigation
- Capital Incentive Scheme
- Consistency of financial assumptions.

Q7. Are there any aspects of the determination about which you require more information?

Generally debt respondents were more comfortable with the level of information provided than equity.

- 11 of the 25 respondents (44%) said there was enough information in the DD. Of these two compared the DD favourably with Ofgem's Initial Proposals.
- The same number said that the information in the DD was inadequate. Some gave this answer because they said it was not possible from the determination to see how Ofwat's results came from its assumptions or how the determinations differed from the companies' business plans
- Three gave no view.

Those who wanted more information made the following comments.

"A number of areas in the DD do not provide adequate explanation of the methodologies or the rationale behind the decisions"

"More rationale for how the assumptions lead to the results"

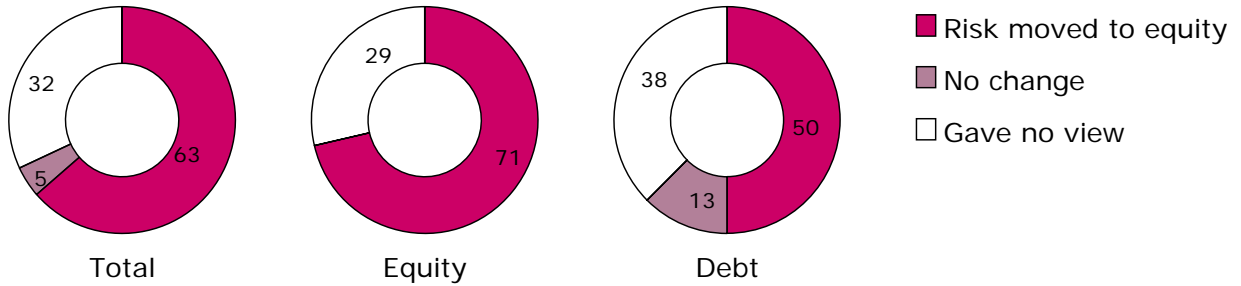
"Analysts need the workings and the modelling to understand how the headlines are derived from the detail"

Specific items about which more information was desired were as follows

- Company specific items
- Company expenditures and revenues rather than customers' bills
- Cash flows
- CIS and capex reductions
- Asset Management Assessment
- Tax calculations
- Pensions
- Energy cost assumptions
- Mitigation mechanisms
- Competition and its consequences.

Q8. Is it clear how risk is allocated between investors and customers?
 Q8.a. Has this allocation changed since the last periodic review?

We found that investors did not separate their answers to Q8 and Q8a and so we focused the interviews on Q8a and have reported the results for this question. It is reasonable to conclude that the investors who gave these answers thought it was clear about how risk was allocated.



Total

63% of respondents said that risk had moved to equity with only 5% considering there was no change.

Equity

Of the ten equity investors who gave a view in response to this question, all said that risk had shifted to equity.

"There is not a lot of risk for customers, it has moved to equity."

"There is more equity risk. Certainty in bills is not free. Equity is happy to bear risk to create certainty in bills but this should mean higher returns and bills."

"There has been a gradual drift in Ofwat's stance, which has been politically and legislatively driven. Ofwat wants to place more risk on investors."

"Ofwat's political meddling increases risk for customers by putting off investors."

Debt

Of the five debt investors who gave a view in response to this question, four said that risk had shifted to equity.

"Risk has clearly shifted from customers to investors"

"Equity has borne the brunt of the changes in allocation of risks - this is a good thing as it recoups the gains they have made in earlier periods"

"Debt is more exposed to risk and this could trigger dividend cuts, equity is squeezed by the low chance of outperformance and equity risk has increased"

"The risk for debt investors is broadly the same. The risk for customers has been decreased, compensated by an increase in risk for equity investors"

The other said *"It is arguable that the risk has changed but not much - the sector is still low risk"*

One rating agency said risk had shifted to equity. Two gave no view.

Q8.b. Have the risks changed since the last periodic review?

Six (three equity, two debt and one rating agency) saw little or no change in risk.

All of the others (19) referred to increased or new risks. The sources of risk they referred to are summarised in the table with the number of times each was mentioned.

Increased or new risk	Times mentioned
Capital market conditions	6
Economy	18
General reference	4
Bad debt	4
Deflation	4
Energy	3
Higher than predicted inflation/ILD	3
Regulation	21
General - regulatory risk	9
Risk mitigations	6
Competition	5
Pensions treatment	1
Other	7
Capex/opex harder to deliver	3
Climate change – flood & drought	2
Demographics	1
Aging infrastructure	1

Q8.c. What do you think about Ofwat's risk mitigation mechanisms?

