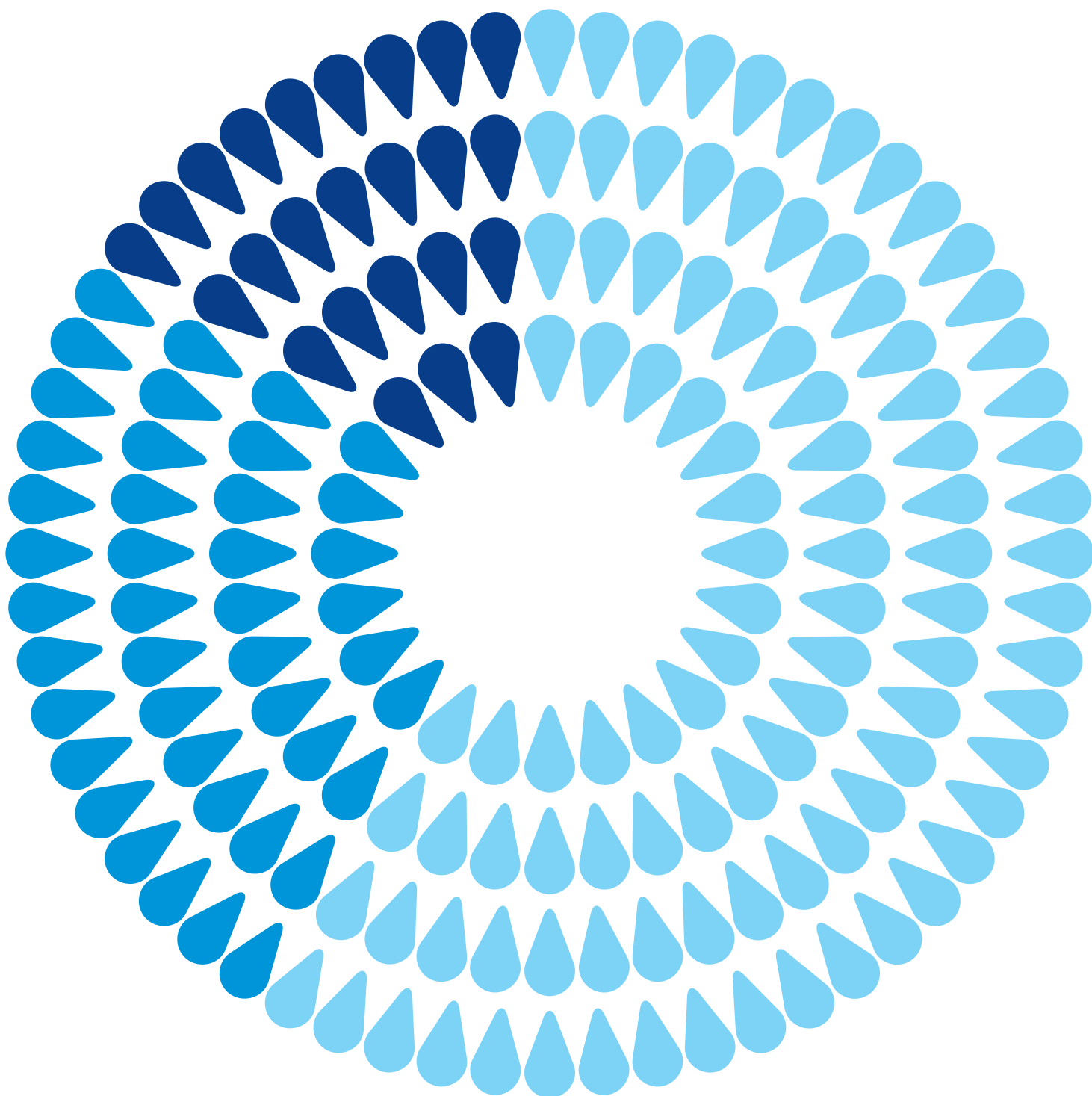


2008 Investor Survey

A report by Indepen
for Water UK

March 2008



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 and manage the associated political and regulatory risk.

We add value by developing business and regulatory strategy that takes into account stakeholder interests and is aligned with good public policy. We also work with boards on transforming organisations and their structures in support of strategy implementation.

Our work is built on our understanding and experience of government and regulators, 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.

Further information can be found at www.indepen.co.uk.

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The questions asked and survey results (Appendix B) can be found on the Indepen and Water UK websites at www.indepen.co.uk and www.water.org.uk.

Executive Summary

Introduction

Indepen was asked by Water UK to carry out the 2008 Investor Survey. It is the fourth investor survey sponsored by Water UK and benefited from the full support and engagement of Ofwat. Its purpose was to ascertain and share investors' views on the sector in a non-attributable manner and thereby contribute to better and more informed decision making by companies and policy makers.

The survey was timed so that it was able to gather early feedback into the 2009 Price Review (PR09) process, including investors' views on Ofwat's proposed methodology.

The survey reflects the results of interviews with organisations covering a comprehensive range of the investor community, including debt and equity investors and analysts, advisers, rating agencies and monoline insurers.

Key issues

Premiums

A majority of respondents to the survey expected that the current market share price premiums¹ (10-20%) for quoted water companies would, to some degree, remain. The important drivers behind the trading premiums were seen to include a significant appetite for owning water assets, a stable regulatory regime, as well as opportunities for financing outperformance.

A major driver behind transaction premiums² included changes in overseas pension requirements that led to a significant demand for assets that would match long term liabilities. Significant competition for these assets and incentives on infrastructure funds also contributed to the price paid. Factors specific to the water sector included significant RCV growth and high levels of regulatory transparency and consistency.

Nevertheless, some interviewees expressed concern that investors may have overvalued assets.

Risk

When asked about key risks facing the sector, regulation and management were named as the two key risks, with regulation ranked as the most important risk. Respondents' perceptions were also that certain risks (political, regulatory, force majeure and management) had risen since the 2004 Price Review.

When asked to compare water with other sectors and companies, respondents considered water to be more risky than UK energy transmission, on a par with UK energy distribution and less risky than electricity generation, UK energy supply and EU utilities generally. It was also seen as less risky than individual companies such as BT and BAA.

Financing

Respondents noted that there has been considerable disruption to the credit markets in recent months. This has affected companies' access to certain types of funding and has also affected pricing. This is particularly true for the highest slice of debt in highly geared companies.

¹ Premiums of share price to regulated capital value (RCV)

² Premiums of prices paid in transactions for water companies relative to RCV

Subject to the outcome of the current turn in the credit cycle and the maintenance of a stable and consistent regulatory regime, most respondents believed that the water sector is well placed to continue to finance its large capital programmes.

Most debt investor respondents also expressed the view that the type of equity owner in a company affected debt investment decisions.

Regulation

Respondents viewed Ofwat positively compared with many other regulators, especially non UK regulators. They have particularly valued Ofwat's transparency and consistency. This has meant that investment committees have become comfortable in lending to the sector.

As regards PR09, respondents held a range of views. Some considered that there had been no change in what Ofwat was trying to achieve. Others considered that Ofwat was reacting to political pressure, that its proposals were introducing greater and unnecessary complexity, or that it had not yet justified the need for change.

Respondents also raised a number of specific issues.

- Some wanted more information on how the proposals were to be implemented and what the cumulative impact of the changes would be.
- Some felt that Ofwat's proposals could potentially distort company decision making.
- Respondents were aware of Ofwat comments that it intends to bring down its assumption on the cost of capital. 97% of respondents considered that Ofwat should take action if, in setting prices, key company financial ratios were inconsistent with solid investment grade.
- Respondents were generally uncertain of the benefits of competition.

