



Water UK 2005 Investor Survey Key Findings

**Dr Angela Whelan, Ecofin
Indepen**

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This report was prepared by Dr Angela Whelan and Indepen for Water UK

Dr Angela Whelan

Ecofin

Burdett House

15 Buckingham Street

London WC2N 6DU

T +44 (0)20 7451 2940

awhelan@ecofin.co.uk

www.ecofin.co.uk

Indepen

Diespeker Wharf

38 Graham Street

London N1 8JX

T +44 (0)20 7324 1800

johnhargreaves@indepen.co.uk

www.indepen.co.uk

Table of contents

Executive Summary	1
- <i>Objectives</i>	
- <i>The survey</i>	
- <i>Key conclusions</i>	
- <i>Results</i>	
Introduction	5
- <i>Background</i>	
- <i>Analysis and presentation of results</i>	
- <i>The survey team</i>	
Survey Results	7
Attitude to risk and considerations in making investment decisions	7
- <i>Risk relative to other sectors/companies</i>	
- <i>Perceptions of risks currently facing water companies</i>	
- <i>Impact of key factors on investment decisions</i>	
- <i>Trends towards higher gearing</i>	
Regulation	19
- <i>The regulatory process</i>	
- <i>Ways in which the regulatory process could be improved</i>	
- <i>Current merger regime</i>	
Prospects for the water sector	34
- <i>Dividend growth expectations</i>	
- <i>RCV and market value</i>	
Future funding of the water sector	37
- <i>Long-term funding of the industry</i>	
- <i>Future rights issues</i>	
Appendix A	41

Executive Summary

Objectives

Since 2002, the UK water industry has commissioned surveys to obtain up-to-date information on investor sentiment about the water sector. In common with previous surveys, the primary objective is to disseminate investors' views in a coordinated manner to stakeholders, including government and regulators.

As well as tracking issues identified in previous surveys, the 2005 survey pays more attention to issues associated with the regulatory regime, the processes that the Regulator and government have adopted, and the conduct and outcome of the 2004 Periodic Review.

The survey

The 2005 survey consisted of 41 interviews: 16 with debt investors, 22 with equity investors and three with rating agencies. The interviews covered most of the major shareholders and the main debt investors in the sector. Interviews with participants took place following the publication of Ofwat's Final Determinations on 2nd December 2004 with the majority of interviews carried out in January and February 2005. The respondents are listed in Appendix A.

Key conclusions

Investors are very positive towards the Regulator and the regulatory process: a large majority said that the 2004 Periodic Review had been fair and that the process was transparent. It was felt that the Regulator had listened to investors. However, investors noted aspects of the Periodic Review which were not transparent. In particular, uplifts to the allowed cost of capital for financeability were not sufficiently well explained and investors did not understand the justification for the significant changes between the Draft and Final Determinations.

Investors indicated that, now the Periodic Review was concluded, the major risks facing the sector now related to management, particularly the challenge of delivering the required outputs within the price limits, given Ofwat's assumptions about opex and capex efficiency. With the completion of the 2004 Periodic Review, regulation and politics were relatively less prominent risk factors, although still significant.

The 2004 survey, which had been conducted prior to the completion of the Periodic Review, revealed that investors had major concerns that there would not be the political will to allow prices to increase enough to reflect the cost of the sectors' future financing requirements. This concern appears to have receded with 65% of investors saying that that the regulator appeared to have demonstrated appropriate independence from the political process.

Results

Risk and other investment considerations

Importance of different types of risk

Investors said that the management of water companies was the most important area of risk now that the 2004 Periodic Review was complete: in particular, they said it was more important than the risks now arising from regulation and political interference. These findings contrast with those of the 2004 investor survey, which took place during the 2004 Periodic Review: investors at that time regarded regulatory risk as relatively more important than management risk.

Capex and opex efficiencies

The most common reason cited by investors for their views on management risk was uncertainty about whether companies would be able to deliver the required outputs within the price control, given Ofwat's demanding assumptions on opex and capex efficiency. Nevertheless, although regulatory and political risks were not investors' dominant concern, a majority said that both regulation and politics continue to have elements of uncertainty associated with them.