The answers to this question were predominantly negative about the mitigation mechanisms as summarised in the table.

Negative views	Times mentioned
Mitigation mechanisms of no or less value to investors	8
Too few re-openers given volatile economic conditions	5
More limited upside implies need for more equity downside protection	5
Substantial adverse effects clause	
Threshold too high	4
Purpose should include the protection of incumbent equity investors	4
Insufficient information about how it will work	3
CIS should mitigate risk but actually increases it as a result of the complexity	5
Poor Ofwat processes and too much discretion	2
Neutral and positive views	
Ofwat can be relied on to mitigate if there is a need	4
Situation has changed little and Ofwat's mechanisms are adequate	3
Mitigations are less important from debt perspective	3

Q8.d. Do you have sufficient information about Ofwat's risk mitigation mechanisms and how they will be applied?

Of the 13 who responded to this question opinion was more or less evenly divided with seven (five equity, one debt, one rating agency) thinking that more information was required and six (two equity, four debt) being positive about the information on the mechanisms.

Two debt providers expressed a view that a degree of vagueness about the information on how Ofwat would apply the mechanisms was helpful to Ofwat's discretion on a case by case basis. Comments included

"The DD is reassuringly vague about the substantial adverse effect clause"

"As hinted by Ofwat, its discretion will be generous. This results from the determination being tight and is a good thing."

Q8.e. Has the initial determination by the Competition Commission (CC) on SES's substantial (adverse) effects (SAE) referral changed your view of risk in the sector?

Seven (four debt and three rating agencies) were positive about the Sutton and East Surrey (SES) outcome and commented favourably that it would reduce moral hazard and that they favoured Ofwat's emphasis on its discretion with respect to the substantial effects clause.

The 14 (11 equity and three debt) respondents who were negative about the outcome referred to the following issues.

- Too vague and discretionary to have value – seven respondents
- Clearly a 'shipwreck clause' – five
- Not intended to protect equity but should be - four
- Has damaged trust in Ofwat – four.

Their comments included the following.

"SES had a genuine case. The outcome increases uncertainty for investors."

"There is too much discretion for Ofwat on the remedy under the SAE clause."

"The effect is a lack of trust in Ofwat's use of the clause. Now unreliable."

"Ofwat's and the CC's handling of SES have been very poor – scandalous – and has sapped investor (particularly equity investor) confidence in the regime."

"It looks like punishment –the SAE does not protect equity investors which we thought it did"

"If the CC criteria are met then equity holders are toast."

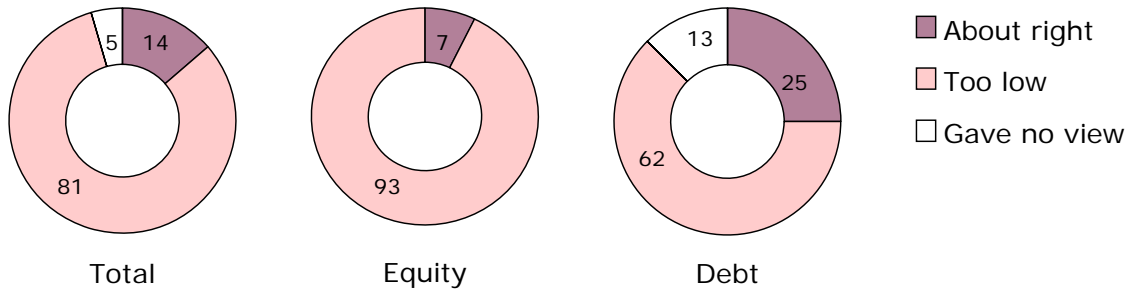
"The SAE is now seen as a shipwreck clause: with few NI's to save investors before the shipwreck. Any upside to investing in the sector has been lost."

"Ofwat has moved the goalposts, reducing the value of the mitigation factors."

"The SAE mechanism will probably only be used for system failure of several companies in difficulty due to the same events - less likely to be used in one-off cases."

2.2 Financial aspects

Q9.a. What do you think about Ofwat's WACC number, is it too high, about right or too low?



The discussions in response to this question were mainly about Ofwat's WACC number (4.5% fully post tax), although some also talked about the components of the WACC separately.

Total

81% of those responding said Ofwat's WACC assumption was too low, 14% about right (two debt and one equity) and none that it was too high.

Equity

13 out of 14 equity investors said the WACC was too low and one that it was about right. Estimates of the right level ranged from 4.5% to 5.25%. Eight of the nine responses were between 4.75% and 5.25%.

All of those (ten) who commented on the cost of equity said it was too low. Five of the eight who commented on the cost of debt said it was about right and three that it was a little high.