Comment

Ofwat and the regulatory regime are generally viewed positively by investors with water relatively well placed to continue to finance significant capital programmes subject to regulatory proposals and the stabilisation of the capital markets. The regime's strong foundations are based on transparency, consistency and communication which investors value. These attributes are especially significant to regulated companies with large capital programmes as they allow for a lower cost of finance than would otherwise be possible.

Some respondents expressed concern over Ofwat's proposed changes as reflected in the following investor quote

'Ofwat needs to maintain consistency and transparency. There is considerable value in credit teams and investment committees in understanding the regulatory and rating agency methodologies. This understanding is key to assessing investment opportunities and if Ofwat adopts an approach of change and inconsistency it may undermine investor appetite.'

The challenge facing Ofwat, policy makers and companies is how to build on the past successes of the regime in ensuring good continued market access at the same time as addressing the many and complex issues facing the sector. This is especially the case at a time of significant volatility and uncertainty in financial markets.

1 Introduction and background

1.1 Objectives

The Investor Survey is a mechanism by which water companies in England and Wales, policy makers, regulators and wider stakeholders can gain a better understanding of the views of the investment community and feed these into the price and policy setting arena. It seeks to inform debate around the issues and process involved in PR09 by tracking items from previous Investor Surveys, understanding changes in investors' views and exploring new issues in more detail.

Objectives for companies included a better understanding of the concerns of existing and prospective investors and what variations to the regulatory regime might result in changes in investor sentiment. Specific issues of interest included an improved understanding of the components of investor valuations and where it might be useful to improve awareness and understanding of regulation and the sector within the investor community.

For investors themselves, the survey is a non-attributable means of voicing views and concerns to companies and policy makers. It could also enhance their own awareness of the issues as well as their understanding of other investors' views.

1.2 Background

This is the fourth Investor Survey which has been sponsored by Water UK into the views of investors in the water industry of England and Wales. It benefits from the continuing full support and collaboration of Ofwat. For this survey, Ofwat joined the project steering group.

The focus of this survey is PR09. The previous surveys include two, in 2003 and 2004, during the build up to the 2004 Price Review (PR04) and one in 2005 to assess investors' views of its outcome. As in 2003, this survey presents an opportunity for investors to feed their views at an early stage into the price review process.

The environment and circumstances of the investor survey are relevant when thinking about its interpretation. This survey was undertaken between December 2007 and February 2008 which was a time when credit market conditions had deteriorated significantly from the benign conditions that existed from 2005 until mid 2007.

The survey was also undertaken

- after Ofwat had published its consultation on the proposed PR09 methodology³ and its report on the future of competition in the water industry⁴ (and the survey is published immediately before Ofwat's final methodology document)
- after the publication by the water companies of their Strategic Direction Statements
- before publication of the Government's strategy for water in England⁵.

More generally, the survey took place at a time of considerable change for the industry and at a time when it has an increased public and media profile. More extreme weather conditions, in the form of

³ Setting price limits for 2010-15: Framework and approach – a consultation paper, www.ofwat.gov.uk, October 2007

⁴ Market competition in the water and sewerage industries in England and Wales. Part one: water supply licensing, www.ofwat.gov.uk, December 2007

⁵ Future water: The Government's water strategy for England (<http://www.defra.gov.uk/environment/water/strategy/pdf/future-water.pdf>), February 2008

drought and floods, have had a direct impact, both in terms of the demands placed on water resources as well as on the water and sewerage infrastructure and operations of water companies.

The growth of infrastructure funds has led to more companies being held privately and higher gearing in the sector.

Additionally, the public policy environment is changing. As companies produce Strategic Direction Statements, Government policy on the environment and, in particular on the long term challenge of climate change, continues to evolve. Parliamentary inquiries have also been undertaken into the regulatory regime and floods.

Ofwat is playing its active part in the general public policy debate. The regulator has also started to take more direct action and impose financial penalties on some companies for failure to meet targets and misreporting.

1.3 Team

The survey was carried out by Matthew Parr, who led the project, John Hargreaves and Henry Wesson, all of Indepen. Both Matt and John were previously involved in the 2005 Investor Survey.

Angela Whelan, senior investment analyst at Ecofin, acted as an adviser to the team.

We were impressed by the fact that many senior people from the investment community were willing to give the time to participate in the survey. We would like to thank all those who participated in the survey for their time, their interest and always thoughtful contributions.

1.4 Structure

The report is set out as follows

- Approach and methodology
- Key findings.

A list of interviewees is attached as Appendix A to this report. The questions asked and survey results (Appendix B) can be found on the Indepen and Water UK websites at www.indepen.co.uk and www.water.org.uk.

2 Approach and methodology

Our approach and methodology were designed to ensure we

- identified and targeted the key issues
- engaged with a broad range of investors including those with specific expertise in the sector
- tracked changes in investors' views from the previous surveys
- received input from Ofwat and water companies on the issues covered
- provided early feedback to Ofwat to ensure input into the methodology consultation.

The survey was in two phases. Unlike the previous surveys this time we undertook a first phase of in-depth interviews to gain a better understanding of what investors thought the issues were and to refine the questionnaire which we used in Phase 2. The two phase process also allowed us to provide early feedback to Ofwat.

In each phase the respondents included investment professionals from infrastructure funds, quoted equity investors, debt and equity analysts, bondholders, banks, pension funds, corporate finance and debt origination advisors, monoline insurers and rating agencies. The list of interviewees is attached as Appendix A.

The majority of the Phase 1 interviews were undertaken between mid December and mid January. In total there were 23 in-depth interviews covering

- valuation issues
- credit markets
- regulation and PR09.

Phase 2 interviews took place between mid January and mid February. We undertook 37 interviews many with people who also took part in Phase 1. We covered

- general financing and valuation issues
- risk
- regulation and PR09.

The findings contained in this report are principally from the Phase 2 interviews. Where helpful, they are supplemented with additional information from Phase 1.

The interim findings from the survey were presented at the Water UK City Conference on 28 February 2008 (available on www.indepen.co.uk).

