



 Indepen

Investor Survey for Water UK (2009)

Water UK City Conference

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An introduction to the Investor Survey



Purpose

- To inform and support understanding amongst investors, companies and policy makers leading to better decision making

Approach

- Engagement with representatives of a range of financial institutions – both equity and debt – 8 January to 5 February
- In depth interviews (21) supported by a questionnaire (23)
- Ofwat participated as a member of the Project Steering Group

Context

- Post privatisation achievements of the sector and regulatory regime
- Dramatic deterioration in financial and economic conditions
- Within sight of the 2009 Price Review

Structure



How has the environment changed?

How do investors view risk?

What are investors' views on the regulatory regime?

How has the environment changed?



Financial and economic context – water sector



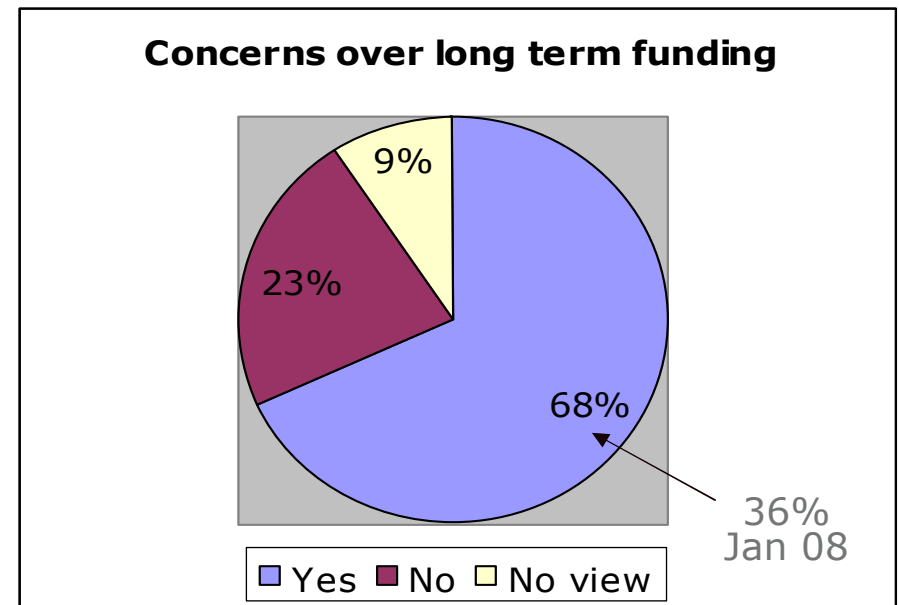
General market conditions have deteriorated and by more than investors had anticipated – both equity and debt

Sector related issues

- Funding environment
 - Magnitude
 - Access and price
- Economic environment
- Regulation

How should the sector respond?

- Companies
- Regulator



Funding issues – bond market (recent)



Since mid 2007 there has been a fundamental deterioration in credit markets and generic re-pricing of risk

Following the bond market closing, Autumn 2008, it is now open but focused on high quality names

- Some recent utility issuance over-subscribed
- Debt spreads 3-6 times earlier levels
- Benefit from low gilt yield at short end
- Focus on fixed bonds
- Index linked effectively closed (wrapped is)

Funding issues – bond market (prospects)