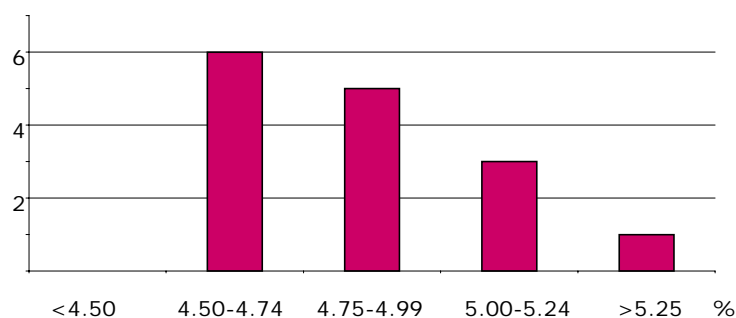
Debt

Two out of eight debt investors thought the WACC was about right, of whom one thought it was about right for today but possibly low prospectively, and five that it was too low. One gave no view.

Five said the cost of debt was about right.

WACC numbers

In discussion, 15 respondents (nine equity, five debt and one rating agency) gave numbers for what they thought Ofwat's WACC should be. The distribution of these numbers is shown in the bar chart.



From the source data we note that

- None gave a WACC number lower than Ofwat's
- Four agreed with Ofwat's number
- The averages, including those who agreed with Ofwat's number, were
 - All – 4.8%
 - Equity – 4.9%
 - Debt – 4.6%.

Q9.b. What do you think about Ofwat's decision on the WACC premium to be included in price limits for smaller companies?

Total

Nine said that there should be a premium for small companies and two said there should not. There were strong views about Ofwat's decision to remove the cost of equity premium.

Equity

Of the 14 equity investors

- Seven gave no view, all on the basis that they did not follow the small companies
- Two said there should be no premium – "small is not high risk"
- One said the premium as determined by Ofwat was about right
- Four said the premium was too small, three of whom said there should be a premium for equity as well as debt.

Comments included the following

- "There is insufficient Ofwat justification for changes in small company premium since PR04"*
- "Ofwat has ignored evidence on the cost of loans and without justification chosen figures at the low end for the small company premium. It has ignored transaction costs."*
- "Small companies cannot raise BBB+ bonds."*
- "Clear risk concentration issues for WoCS that have limited ability to manage specific risks."*
- "Independent NEDs are considering their positions due to risks inherent in the DD."*
- "There should be a different regulator for the WoCs in order that it understands WoC issues."*

Debt

Four gave no view and four supported the premium as determined by Ofwat. One of the latter said the small companies should be more active in exploring financing options.

Rating agencies

Two supported the premium and one gave no comment.

Q10. What do you think about the level of gearing Ofwat has assumed in its WACC calculation?
 Q11. What level of gearing should Ofwat have assumed?

Total

Eight considered Ofwat's assumption to be reasonable while five thought it was too low. Of those that said it was too low three thought it should be between 60% and 70% and two greater than 70%. A point was made to us that Ofwat had departed from its previous approach of taking a steer from the industry average level of gearing.

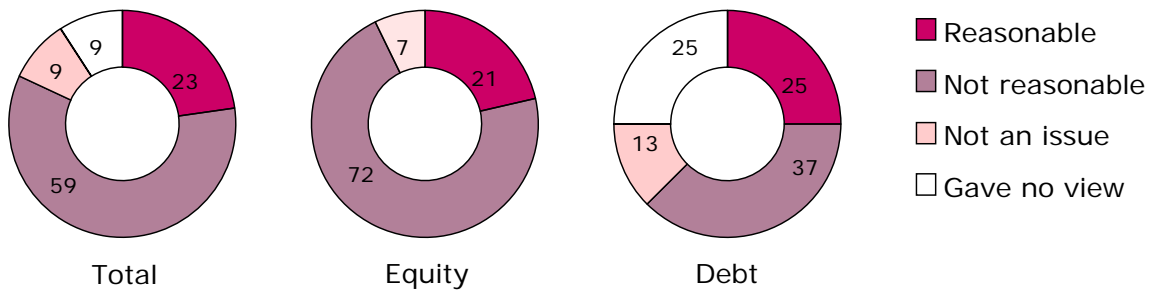
Equity

Five out of 14 said Ofwat's level of gearing was reasonable, three said it was too low, four said it was not an issue and two gave no view.

Debt

Two out of eight said that 57.5% was low given the BBB+ rating target for financeability, three thought it was reasonable and one said it was not an issue. One gave no view

Q12. What do you think about Ofwat's treatment of financeability?