Risks of the water sector compared with other sectors

Investors' perceptions of the overall level of risk for the water sector, relative to other sectors and companies used as comparators, were broadly consistent with the findings of the 2004 survey. However, compared with 2004, a greater proportion of investors saw water as less risky than both electricity distribution and NGT. Investors viewed the electricity distribution sector as the most comparable to the water sector in terms of risk.

Quality of management central to investment decisions

Investors' views about management risk were consistent with the factors they considered important when deciding whether or not to invest in UK water companies. The quality of management was the most significant single consideration, with the size of future capital programmes, potential for out-performance and degree of diversification, all viewed as relatively less important. In 2004, investors said that quality of management was relatively less important than these factors.

Post-maintenance cash-based interest cover is regarded by debt investors as the most important financial indicator in making investment decisions.

Dividend cover, dividend growth and yield were regarded as most important by equity investors, the majority saying that they were significant or dominant determinants in their investment decisions.

Net debt/RCV. As in the 2004 survey, respondents were almost unanimous in their view that net debt/RCV was an important consideration in making investment decisions.

Investors said that investment criteria for the water sector did not fundamentally differ from those for other investments, although some investors said that a different type of investment analysis is required for regulated businesses.

The regulatory process and the outcome of PR04

Investors were very positive towards the Regulator and the regulatory process: a large majority said that the outcomes of the 2004 Periodic Review were fair, that the process was transparent and that the Regulator listened to investors. While the majority of investors consider that they were treated fairly, they observed that some aspects of the outcome, in particular Ofwat's assumptions about capex and opex efficiency, were demanding.

Although virtually all investors agreed that the Regulator had adopted transparent processes during the 2004 Periodic Review, fewer agreed so strongly that the outcomes were transparent. In particular, investors thought that the reasoning behind the financeability uplifts and the significant changes between the Interim and Final Determinations were not sufficiently clear.

Cost of capital

Most equity investors were comfortable with Ofwat's approach to determining the cost of capital, recognising that his approach was a judgement based on technical analysis and investor input. A minority said that more emphasis should be placed on investor views and market observations. In

relation to the 5.1% real post tax cost of capital allowed by the regulator, 76% of equity investors thought it was about right. A small number of investors thought it was too high and one that it was too low.

Ways in which the regulator can improve the process

The main suggestions for improving the regulatory process included:

- extending the regulatory period beyond the current five years
- increasing consistency with other Regulators, such as Ofgem.

However, the majority of investors indicated they believed that the current process is working well.

Independence of the regulator

The 2004 survey revealed that investors had major concerns as to whether there would be the political will to allow prices to increase enough to reflect the cost of the sectors' future financing requirements. This concern appears to have receded with 65% of investors saying that the regulator appeared to have demonstrated appropriate independence from the political process.

Prospects for the sector

Equity investors were more optimistic about the future performance of the water sector compared with the 2004 results, although the majority expected real earnings per share growth to be less than those for the UK market as a whole.

Dividend growth

Of those that offered a view (around two thirds of equity investors), around 50 per cent expected real dividend growth from the sector to be in the range of 0-2% pa over the next 5 years and a further 40 percent expected real dividend growth in the range of 2-4%. Growth in the water sector was expected to be lower than the overall market.

Equity investors had mixed views about how market values would move compared with RCVs over the next five years, with a majority expecting them to be at a premium or to fall to parity.

The merger regime

There was no clear consensus view about the merger regime. Around 40 per cent of investors would like to see change with 30% neutral and 30% in favour of maintaining the status quo. However, there was a difference in the views of debt and equity investors with more equity investors in favour of change compared with debt investors.

Future funding of the sector

The majority of investors did not have concerns for the long-term funding of the UK water industry. This represents a significant change from 2004, when almost 70 per cent believed there were funding risks associated with the capital programme from 2004 onwards. Those who did have concerns commented on the impact of the trend towards higher gearing, management issues and the large ongoing capital expenditure programmes.

Rights issues

The majority of investors surveyed did not expect companies to announce rights issues or to reduce dividends to fund their capital programmes.