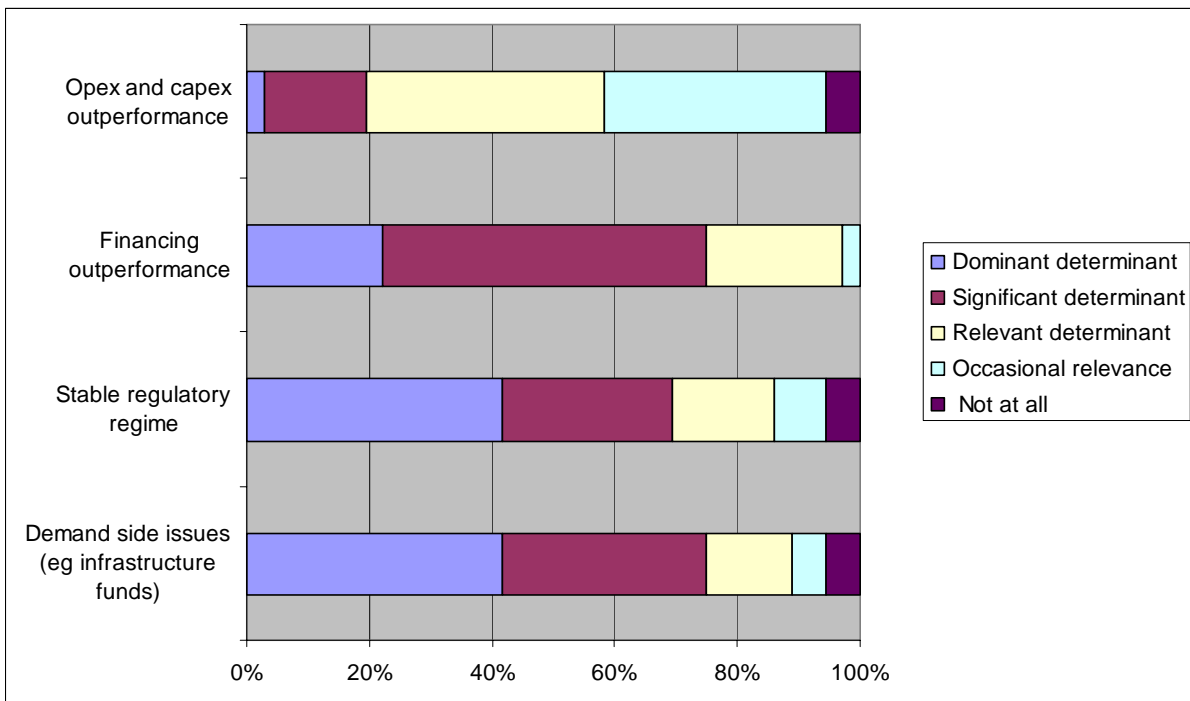
3 Key findings

3.1 General financing and valuation issues

3.1.1 Premium to RCV

Respondents were asked what they thought were the key drivers of the current market premiums (10-20%) for quoted water companies. Over 40% of respondents thought demand side issues (i.e. significant appetite for infrastructure assets) and the stable regulatory regime were both dominant determinants of the premium. Over half thought financing outperformance was a significant determinant. Opex and capex outperformance were seen as being significantly less important.

How important are the following drivers of current premiums of quoted water company market values to their regulatory capital value (RCV)? (36 responses)



While some made reference to 'exuberant liquidity' in financial markets and the 'wall of money', there was also a general recognition that the combination of appropriate lending vehicles and the fact that water companies represented unique and scarce assets implied that the premium was not just a transient feature. On the supply side, respondents referred to the transparency and thoroughness of the regulatory regime and the fact that it was tested, stable and well understood. These factors supported the financing structures and costs achieved in the sector. So far as financing was concerned, respondents referred to the influence of higher gearing in both the regulated assets and the holding companies as well as the impact of the 'credit boom' following the last price review.

Transactions

In Phase 1 we explored the factors driving the premiums to RCV paid in recent transactions. Respondents identified the following significant factors.

- Pension requirements, particularly in Canada and Australia, have led to a significant level of investment seeking to match long term liabilities with long term infrastructure assets. Certain infrastructure investments are particularly attractive if their revenues are linked to inflation. The recent establishment of European infrastructure funds has led to high levels of competition for control which has pushed up prices. By way of background, in 2006, Standard & Poor's⁶ estimated that \$100-150 billion of fund money had been raised globally and was waiting to be placed in suitable assets for the infrastructure sector. M&A activity increased by 180% between 2000 and 2006.
- Some equity investors tended to take a very long view of their investments, assessing value over a 25 to 50 year time horizon. Whilst valuing over the long term does not drive premiums, it does reflect the long term view of investors who may, under an incentive based regulatory regime, assume a degree of outperformance. RCV growth was also identified by some respondents as highly desirable and one of the factors driving the acquisition premium.
- The regulatory regime in the UK offered high levels of transparency and certainty compared with regimes in other countries. Some respondents also referred to the clarity provided by legislation and the licence arrangements.
- Growth in the number of infrastructure funds meant there was pressure for these new funds to acquire their first or seed asset which has generated strong competition for assets. Certain funds are also incentivised to undertake transactions and manage assets.

Respondents made a number of additional points.

- Higher prices may be justified in return for complete control as opposed to shared ownership.
- There may have been different risks in acquiring a business in a private to private as opposed to a public to private transaction. The latter, where a company would be delisted, was considered to be riskier, with a potentially higher profile and hence was less attractive.
- In the current credit market conditions, some investors who wished to own highly geared companies may have viewed companies that were already securitised as lower risk than those that would have to be newly securitised.
- Respondents observed differences between companies including scale, whether they were water only or water and sewerage, the quality of the management and operational characteristics such as metering and growth prospects. Respondents had a range of preferences.
- A small number of respondents considered that prices in recent transactions may have reflected some irrationality or mispricing of risk. They expressed caution that the regulator should not penalise existing investors for the possible mispricing of risk by some of the recent acquirers. In particular, they identified as a risk the potential for regulatory overreaction to recent premiums leading to an overly harsh regulatory review. They observed that this could result in a rise in the cost of capital or, *in extremis*, financial markets being closed to the sector.

⁶ The amazing growth of global infrastructure funds: too good to be true?, Standard and Poor's, November 2006

Future of the premium

The vast majority of respondents believed some sort of premium would continue over the next five years. The table below shows that 53% thought the level of the premium would decrease from current levels. The outcome of PR09 was seen as a significant factor in this, as were the economic fundamentals. However, while some pressures might tend to reduce the premium, a number of interviewees pointed out that the scarcity value of water companies would remain, as would the fact that they have a defensive value.

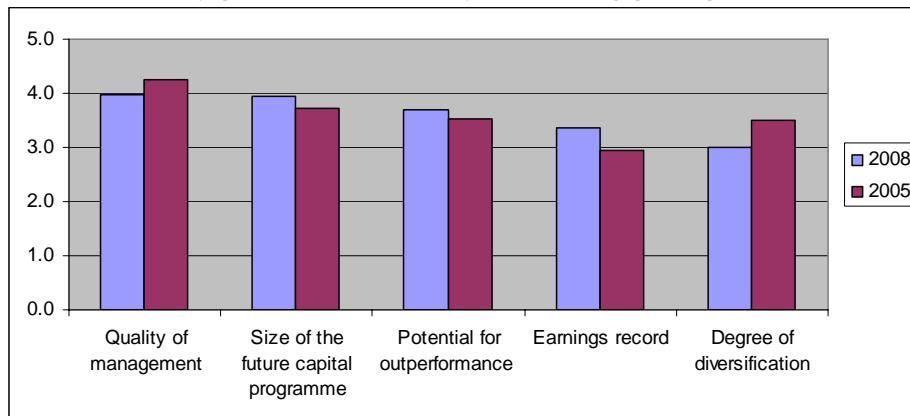
How do you expect the premium ratio to move over the next five years? (34 responses)

	Percentage
Up	0%
Stable	29%
Down	53%
No view	3%
Unsure	15%

Criteria for investing in water companies

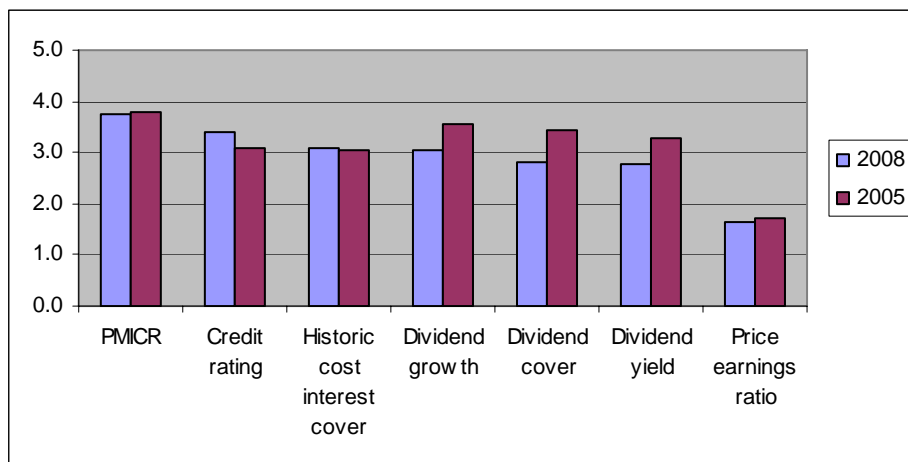
Respondents were also asked what criteria they used when deciding whether to invest in water companies. The average impacts of general and financial factors across all respondents are shown below. When compared with the results from the 2005 survey, it can be seen that there has been relatively little change in the general criteria, with quality of management proving to be marginally the most important factor in both years.