Total

Almost 60% thought Ofwat's approach to financeability was not reasonable. Approximately a third thought it was either reasonable or that it was not an issue.

Equity

Three thought the treatment was reasonable, without qualification.

Five thought it was not reasonable. Two of these observed that some companies would have problems and one thought Ofwat should use the rating agency method of assessment, case by case. Four expressed a concern about Ofwat's index linked debt (ILD) assumption.

Five gave an answer of the form "reasonable provided the WACC assumption is reasonable but it isn't". In the chart, we have classed these as not reasonable.

One said it was not an issue.

Debt

Debt respondents' views were more diverse.

- One thought the treatment reasonable and that it was right that the companies should manage their own finances.
- Three said it was not reasonable with particular concern about access to ILD.
- One thought a case by case approach was needed, with particular concern about securitised entities and those with relatively little ILD. In the chart, we have classed this response as not reasonable.
- One said it was not an issue
- Two gave no view.

Two said that the use of BBB+ for the financeability test (rather than A- as in the WACC assumption) reflected Ofwat seeking to make the financeability test easier to pass without the need for adjustments.

Q13. Should Ofwat allow companies to recoup higher tax charges if companies receive equity injections?

Eight equity and two debt respondents said that symmetry would be correct and most expected symmetry in the FD. One of these commented

"If Ofwat wishes to see equity injected into the sector, it should not dilute returns by tax charges"

The remainder gave no view.

Q14. What credit rating should Ofwat assume in setting prices?

The table shows the distribution of answers.

Eight noted the need for consistency with other assumptions, including WACC, gearing and dividends.

The ratings agencies expressed no views on the rating Ofwat should use.

	Equity (14)	Debt (8)
A -	3	2
BBB +	8	5
No view given	3	1

In its DD Ofwat included the following statement.

"We understand investors appear to be less sensitive to the difference between high BBB and low A range ratings where utilities are concerned (p114)."

11 respondents commented on this, unprompted. With two exceptions (one equity and one debt), the respondents who commented did not support Ofwat's statement (two equity, five debt and two rating agencies).

Q15. What do you think about Ofwat's dividend policy assumptions?

Equity

Of the eight that responded, six said the numbers were too low. Of these

- Two focused on particular company situations
- One said that Ofwat was "ridiculously theoretical about dividends"
- One said Ofwat's assumptions could not apply to all cases
- Two noted an unwelcome shift in policy with Ofwat intervening in dividend policy in a way that would deter investment and one of these said

"I have no idea why Ofwat has said anything about dividends. People should be encouraged to outperform but Ofwat seems to have taken offence. Instead of letting incentives work it punishes those that have done well."

Only one suggested alternative assumptions - a yield of 6 – 7% and growth of 1%.

Debt

Two thought the assumptions were reasonable and one was concerned about individual companies. Five gave no view.

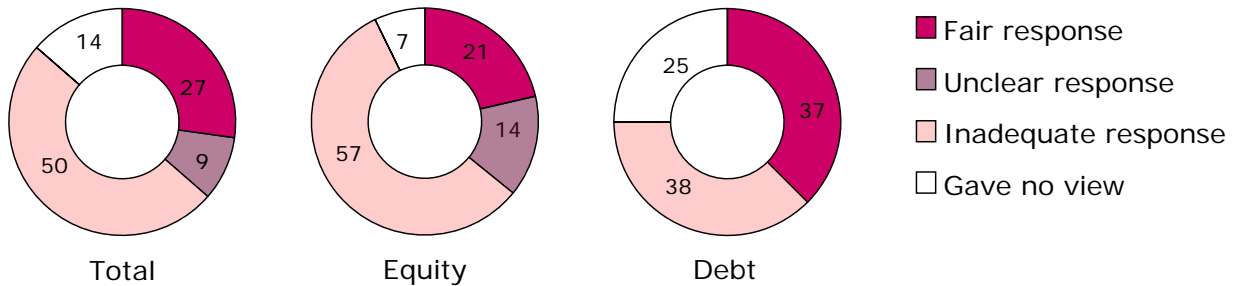
One ratings agency observed that debt investors would not wish to see prolonged or seriously inadequate returns to equity.

2.3 Treatment of general economic conditions

Q16. What do you think about Ofwat's assumptions about and treatment of the possible consequences of current economic conditions?

What about ...

- i. Inflation/deflation?
- ii. Potential for revenue to fall as a consequence of the effect of the recession on metered use?
- iii. Potential for bad debt to increase?
- iv. Other possible consequences of the recession (specify)?



Total

A quarter thought Ofwat's assumptions and treatment of current economic conditions were reasonable while half thought them unreasonable.