Debt markets

Almost 80% of the investors surveyed either expected that debt markets would provide the funds needed by water companies or said that the debt markets might not provide funds only in circumstances which were remote or specific to an individual company. This is a similar result to 2004, where 70 per cent of investors surveyed believed that the debt market could be relied upon to fulfil future funding requirements.

Debt investors continue to believe that companies should retain at least a thin layer of equity for a sustainable financial structure.

Over 70 per cent of debt investors said that differences in the type of equity owner affect their investment decisions. The majority said they preferred publicly quoted companies as owners, but nearly all investors said that it was the strategy rather than the type of the owner that had the biggest impact on debt investment decisions.

Introduction

Background

Supportive capital markets are essential to a sustainable UK water industry. Since 2002, Water UK has commissioned surveys to obtain up-to-date information on investor sentiment about the sector from the full range of investors. They have enabled investors' views about the UK water industry to be disseminated to stakeholders, including government and the Regulator.

The 2004 investor survey provided an important input to the regulatory process for the 2004 Periodic Review. As well as following up on some of the issues covered by previous surveys, the 2005 survey pays more attention to opinion about the wider regulatory regime and the processes that the Regulator and government had adopted. Specific objectives of the 2005 investor survey were:

- to assess the considerations driving investment decisions, including perceptions of risk in the sector, how they have changed and how they might move in the future
- to obtain views on the conduct and outcome of the 2004 Periodic Review
- to obtain views on how the policy and regulatory framework for the sector might develop.

The 2005 survey consisted of 41 interviews, 16 with debt investors, 22 with equity investors and three with rating agencies. This report sets out the results. The majority of the questions were directed to both debt and equity investors, although some were only relevant to one or the other. The survey covered almost all of the significant providers of the sector's debt and a majority of major shareholders.

Analysis and presentation of results

The results have been presented separately for each question in the survey.

Each question has been reproduced in the text, and then the responses summarised in overall terms and relevant analysis provided. For example, if the responses from the different types of respondent differed, then these were reported. In general, the quantitative analysis reports the percentages of those that had responded to a question. For most questions, this included all or nearly all investors. However, for some questions the proportion of respondents who either did not know or would not give an answer to a question was significant. Where significant, this proportion has been reported and clarification given as to how the detailed analysis was conducted in each case. In conducting the analysis, responses from the rating agencies have been amalgamated with those of debt investors. However, where the rating agencies' views were distinctive these have been highlighted.

The survey team

Dr Angela Whelan, Director of Research at Ecofin led the survey work, supported by Indepen.

Dr Whelan is an economist with 15 years' experience as an equity analyst specialising in the utilities sector. She acted as an independent advisor to Sir Ian Byatt for the 1994 Periodic Review, a role that involved interpreting and presenting the views and interests of institutional advisors. Following the Review, she continued to advise Ofwat on investor-related matters. Angela is the Director of Research at Ecofin but has undertaken this survey in an independent capacity.

Indepen is a strategic consultancy with considerable experience in the water and other utility sectors in the UK, other countries of the EU and elsewhere. They have worked for regulators, regulated businesses, investors, potential investors and other stakeholders. Further information can be found at www.indepen.co.uk.

Survey Results

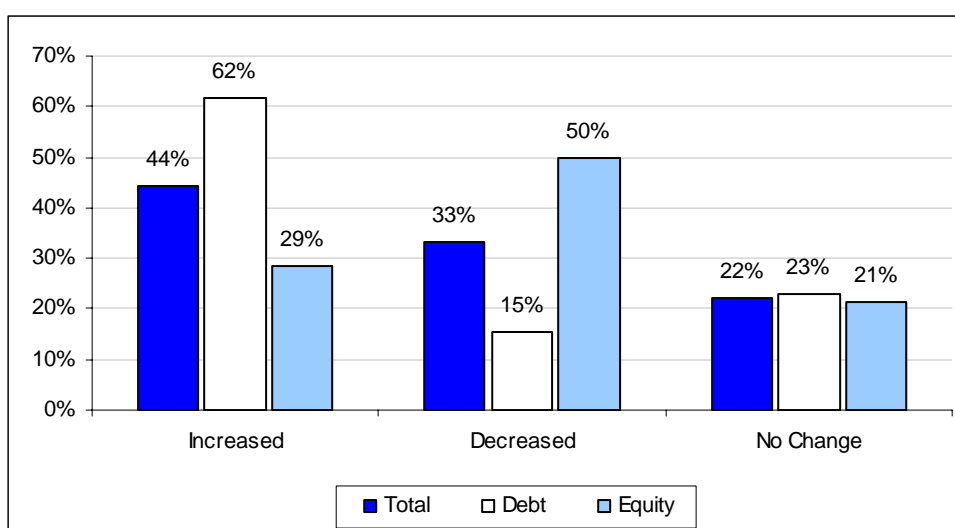
Attitude to risk and considerations in making investment decisions