Investors remain concerned

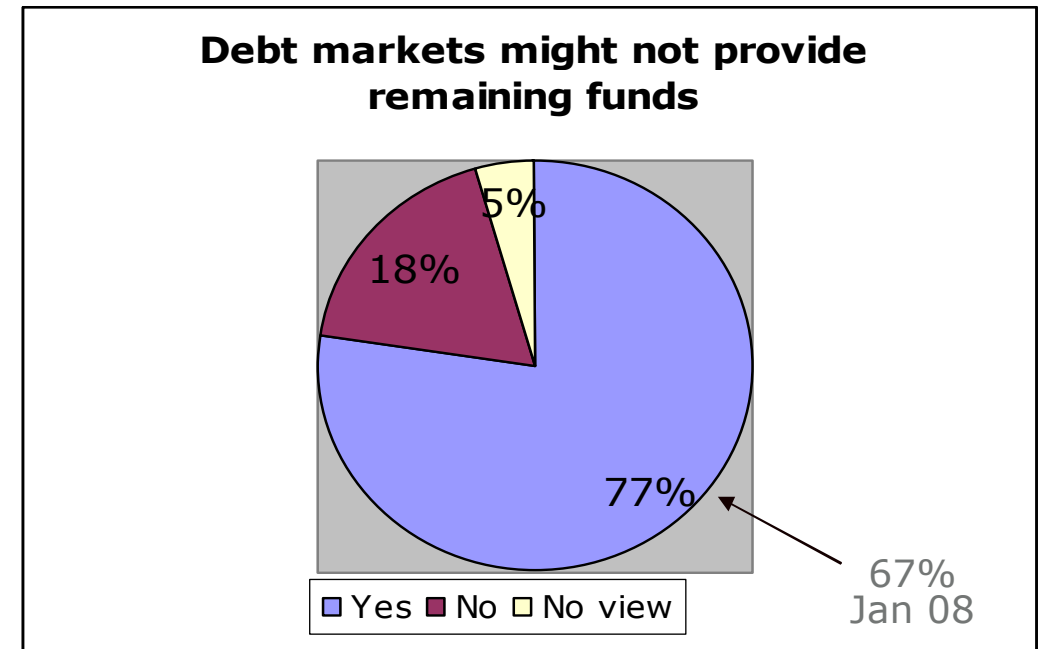
- Fickle market
- Might be a mini rally
- Exposed to impact of continuing negative news flow
- Sector risk – Depfa / Dexia?

Investors welcome

- Transparency
- Disclosure
- Liquidity

How will debt spreads change?

What prospects for gilt yields?



Funding issues - loans



Majority of water companies have five year facilities in place for AMP4

Banks' appetite for lending is much diminished compared to five years ago

- Banks seeking to re-build their balance sheets
- Continuing negative news flow anticipated
- Continuing sterling weakness anticipated
- Relationships require transparency on the return of capital and return on capital and this entails
 - Higher price, say, Libor plus 200bp-400bp depending on rating and term
 - Higher arrangement fees c100bp vs 25bp
 - Shorter terms – typically 3 year with steps up to 5 years

EIB remains an attractive source of loans

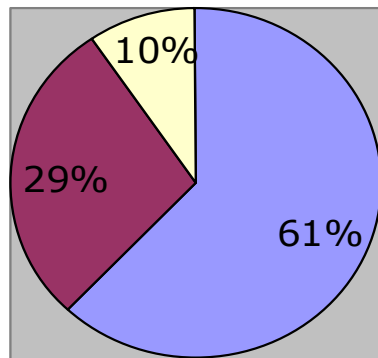
Funding issues - equity



Greater competition for equity capital for water now and in the future

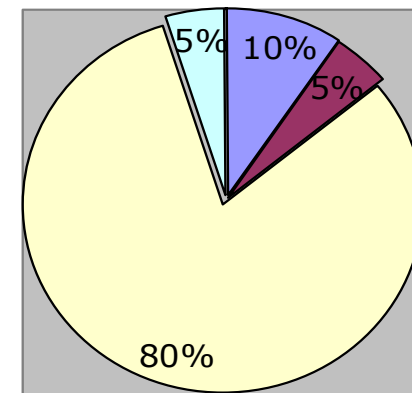
- Rights issues likely across the economy
- Overweight in infrastructure; infrastructure fund raising slowed
- Water dividend streams more volatile and liquidity issues