On a scale of 1-5, to what extent do you use the following general criteria when deciding whether to invest in a conventionally geared water company? (Assuming gearing of 55-65%; 30 responses)



As shown below, there was greater variation in the financial factors with credit ratings of greater importance in 2008 than 2005 and dividend measures less. It is noted that this might be assumed to reflect the increased proportion of privately owned highly geared, rather than publicly owned, companies.

On a scale of 1-5, to what extent do you use the following financial criteria when deciding whether to invest in a conventionally geared water company? (Assuming gearing of 55-65%; 36 responses)⁷



Separately, respondents were asked about the importance of general and financial factors when considering investment in water companies that were securitised. Compared with conventionally geared companies credit rating factors were more important under securitisation, dividend factors less so.

3.1.2 Prospects for funding

Changes in the cost of debt

The table below shows the results when interviewees were asked how the current incremental average cost of debt finance compared with 2004-05.

How does the current average cost of debt finance compare to 2004-05? (36 responses)

	Percentage
Higher	53%
Similar	17%
Lower	25%
No view	6%

Over half the interviewees believed that the cost of raising debt was higher than in 2004-05 and that this reflected the turn in the credit cycle. Respondents also observed that conditions were significantly worse than during the ‘credit boom’ which following the last determination.

Respondents indicated that credit spreads had widened significantly and that this was particularly pronounced for the higher slices of debt (often seen at the holding company level). Indeed, in some cases, prices for holding company debt were now higher than the returns required by equity. The higher cost reflected uncertainty in the markets, with banks balance sheets weakened, monolines under pressure and in some cases the value of their credit wrapping being discounted, a repricing of risk and, in other sectors, the approach of the rating agencies being questioned. In terms of the impact on water companies, while some companies had pre-funded for the remainder of the regulatory period (up to 2009), this was not the case for all. Uncertainty was prevalent as to the duration and depth of the current credit market difficulties.

⁷ PMICR: post maintenance interest cash ratio

Long term funding of the water industry

As in the previous survey (2005), the majority of interviewees did not have concerns about the long term funding of the water industry, although the proportion has reduced from over three-quarters (76%) to under two-thirds (61%) Of those that did have concerns a number expressed the concern that Ofwat might not maintain its current stable and reliable regulatory regime. A few expressed concerns about the risk of political influence over the regime; others about whether it was reasonable to assume that such high levels of capital expenditure could readily be funded. Of those who did not have concerns, a number commented that this was on the assumption that the current regulatory regime would continue.

Do you have any concerns for the long term funding of the UK water industry? (36 responses)

	Percentage
Yes	36%
No	61%
No view	3%

Looking ahead, and when asked whether specific sources of finance might not be available or competitive, a third of respondents expressed concern regarding the availability or competitiveness of index-linked debt, which many saw as a natural source of finance for water companies. Roughly half that number specifically referred to both very long dated bonds and other bonds wrapped by monoline insurers.

Debt funding shortfall

The table below indicates the extent to which interviewees felt there were circumstances in which debt markets might not provide the funds required by water companies.

Can you conceive of circumstances in which debt markets might not provide all the remaining funds needed by water companies? (36 responses)

	Percentage
Yes	67%
No	31%
No view	3%

While most (67%) said they could conceive of such circumstances, these were generally seen as unlikely. However, it was felt that they could come about should conditions in the credit market continue to worsen or if other external events caused debt markets to close. Changes in the regulatory regime that led to a loss of confidence among investors could also cause similar problems.

The percentage of those who could **not** conceive of the circumstances in which debt markets might not provide all the remaining funds has fallen steadily from 70% in 2004 to 56% in 2005 and 31% this year.

Prospects for the cost of finance for the next five years

When asked about the prospects for the cost of finance for the next five years compared with present levels, there was a variety of views. Future prospects were difficult to predict and, while some thought interest rates would rise slightly, others thought credit markets would eventually settle. This would lead to a reduction in bond spreads compared to current levels although most did not see them falling to the low levels of 2005-07.

Rights issues and dividend cuts

Interviewees were asked whether they thought companies would announce rights issues or reduce dividends to fund their capital programme. The table below shows that there was an equal split with 40% expecting these outcomes and 40% not. However, an overwhelming 86% did not think these would be a major source of funds.

Over the next five years do you expect any water companies to announce rights issues or reduce dividends to fund their capital programmes? (35 responses)

	Percentage
Yes	40%
No	40%
No view	20%

When asked what their reaction would be to such outcomes, the table below shows that nearly half would view them negatively. While overall only 20% would view them positively, this proportion was significantly higher for debt (36%) as opposed to equity investors (11%). A number of those that saw them as positive stressed the need for them to be supported by a strong rationale. Some respondents stressed the difference between rights issues and greater retentions in that the former could indicate distress and hence were regarded less favourably. Others favoured the maintenance of the dividend stream.

If one were announced, what would your reaction to the potential issue be? (35 responses)

	Percentage
Positive	20%
Neutral	23%
Negative	46%
No view	11%

3.1.3 Perspectives on industry trends

A number of questions were posed about perspectives on industry trends. Differences between equity and debt investors were frequent as equity investors were often the ones driving changes in ownership and financial structure.

More privately owned water companies

Overall, respondents were evenly split in their attitude towards further delisting and private ownership of water companies. However, within that equity investors were more positive towards it (61%) than debt investors (50% negative).

What do you think of the trend of more water companies being held privately? (36 responses)

	Percentage
Positive	31%
Neutral	31%
Negative	31%
No View	8%

Continued role for quoted equity

Respondents were also split over the importance of the role of quoted equity in financing water companies, although three quarters did attach some importance to it. Once again, there were

significant differences between equity and debt investors, with 35% of equity investors saying equity's role was not important, whereas only 8% of debt investors said it was not important.

How important is it to ensure quoted equity can continue to play a role in financing water companies (35 responses)

	Percentage
Not important	23%
Marginally important	29%
Important	26%
Very important	23%
No view	0%

Those attaching importance to the availability of equity tended to feel that it would not be wise to close down possible financing options for the industry in the future. A number also attached importance to the transparency and information provided by listed companies. A handful mentioned the need to retain a mix of financing models.

Equity owners and investment decisions

A series of questions was intended to ascertain the perspectives of investors on industry trends. One was aimed at debt investors only and indicated that 70% of debt investors believed that the type of equity owner influenced debt investment decisions.

Does the type of equity owner affect your debt investment decisions? (7 debt investor responses)

	Debt
Yes	70%
No	30%
No view	0%

A number of factors were seen to be at work. Some referred to the influence that the financial strategy of owners could have on debt investment decisions, others mentioned the length of owners' investment horizons or their expertise in infrastructure management. The extent to which investors were supportive of management was mentioned by others, and some respondents again drew attention to the significance of the distinction between complete control and shared ownership of a company.

Higher gearing

When asked about their attitude to higher gearing, there was a mixed response from investors with roughly a quarter saying they would feel positively towards it and the same proportion saying they would be concerned. 42% were neutral on the issue. However, equity investors were significantly more positive towards it (41%) compared with debt investors (17%).

Equivalent figures in 2005 were 34% concerned, 41% neutral and 24% positive.

What do you think of the trend towards higher gearing in the water sector? (36 responses)

	Percentage
Positive	28%
Neutral	42%
Concerned	25%
No view	6%

Those who were positively disposed towards higher gearing tended to feel it would be financially more efficient and was an incentive on the management to perform well. Some saw it as a business opportunity for the providers of debt. Those who expressed concern spoke of the increased risk for investors and the increased risk of default.