Importance of water in investment portfolios

Q1 A: Have you changed the weight of the water sector in your portfolio over the last five years?
B: If yes, by how much?
C: Why have you made this change?

Approximately 30% of both debt and equity investors either did not know or would not say how the weight of water in their portfolio had changed over the last five years. Figure 1 below shows the distribution of responses among those that expressed a view. Of these, some indicated that they did not pay much attention to the relative weight of water in their portfolios in making investment decisions and that their response should be seen in that light.

Figure 1: Change in weight of water in investment portfolios over the past five years



Note: Figure 1 includes results for 27 investors (14 equity and 13 debt). 14 Investors had no view.

Of those investors that responded, 78 per cent had changed the weight of water in their investment portfolio over the last five years with an approximately equal balance between those who had increased and those who had reduced their exposure to the sector.

There was a substantial difference between equity and debt investors. 50 per cent of equity investors had reduced their exposure to the sector while 29 per cent had increased their exposure. Some equity investors who had reduced or not changed their exposure noted that they were currently underweight relative to the All-Share Index.

In contrast, the majority of debt investors who had changed the weight of water in their portfolio had increased their exposure to the sector.

In general, equity investors cited a variety of reasons for the relative movement in their portfolios. Company specific considerations and general market valuations were an important consideration in many cases. Around a third of equity investors who had changed the weight of water in their portfolio, whether increasing or reducing it, cited their perceptions of the impact of the regulatory

regime as the primary reason for the change. Most of these were positive about the regulatory environment, due mainly to the approach taken by Ofwat to the 2004 periodic review. Investors generally cited other factors where they had reduced the relative weight of their holdings. Some investors had reduced their holdings in response to recent share price increases. Some also noted that the weight of water in the All Share Index had fallen over the past five years and that this was a factor in their reduced weighting.

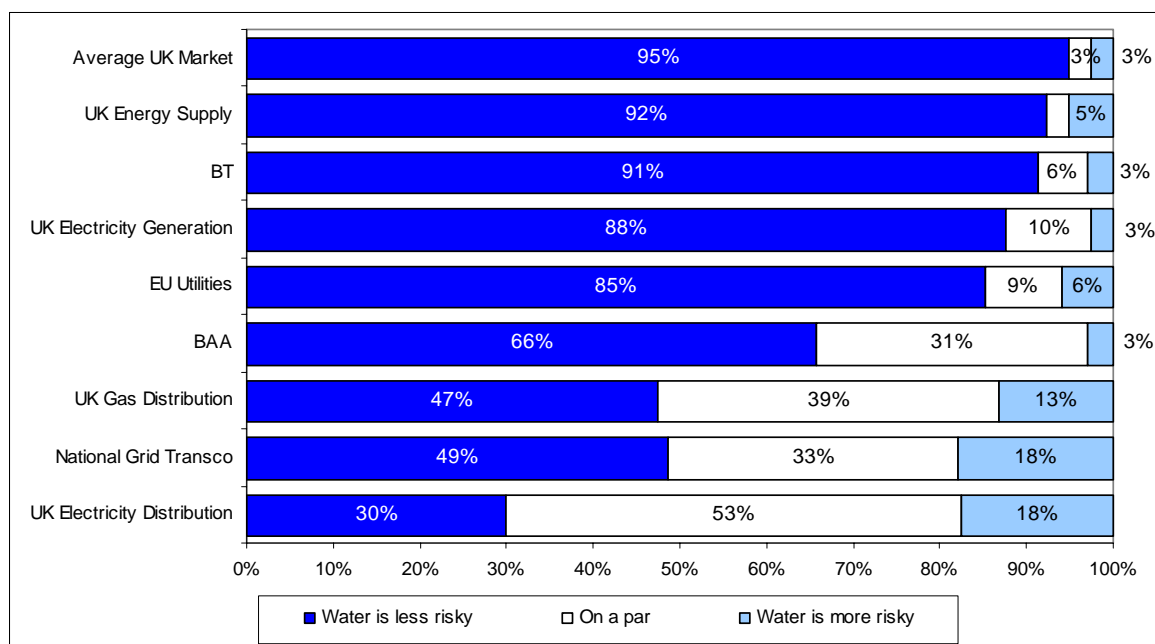
The majority of debt investors who had changed the weight of water in their portfolio had done so because of a perception that the water sector was stable, with regulatory support and relatively secure returns. The outcome of the periodic review had influenced some debt investors to increase their exposure to the sector.