Expect a rights issues or dividend cuts



■ Yes ■ No ■ No view

Reaction to a rights issues



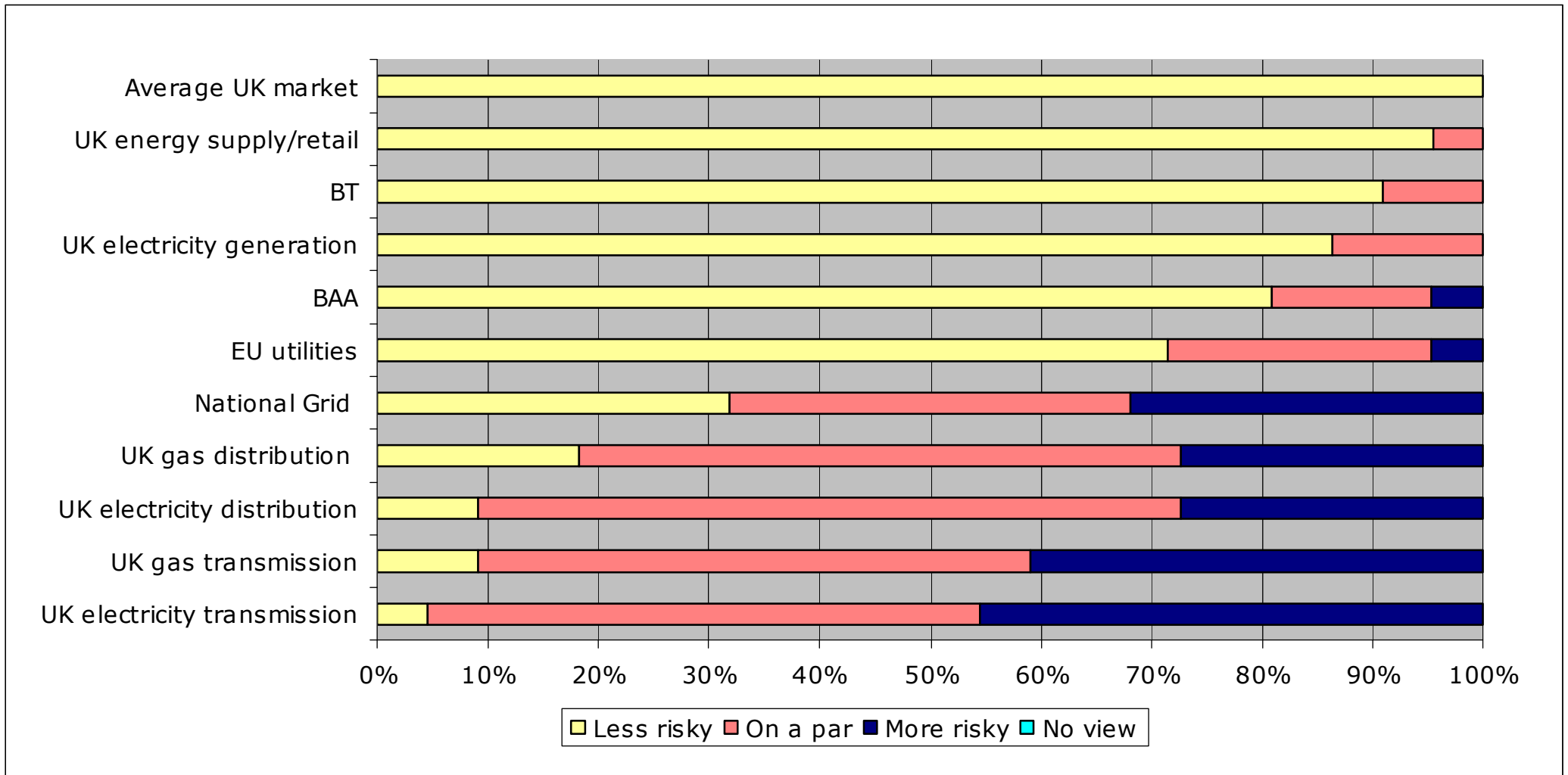
■ Positive ■ Neutral ■ Negative ■ No view

'What is the equity story for greater retentions or capital injections?'