3.2 Risk

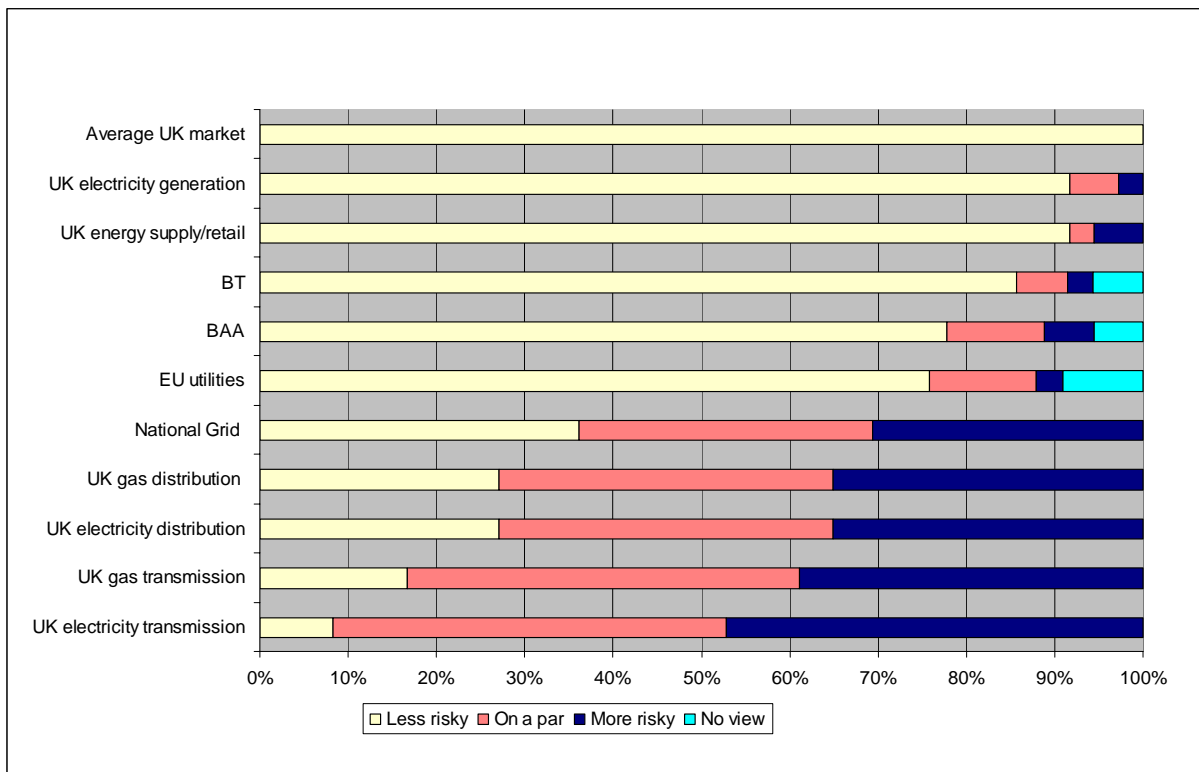
3.2.1 Relative risk

The graph below shows the views of respondents on the relative risk of the UK water sector compared with other sectors. It was viewed as being less risky than electricity generation, UK energy supply and EU utilities generally, as well as individual companies such as BT and BAA. Its risk was seen as being broadly on a par with National Grid and UK gas and electricity distribution but more risky than UK gas and electricity transmission. On the whole, debt investors thought water was less risky than did equity investors.

Some respondents explored the difference between the water sector and the regulated energy distribution and transmission businesses. They considered that water may have been more risky due to operational risk whether through manufacturing (water resources and treatment) or disposal risk (sewerage and treatment). Others cited revenue risk, environmental focus (EU directives, prosecutions) and the significant capital programmes.

On the other hand some saw gas as more risky than water because of the safety risk, greater demand sensitivities and higher investment profiles. Aviation was more risky because of terrorism.

Is investment in the UK water sector more or less risky compared with the following? (36 responses)



When asked whether they perceived investing in water-only companies (WoCs) to be more or less risky than investing in water and sewerage companies (WaSCs), there was no clear view. Those that saw WoCs as being less risky mentioned that they were less susceptible to Environment Agency and capital expenditure demands and were more focused. Those seeing WaSCs as less risky cited lower operational risk and improved ability to absorb shocks, greater size of the company and greater capability to deal with increasingly complex issues such as climate change and security of supply issues.

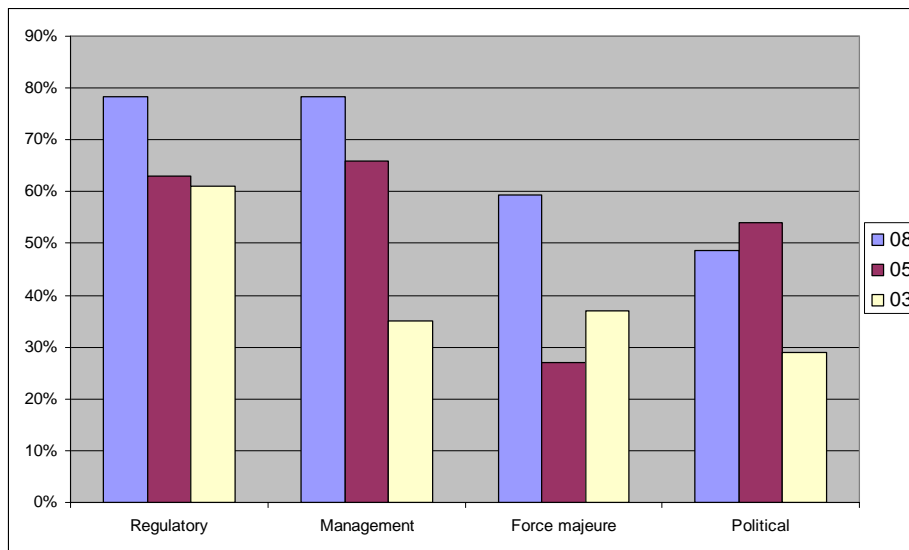
Do you think investing in WoCs is more or less risky than investing in WaSCs? (36 responses)

	Percentage
Less risky	25%
On a par	25%
More risky	36%
No view	14%

3.2.2 Key risks and changes since PR04

Key risks for water companies?

Which of the following are key risks currently facing water companies? (37 responses)



The chart above indicates what respondents believed to be the key risks facing water companies. 78% of respondents mentioned regulatory risk and management risk – the latter in terms of management’s ability or otherwise to meet its capex and opex commitments and targets. Force majeure and political risk were seen by approximately half or more of respondents as key risks while one third also referred to financing.

All risks were mentioned more frequently in 2008 compared with the 2003 survey (a survey undertaken at a similar period in the price review cycle), with mentions of management risk more than doubling. Compared with the last survey (2005) only political risk was mentioned slightly less frequently as a key risk. Although the questionnaires have been at different times in the regulatory cycle, whether this was the reason for the perceived increase in risk was not explored.