Relative risk of the water sector

Q2 A: Is equity investment in the UK water sector more or less risky compared with the following?
 B: Do you think investing in WoCs is more or less risky than investing in WaSCs?

Figure 2 shows the views of investors on the comparative risk of the UK water sector.

Figure 2: Risk of the UK water sector compared to other sectors (2005)



Note: Figure 2 only includes results for those who had a view; this varies between each sector, from 35 to 40 investors.

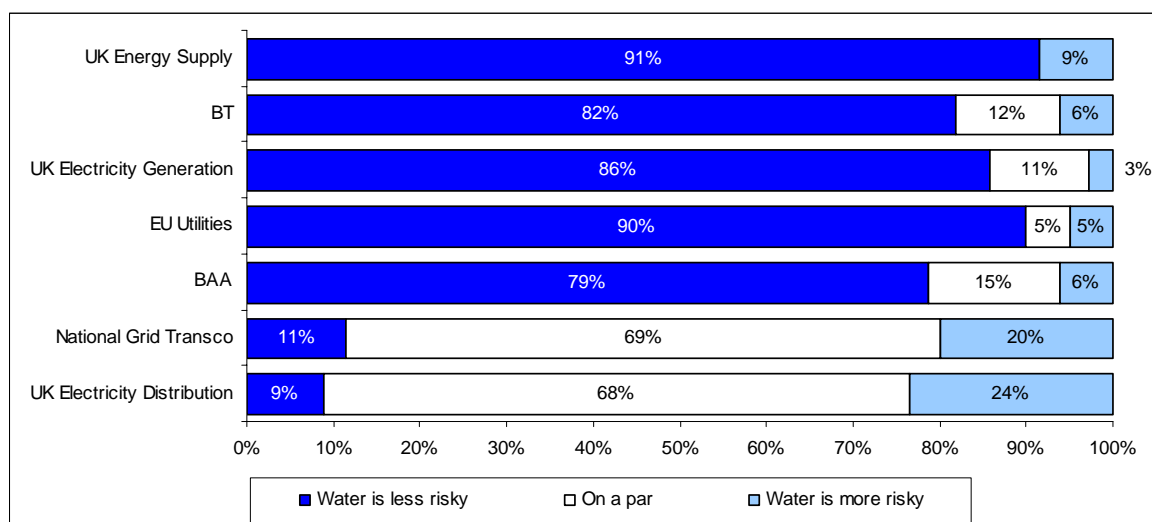
The majority of investors surveyed considered that UK water was a less risky investment than the average investment in UK equity or debt markets, and specifically less risky than UK electricity generation, UK energy supply, British Telecom or European utilities. Around half of the investors surveyed thought that water was less risky than National Grid Transco and UK gas distribution, two thirds said that water was less risky than the British Airports Authority (BAA), while a further third considered that these sectors had comparable risk to the water sector. As Figure 2 shows, the only sector that investors in aggregate regard as having a comparable level of risk to the UK water sector was UK electricity distribution, with only 30% saying that water was the less risky sector.