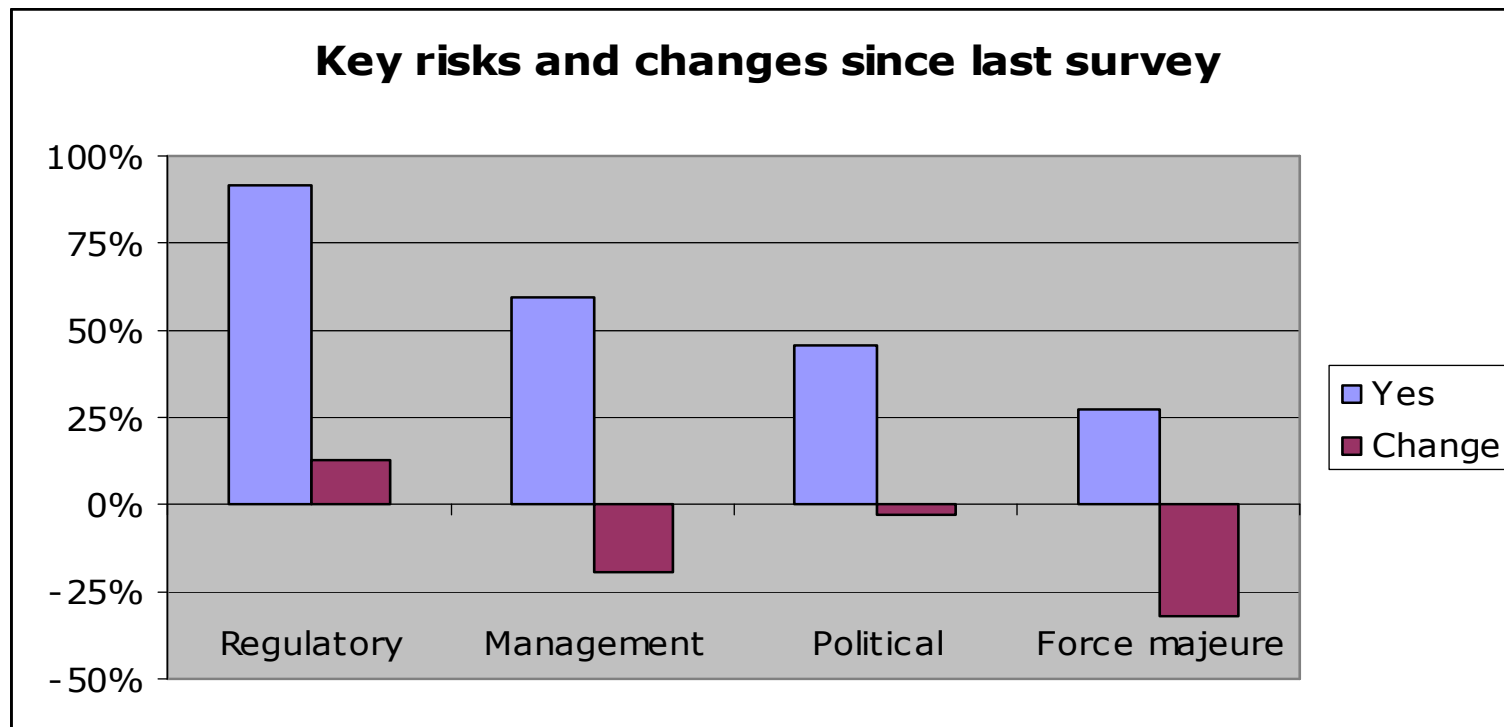
How do investors view risk?



Relative assessment of water



Key water sector risks



Importance of the risks



Investors were asked to rank the top five risks in order of most importance

Respondents	20 *			
	Most important	2	3	4
Regulatory	57%	29%	10%	5%
Financing	27%	36%	27%	9%
Political	18%	36%	9%	27%
Force majeure	17%	8%	25%	25%
General economy	17%	0%	50%	33%
Management	7%	33%	33%	27%
Other	0%	17%	0%	17%

* Max results for individual risk

57% of those that mentioned regulation considered it to be the top risk

Greater concern over the financial and economic environment than a year ago

What are investors' views on the regulatory regime?



Regulation - overview



The regulatory regime is generally viewed positively by investors

Although many are anxious

Investors suggest that Ofwat

- has become more aggressive
- has become more difficult to read
- has not said how decisions will be made

They say there is a lack of clarity about

- how the regulator will respond to the external environment - funding, liquidity, deflation, deteriorating economic conditions
- key policy positions and decisions – returns, gearing, pensions, etc
- competition and industry structure

Regulation – scoring on six performance factors



Respondents	21	-	23		
	Strongly agree	Agree	Neither	Disagree	Strongly disagree
Water companies' ability to finance their functions	13%	57%	22%	9%	0%
Transparent process	14%	45%	23%	18%	0%
Balance between customers' and investors' interests	9%	23%	64%	0%	5%
Listening to investors	0%	48%	29%	5%	19%
Policy signalling and consistency	14%	36%	18%	32%	0%
Independence of political influence	9%	43%	22%	26%	0%



Investors recognise that Ofwat faces a challenging task in fixing financial assumptions for a five year period although welcome the certainty it provides

A small number of investors suggested

- other options (e.g. indexation, cap/collar arrangements)
- companies with relatively large capex programmes would be disadvantaged

Investors' views on the WACC that Ofwat will assume have changed

- Last year, 56% thought Ofwat would set a WACC below 4.6%
- Now
 - None believe the WACC assumption will be below 4.6%
 - 90% believe Ofwat will assume a WACC between 4.7-5.1%