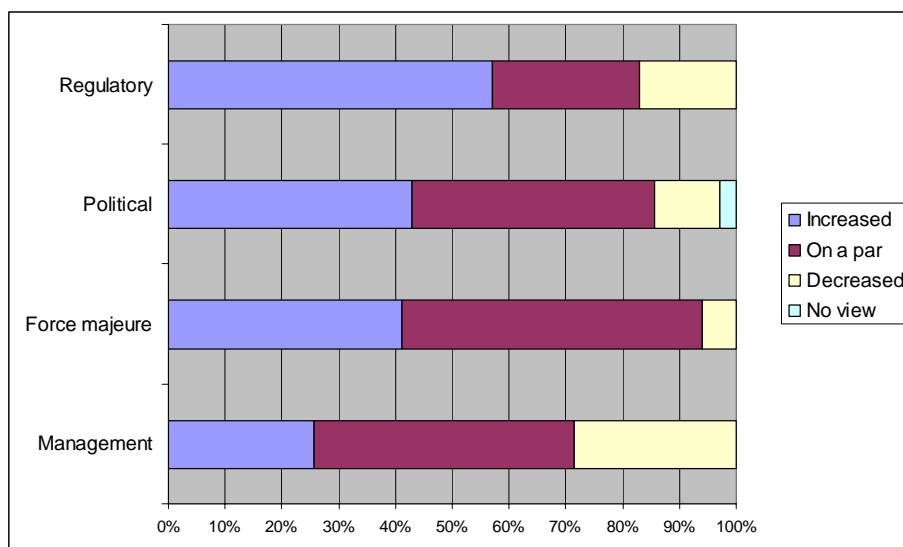
The following table shows the ranking of risk in 2008. This highlights the perceived importance of regulatory risk – identified as the most important risk by 72% of those who had deemed it a risk, significantly ahead of management and political risk. No-one considered force majeure as the most important risk, although it was the second most important risk for 72% of those who saw it as a risk.

Could you rank the top risks in order of most importance? (30 responses)

	Most important	2	3	4
Regulatory	72%	7%	3%	17%
Management	20%	16%	56%	8%
Political	12%	12%	29%	47%
Force majeure	0%	72%	6%	22%

Contrasting the views of investors in different years, the next chart shows how respondents this time perceived risk to have changed since PR04. Regulatory risk is seen to have increased by 57% of interviewees, while political and force majeure risks were seen to have increased by some 40%. Within this overall result, more equity investors than debt were concerned at the increase in regulatory risk. Once again, over one-third of all respondents also referred to the increase in financing risk since PR04.

How have political, regulatory, management and force majeure risks changed since PR04? (34 responses)



3.3 Regulatory regime

3.3.1 General views on the regime

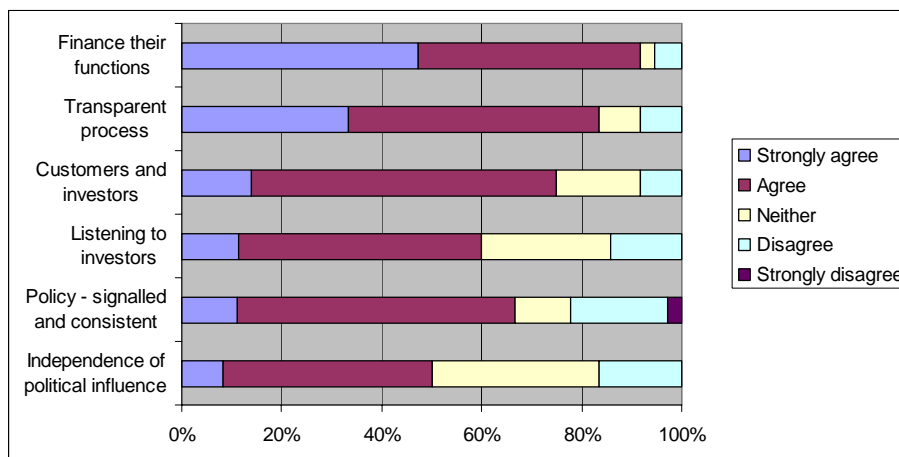
The following graph reports respondents' views of the regulator. This shows that at least half of respondents agreed or strongly agreed that

- the regulator is meeting its statutory duty to secure that water companies are able to finance the proper carrying out of their functions
- the regulator is independent of political influence
- the regulator is balancing customers' and investors' interests reasonably
- the regulator is adopting a transparent process

- the regulator’s policies are well signalled and consistent
- the regulator is listening to investors.

The lowest percentage of support concerned the regulator’s independence of political influence, where 50% agreed or strongly agreed that Ofwat was independent. There was a significant minority who thought the regulator’s policies were not well signalled and consistent (22%) or the regulator was not listening to investors (14%).

Please evaluate the following statements on the regulator’s current performance (36 responses)



Overall, results from the 2008 and 2003 surveys were broadly similar with the exception that 23% more respondents felt the process was transparent in 2008. Results were also similar when 2008 was compared with the 2005 survey, although fewer respondents in 2008 felt Ofwat listened to investors (reduction of 30% relative to 2005), had a transparent process (15% reduction) or displayed policy signalling and consistency (10% reduction). It should be noted that the 2005 survey was undertaken shortly after PR04 had been completed.

3.3.2 PR09

In its paper, ‘Setting price limits for 2010-15: Framework and approach – a consultation paper’ Ofwat set out its proposed approach for PR09.

When respondents were asked about what Ofwat was trying to achieve at PR09 and how that had changed since PR04 there was a wide variation in the responses. Some saw stability between the two price reviews as a major theme, both as regards content and process. Some were uncertain what Ofwat was trying to achieve with its proposals and others saw change. Some felt the regulator was responding to political influence, others that Ofwat was attempting to return benefits from financial outperformance to customers (and a few referred to perceptions of a generous PR04 settlement for companies). A number of respondents referred to the reputational and credibility challenge faced by Ofwat in determining an outcome that provided adequate returns for investors and fair prices for consumers. Some respondents referred to specific changes being proposed by Ofwat, such as competition, where understanding of the rationale and detail of Ofwat’s proposals appeared to vary.

When asked about how respondents viewed Ofwat’s consultation on its methodology for PR09, again there was a variety of views although the largest single response (36%) was negative. Amongst this group, main reasons mentioned included the fact that Ofwat was proposing to change a system that respondents did not think was broken and was introducing additional complexity. They also

expressed concern that Ofwat did not appreciate the importance of incentive mechanisms or the benefits of regulatory stability in providing finance to the sector. Those that viewed the changes more positively (28%) tended to refer to the transparent process Ofwat was adopting for discussing its methodology, rather than support for some of the specific changes being proposed.

A number of questions explored in more detail the views of respondents as regards some of the specific possibilities Ofwat had raised in its consultation. The results are in the table below. Some proposals were regarded positively, but most received a more negative response.

Views on Ofwat consultation on its PR09 methodology and proposals (36 responses)

	Summary	Positively	Neutral	Negatively	Need more info	No view
How do you view Ofwat's recent consultation on its methodology?	Slightly negative	28%	28%	36%	na	8%
Specific proposals						
- revenue corrected price control	Positive	58%	11%	19%	8%	3%
- proportion of index linked debt	Slightly Positive	33%	25%	25%	14%	3%
- menu regulation	Mixed and more info	22%	11%	25%	39%	3%
- no small company premium	Slightly negative	17%	29%	31%	9%	14%
- removal of notified items	Negative	17%	25%	47%	6%	6%
- no need for financeability uplifts	Negative and more info	14%	19%	31%	31%	6%
- shorter term evidence for the WACC	Negative	14%	6%	64%	14%	3%
- linking WACC to a market measure	Negative and more info	11%	6%	56%	28%	0%
- competition proposals	Negative	8%	11%	58%	19%	3%

Specific proposals were commented on as follows.

- What do you think about Ofwat's proposals for revenue corrected price control?

Most respondents (58%) viewed positively Ofwat's proposals for a revenue corrected price control which would, over the medium term, reduce revenue risk for companies related to consumption levels. The proposal aimed to remove a perceived disincentive on companies to promote water efficiency measures. Those that supported this option tended to express the view that the revenue risk related to consumption levels was an inappropriate one for companies to bear. Those against the change felt there should be separate and specific incentives on customers to improve water efficiency.

- What do you think about Ofwat's proposals of assuming a proportion of index linked debt in companies' balance sheets?