Over 80 per cent of debt investors said that water was less risky than euro denominated debt in EU utilities. Around 60 per cent of equity investors thought it less risky than other EU utilities, although

30 per cent did not offer a view. A number of investors noted that it was difficult to generalise about EU utilities, but many cited the greater certainties offered by independent British regulation and regulated asset bases. Note, however, that not all respondents are active in European markets.

Compared with results from the 2004 investor survey, the main changes were that the risk in UK water companies is generally perceived to have reduced, a view that might reflect the completion of the Periodic Review. Compared to 2004, a greater proportion of investors see water as less risky than NGT and UK electricity distribution, but a smaller proportion (although still more than half) see it as less risky than the British Airports Authority (BAA). The comparison to electricity distribution is interesting as this sector has, like water, completed its Periodic Review in the last year. There was little change for other sectors and companies. Figure 3 below shows the results of the 2004 survey.

Figure 3: Risk of the UK water sector compared to other sectors (2004)



Note: Figure 3 includes responses from 37 investors (18 equity and 19 Debt)

The majority of investors surveyed either did not have a view or did not believe that there was a difference in risk between WoCs and WaSCs. In general, equity investors did not distinguish between WoCs and WaSCs, although a number noted that they did not invest in WoCs due to the small size of these companies. Around a third of debt investors did not have a view about WoCs. Of those debt investors that did express a view 62% said that they considered WoCs riskier than WaSCs, although they noted that this was largely dependent on the type of risk being considered. For example, some investors said that WoCs had more liquidity risks but that WaSCs had higher risks associated with funding larger wastewater capital expenditure programmes.

Perceptions of risks currently facing water companies

Q3 A: What do you think are the main sorts of risk currently facing water companies?

B: Are the following important risks?

Y/N

Political risk (e.g. risk of unexpected political interference or legislation resulting in costs)

Regulatory risk (e.g. risk of unexpected adverse actions by the regulatory authorities)

Management risk (e.g. risk that companies will make poor management decisions)

Force majeure (e.g. risk of adverse consequences of unpredictable events such as drought)

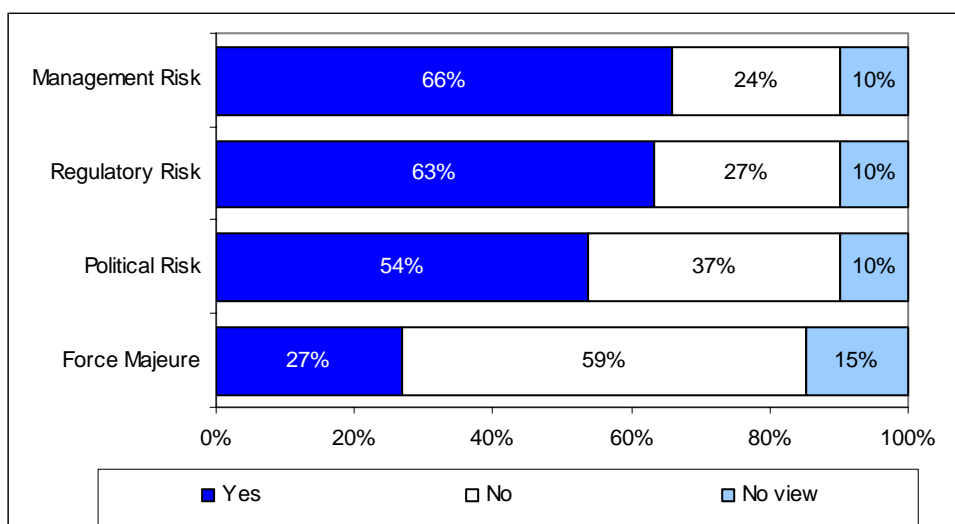
C: Could you rank the top five risks in order of importance?

In response to Question 3A (unprompted), just over 40% of those surveyed said management risk was important. The most commonly cited specific risk areas related to whether companies would be able to deliver against Ofwat's assumptions on opex and capex efficiency, and whether they could deliver the required capital programme outputs. Around 20% thought regulatory risk and financial risks were important risks.