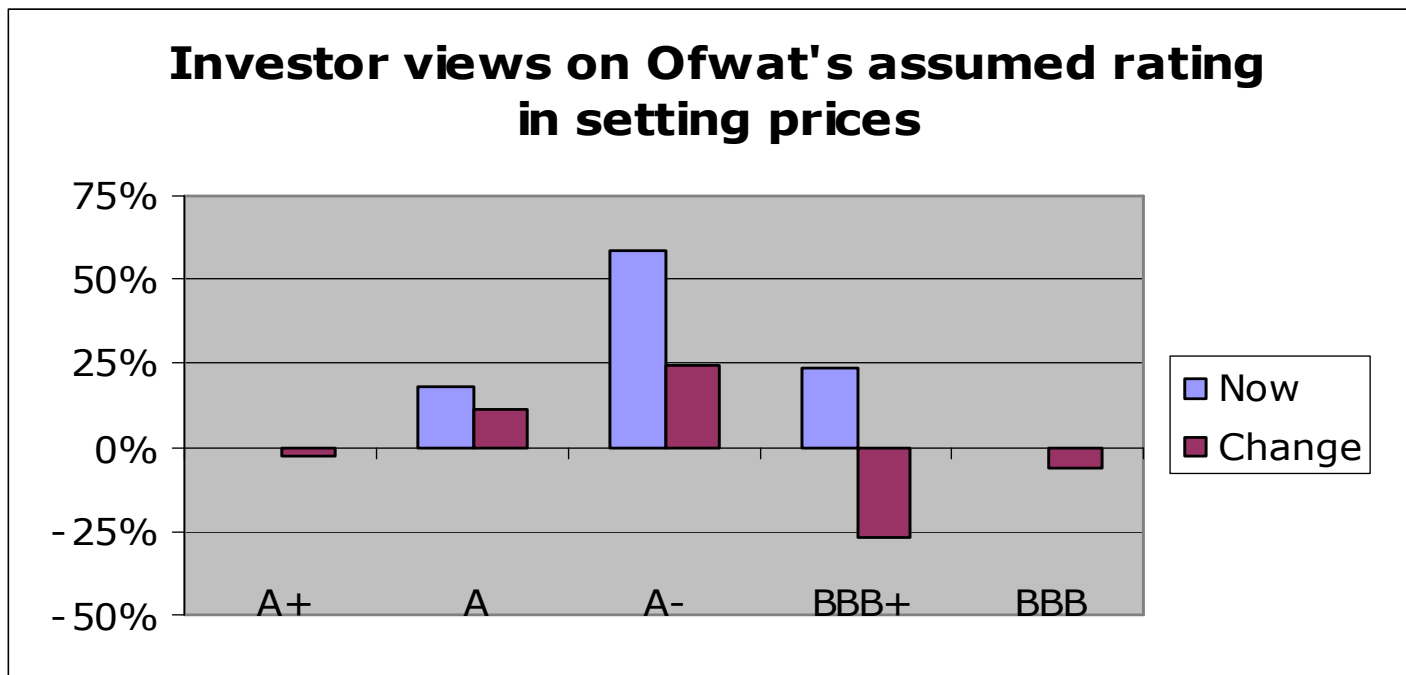
Access to capital is more difficult for small companies

30% thought Ofwat should apply a small company premium - 50% did not with many proposing industry rationalisation

Regulation – gearing and credit rating



'Is A- the new BBB+?'



95% (up marginally from 89%) believe Ofwat should assume gearing in the 55-65% range

Regulation – worsening conditions after PR09



Ofwat proposed the use of the existing SE Clause and deferral of capex in response to deteriorating conditions following the determination

55% of investors considered the SE clause positive as opposed to only 23% for capex deferral. There was a lack of clarity over how the proposals would work

- SE Clause – Sutton and East Surrey IDOK mentioned
- Deferral capex - essential investment and impact on performance

58% of investors did not consider that the mechanisms proposed by Ofwat would be sufficient

Key points and some questions



Since the last survey, market conditions have deteriorated significantly and by more than investors had anticipated

- Optimism about a quick end to the credit crisis has evaporated
- Growing uncertainty - depth / duration of depressed economic conditions
- Investors more cautious and sensitive to news flow

How should companies respond?

- Capital structures
- Capital requirements
- Sources of capital and liquidity management
- Investor engagement

Investors' regulatory concerns are heightened

How will Ofwat respond to circumstances unprecedented in its lifetime?