The option of assuming a proportion of index linked debt in company balance sheets was received slightly positively (by 33%). Those that did so saw it as a sensible move that reflected what was happening in the market. Those against the assumption felt the regulator would be forcing or pre-empting decisions that were a company's to make and hence constraining decision making or alternatively that to make such assumptions implied that these markets would continue to be open and a competitive source of future funding, which might not be so.

In Phase 1 of the survey it was pointed out that index linked debt was very attractive in a low inflation and interest rate environment but that these circumstances might not continue.

As regards other proposals, respondents wanted more information or comments were more negative.

- What do you think about Ofwat's proposals for menu regulation?

On menu regulation, many respondents remained to be convinced of the benefits suggesting it introduced more complex gaming incentives or that there was a risk of setting an inappropriate baseline. Those viewing it more positively saw it addressing some of the issues concerning information asymmetry between companies and regulator. 39% wanted more information on the subject.

As part of the Phase 1 interviews, one investor commented that it would be preferential for the regulator to publish future adjustments regarding menu regulation for rating purposes.

- What do you think about Ofwat's proposals for not assuming a small company premium to the weighted average cost of capital (WACC) assumptions?

Those in favour of retaining a small company premium (31%) felt it reflected higher borrowing costs for smaller companies.

- What do you think about Ofwat's proposals for the removal of the current notified items?

Many respondents (47%) also saw benefit in retaining the current range of notified items that have been put in place to cover potentially material costs that are uncertain when Ofwat make decisions on price limits.

- What do you think about Ofwat's view that there is unlikely to be a need for financeability uplifts?

Support for the view that there was unlikely to be a need for financeability uplifts was low, at 14%. Respondents remained to be convinced that uplifts could be dispensed with and others saw them as potentially essential, for example to help companies retain investment grade ratings. This is explored in more detail in section 3.3.4.

- What do you think about Ofwat's proposals for placing more weight on shorter term evidence for the WACC assumption?

The majority of respondents (56%) had negative views towards placing more weight on shorter term evidence for the WACC assumption. Respondents felt that an industry that invests for the long term should have prices set within a long term perspective.

- What do you think about Ofwat's proposals for linking an element of the WACC to a market measure?

56% were against linking an element of the WACC to a market measure and felt it would begin to undermine incentive-based regulation and were unclear exactly how Ofwat would do it. A limited number of respondents (11%) saw it as appropriate to link the WACC to such a measure.

- What do you think about Ofwat's competition proposals?

Respondents were sceptical of the benefits of competition with 58% viewing them negatively. Some were concerned that Ofwat was diverting resources away from the price review.

An investor in Phase 1 commented that there might be benefit in seeing what lessons could be learnt from observing competition in Scotland over the next two to three years before deciding what to do in England and Wales.

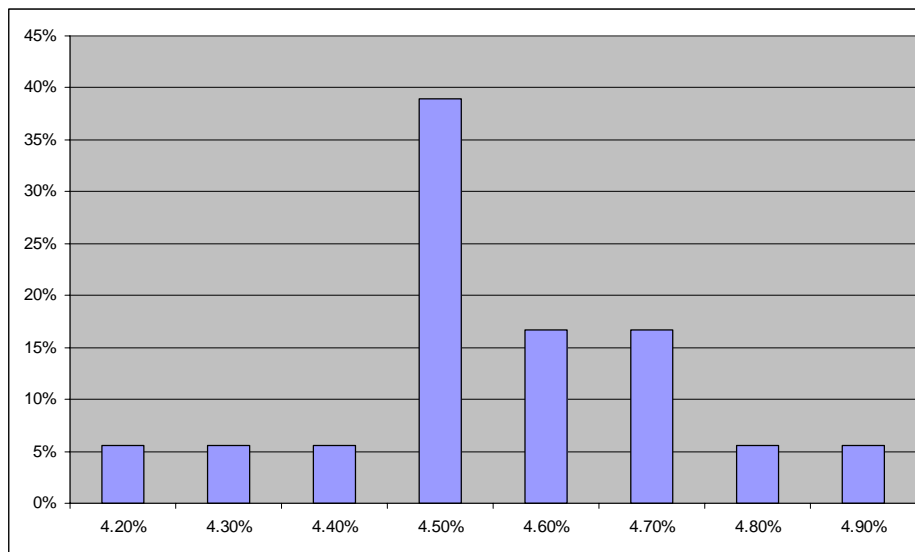
3.3.3 Cost of capital

Setting the cost of capital

Most respondents did not want to divulge what WACC they required Ofwat to set or felt it a difficult question to answer. Some said it was dependent on the relevant levels of risk and return and others pointed out that there were other measures by which to gauge performance.

When asked about what level of WACC Ofwat would actually set, 18 respondents were willing to advance a figure. As shown in the table below, most of these mentioned a figure in the range 4.50% - 4.70%⁸

What WACC do you think Ofwat will set? (Assuming gearing of 55-65%; 18 respondents)



Level of gearing

When asked what level of gearing Ofwat should assume in setting prices, 89% of respondents gave a figure between 55-65%, in line with Ofwat’s PR04 assumption, with the remaining 11% in the 66-70% range. Of those that indicated a level above the PR04 assumption some indicated that Ofwat would need to assume a level consistent with maintaining headroom relative to solid investment grade rating.

What level of gearing do you think Ofwat should assume for its WACC calculation? (27 responses)

	Percentage
55 - 65	89%
65 - 75	11%

In Phase 1 of the survey respondents mentioned a number of issues in relation to gearing and Ofwat’s proposals on tax: clawing back tax outperformance gained from gearing up and assuming tax in line with the notional level of gearing for those companies with gearing below that level.

Respondents’ views were mixed on tax clawback with some indicating it was fair. Others were opposed for a range of reasons: some investors had already benefited from gearing up; clawback might insulate underperforming management from acquisitions; it could put pressure on companies to gear up outside the ringfence; and that it was unclear how the methodology would be applied.

⁸ Post tax (equity and debt) cost of capital. This compares with Ofwat’s assumption at PR09 of 5.1%.

In terms of assuming tax in line with the notional gearing assumption (for those companies with gearing below the notional level) then some respondents thought it appropriate that customers pay a level of tax in line with an efficient balance sheet while others questioned whether Ofwat was well placed to identify an efficient balance sheet, and whether it would distort management financing decisions.

Small company premium

Just over one-third of respondents felt that the small company premium should be maintained, while just under a quarter felt it could be removed. 40% had no view, often because they did not invest in small companies. This compares with stronger support for the premium in 2005, when 70% felt that it should be retained.

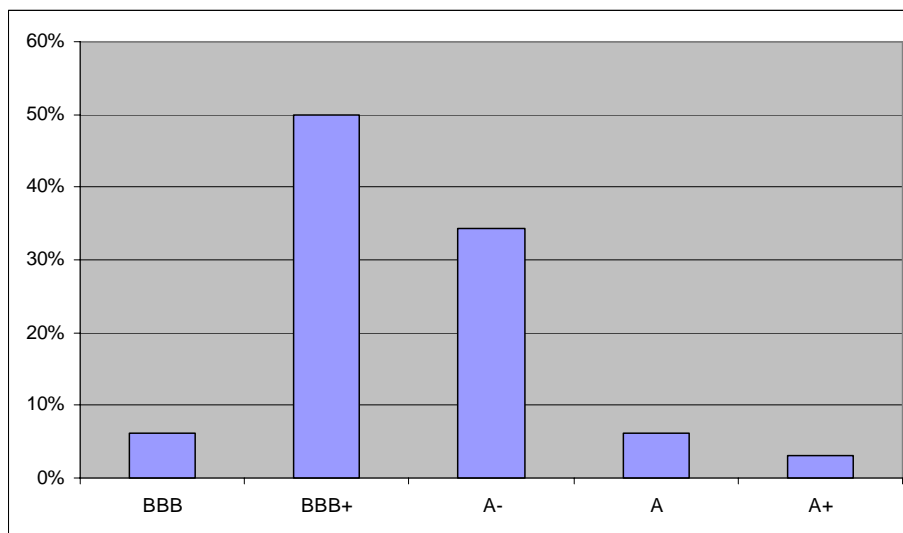
In future should the regulator continue to apply the small company premium? (26 responses)

	Percentage
Yes	35%
No	23%
No View	42%

3.3.4 Financeability

When asked what credit rating Ofwat should assume in setting prices, most respondents said it should be a solid investment grade, the vast majority specifying BBB+ or A-. Some raised concerns about the state of the credit markets and observed that Ofwat should be cautious in its approach.