Equity

Eight (57%) thought Ofwat's treatment was inadequate, two said it not clear how the DD had dealt with these risks as between the cash-flows, the WACC and the mitigations.

Three (21%) said Ofwat's treatment was fair and that these risks were for companies to manage. One gave no view.

Debt

Three (37%) thought Ofwat's response to conditions was inadequate and the same number that Ofwat's treatment was fair and these risks were for companies to manage. One said

"Ofwat should not change its approach because of such circumstances"

Two gave no view.

Ratings agencies

One was positive about Ofwat's determination – "commendable considering volatility in the economy" and two gave no view.

2.4 Other aspects of the draft determinations

Q17. What do you think about Ofwat's treatment of capital expenditure?

What about ...

- i. CIS?
- ii. Efficiency assumptions?

Equity

Nine (64%) thought it was too tough. They made the following comments.

- "Ofwat ignored the evidence on capex costs and willingness to pay."*
- "Arbitrary adjustments, gave no reasons and this adds to risk."*
- "Ofwat's approach pushes down the effective WACC."*
- "Inconsistent with 5% yield – yield should be higher with no RAV growth."*
- "Removes innovation"*
- "Ofwat parked some areas of expenditure to keep headline bills down in the short term."*

One said that it was not material and one that it was reasonable. Three gave no view.

Debt

Three thought the treatment was too tough; one that it was generous, four gave no view.

CIS

Several respondents discussed the CIS at some length. In summary

- 15 respondents (ten equity investors, two debt and the three ratings agencies) had expected CIS ratios to range around 100
- Nine respondents said the scheme was too complex and was not understood by many investors
- Six said it was good in principle, but that it did not work and would have to be changed
- Three observed that constant changes to the regime creates risk
- Three said there should not be one sided adjustments
- Two said that the application appeared arbitrary with Ofwat ignoring the evidence and companies unable to replicate Ofwat's answers.

Quotes on this topic that had a positive tone were limited to the *"good in principle but ..."* kind.

Quotes from the negative side include

- "Absurd that no company has a ratio of less than 100"*
- "Why discourage necessary capex"*
- "Mind bogglingly complicated"*
- "An almighty fudge"*
- "CIS has been unfair, a mechanism for taking money from the system"*
- "Penal, politically motivated and will put off investors"*

Q18. What do you think about Ofwat's treatment of operating costs?

What about ...

- i. Energy?
- ii. Pensions?
- iii. Efficiency assumptions?

Two respondents, both debt, thought that Ofwat's approach to opex was reasonable.

Seven (three equity and four debt) thought that the allowances were too tough

"Operating costs are underfunded (power, pensions, abstraction charges) these should be reflected in costs or the beta."

"Ofwat did not sufficiently research energy forward curves."

"Pensions are a significant problem. Ofwat appears to have taken a more strident position – deficits are dependant on the equity market."

"Opex is just a balancing number for Ofwat and companies will be squeezed."

11 said that, in current circumstances, more flexibility was needed either in the form of headroom or re-openers with regard to

- Energy (four, although two thought Ofwat's energy line was reasonable)
- Pensions (four)
- Deflation (two)
- Inflation (two).

Q19. Is there anything more you would like to say about the draft determinations or Ofwat's approach?

Matters arising in response to this question are reported under other more specific questions.

Appendix: List of interviews

3i Investments

Phil White

Aviva

Ryan Staszewski

Barclays Capital

Jeremy Froud

Colonial First State

Christine O'Reilly

Deutsche Bank

Unnamed equity investor

Fitch Ratings

Oliver Schuh

John Hatton

Gavin Macfarlane

Hastings Funds Management

Valeria Rosati

Kanishk Bhatia

HSBC

Ben Broad

HSBC

Eric Lyons

Erico Lima

Udetanshu

Independent Advisor

Robert Miller-Bakewell

Invesco Perpetual

Stephen Anness

Stephen Lamacraft

JP Morgan

Callum Mitchell-Thomson

Legal & General Investment Management

Graham Taylor

Lexicon Partners

Unnamed

Lloyds Banking Group

Nick Walker

M & G Investments

Orlando Finzi

Macquarie European Investment Fund

Martin Stanley

Martin Baggs

Moody's Investors Service

Neil Griffiths-Lambeth

Stephanie Voelz

Ontario Teachers' Pension Plan

Unnamed

Standard & Poor's

Peter Kernan

Mark Davidson

The Royal Bank of Scotland

Peter Dooley

Andrew Blincoe

Threadneedle

Jonathan Barber

UBS

Paul Moy

Unnamed equity investor**Unnamed debt investor**