What credit rating should Ofwat assume in setting prices? (32 responses)

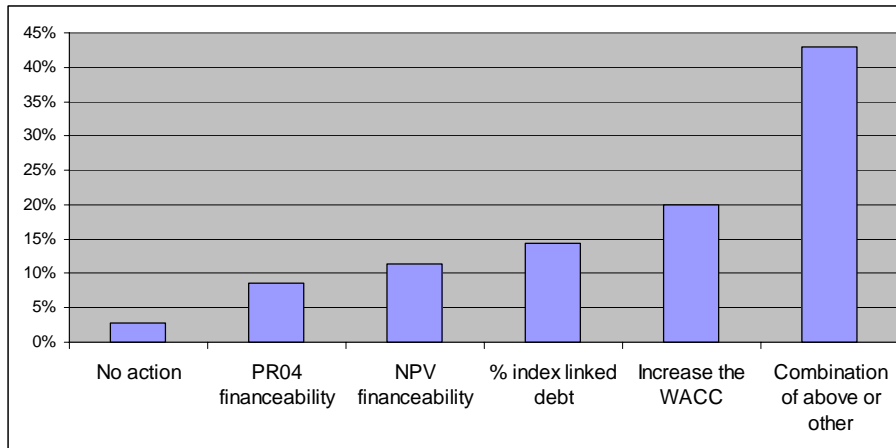


Key financial ratios

Respondents were asked what the regulator should do if the regulatory package were likely to breach key financial ratios. As shown in the graph below, only a small percentage (3%) felt the regulator should take no action. Others thought the regulator should introduce financeability uplifts as at PR04 (9%) or financeability uplifts in a net present value (NPV) neutral manner to be clawed back at a later point in time (11%). 14% felt the regulator should assume a proportion of index linked debt and 20% that Ofwat’s WACC assumption for the sector should be increased. 43% wanted a combination of the

actions with around half assuming a proportion of index linked debt and the application of an NPV neutral financeability uplift. Only one respondent specified rights issues or greater dividend retentions.

What should be the Ofwat response in response to breaches in key financial ratios? (35 responses)



Some scepticism was expressed about how the NPV neutral approach could work with the continuing demand to fund large capital programmes and whether index linking was a sensible solution given the less liquid nature of that market as well as the implied pre-emption of company treasury decisions.

Rating agency views

Do investors believe it is important for Ofwat to set prices consistent with rating agency views on investment grade credit rating? (34 responses)

	Percentage
Yes	85%
No	15%
No view	0%

85% of respondents agreed that Ofwat should set prices consistent with the views of the credit rating agencies. They also recognised the complexity of the situation and the interplay of a number of factors such as the credibility of agencies, the degree of transparency in the process, difference in approach between the agencies and the existence of different markets for different tranches of debt. Of those that disagreed a small number suggested that Ofwat should not slavishly follow the agencies and needed to develop its own view.

3.3.5 Competition

Ofwat’s recommendations⁹ with regard to the Water Supply Licensing Regime include proposals to

- remove the Costs Principle from legislation and replace it with a set of general criteria for access pricing
- reduce the threshold initially to a level of 5MI, to be followed as soon as possible by removing the threshold to include all non-household customers.

⁹ ‘Market competition in the water and sewerage industries in England and Wales - Part one : Water Supply Licensing’ December 2007

More generally Ofwat is considering cost allocation, value chain analysis and market analysis with the potential for structural separation.

What form of competition would be desirable? (29 responses)

	Percentage
None	45%
Outsourcing	21%
Wholesale	10%
Retail	7%
Other	17%

When asked about Ofwat's proposals for competition, respondents, as in Section 3.3.2 above, were sceptical. 45% of respondents did not believe competition was appropriate for the sector and there was limited support for wholesale (10%) or retail (7%) competition.

3.3.6 Mergers

The current water merger control requires that the Office of Fair Trading refers to the Competition Commission (CC) a merger of two water companies whose turnovers exceed £10m. The CC considers whether the merger has prejudiced, or may be expected to prejudice, Ofwat's ability to make comparisons between different water enterprises for the purposes of assessing performance and setting price controls. As shown below, 69% wanted to see change. The equivalent figure in 2005 was 40%, with 30% in favour of the status quo and 30% neutral.

What do you think of the current merger regime? (36 responses)

	Percentage
In favour of the status quo	8%
Would like to see change	69%
Neutral	22%

Appendix A: List of Interviewees

Interviewees (Phase 1 only)

Morgan Stanley & Co Ltd	Andrew Bishop
Newton Investment Management Ltd	Robert Canepa-Anson
Veolia	Richard Bienfaip

Interviewees (Phase 1 & 2)

3i Investments Ltd	Cressida Hogg
Barclays Capital	Jeremy Froud
Depfa Europe Plc	Ira Epstein
Ecofin Ltd	Chris Rowland; Joe Mangion
European Investment Bank	Jean Christophe Chaline; Joseph Blackenweiger; Florence Gaboreaud
European Credit Management Limited	Frances Hutchinson, Alexander Cattermole
Fitch Ratings Ltd	John Hatton; Stephen Edds; Greg Liu; Steve Durose
Financial Security Assurance (UK) Ltd	Douglas Segars
GIC Special Investments	Stuart Baldwin
Hastings Funds Management (UK)	Valeria Rosati
Invesco Perpetual	Stephen Anness
Lexicon Partners	Read Gomm
M&G Investment Mgt Ltd	Orlando Finzi
Merrill Lynch	Robert Miller-Bakewell
Moody's Investors Service Ltd	Monica Merli; Stefanie Voelz; Joanna Fic
Ontario Teachers' Pension Plan	Tanya Covassin
RBS	Peter Dooley
Standard and Poor's	Peter Kernon; Mike Wilkins
Threadneedle Asset Mgt Ltd	Jonathan Barber
UBS Global Asset Mgt (UK) Ltd	Paul Moy; Jaron Yuen; Stephen Deeley

Interviewees (Phase 2 only)

ABN AMRO	Jamie Tunnicliffe
Aegon	Laura Gallacher; Donald Phillips
Ambac Assurance UK Ltd	Mark Cheng; Gordon Rowan; Ralph Eley
Balfour Beatty Capital	Richard Leigh
Cheung Kong Infrastructure Holdings Limited	Joanna Chen
Deutsche Bank AG London	Martyn Nicholas
FGIC	Glenn Fox
HSBC Bank Plc	Erico Lima; Eric Lyons
HSBC Bank Plc	Richard Richmond
JP Morgan Plc	Callum Mitchell-Thomson
L&G Investment Management Ltd (UK)	Graham Taylor
Macquarie European Infrastructure Fund	Martin Stanley; Martin Baggs
MBIA UK Insurance Ltd	Deborah Zurkow; Adrian Jones; Max Blackler
Morley Fund Management Ltd	Quin Casey; Ryan Staszewski
Standard Life Investments Ltd	Karen Robertson
Standard Life Investments Ltd	Joanna Dormer
Threadneedle Asset Management	Alasdair Ross

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