When asked to rank risks in order of importance (Question 3C), just under half of investors thought that management (including delivery against Ofwat's efficiency assumptions) was the top risk, while a further quarter thought this was regulation. Other top ranked risks included financing of ongoing large capital programmes, political interference and general economic conditions.

Responses to Question 3B are illustrated in Figure 4 below.

Figure 4: Are the following key risks? (2005)



Note: Figure 4 includes responses from 41 investors (22 Equity and 19 Debt)

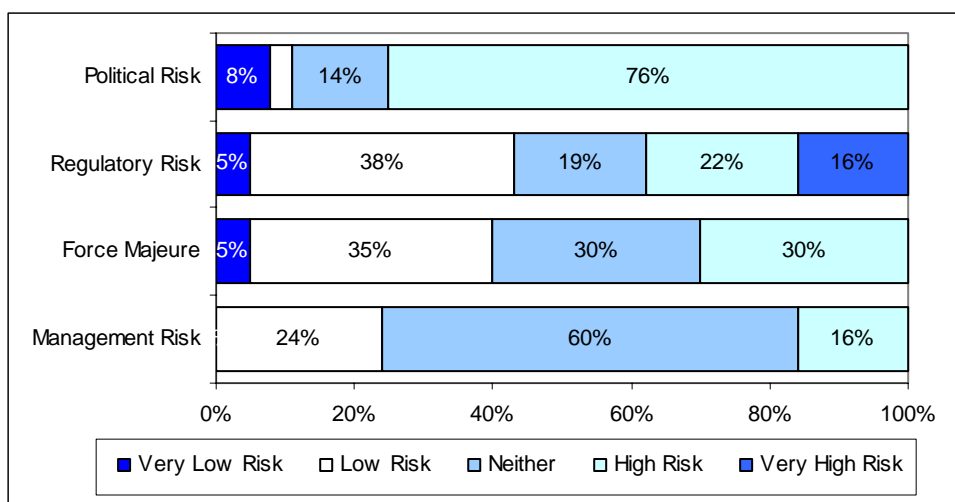
This shows that management, regulatory and political risks are seen as critical risks for the sector by a majority of those surveyed, although marginally more investors thought that management risk was key compared to other types of risk, which seems consistent with investors' responses regarding the relative importance of risks above. Equity and debt investors had different views of management risk with 73% of equity investors and 58% of debt investors saying that it was a key risk. There was little difference in view about regulatory risk with 64 per cent of equity investors and 63 per cent debt investors saying that it was a key risk. Similarly, there was virtually no difference in

the proportion of debt and equity investors who considered political risk important. Less than one third of investors surveyed thought force majeure was a significant risk (36 per cent of equity investors and 16 per cent of debt investors.)

Change in perception of relative importance of different types of risk since 2004

The contrast between these results and those of the 2004 survey, shown in Figure 5 below, is striking, although care should be taken in making this comparison as the question asked in 2004 differed slightly to that asked in 2005.

Figure 5: What is the risk profile of the UK water industry with regard to the following risks? (2004)



Note: Figure 5 includes responses from 37 investors (18 equity and 19 Debt)

The findings of the 2005 survey show that more investors view management related risks as more important than regulatory risks. This appears to be the opposite of the views expressed in 2004 that management risk was substantially less important than regulatory risk. This indicated that there may have been a significant shift in sentiment among the investment community regarding the risks faced by the sector and their relative importance over the last year.

Investors cited a number of factors influencing the perceptions about both types of risk. Concerns about delivery of capital programme outputs and meeting efficiency assumptions were expressed but investors' views about the processes and outcomes of the 2004 Periodic Review influenced their views on regulatory and political risk. Some investors noted that views about regulatory and political risks were influenced by when the survey was conducted: previous uncertainties associated with the Ofwat's Final Determination had disappeared and investors were now paying more attention to how companies might respond to it.

Political risk was considered significant by 54 per cent of those surveyed in 2005. However, it was important to many fewer investors than in 2004 when 76 per cent of investors surveyed thought political risks were relatively high and only 11 per cent thought political risk was relatively low.

Impact of key factors on investment decisions

Q4 On a scale of 1-5, to what extent do you use the following criteria when deciding whether to invest in a conventionally geared water company?

General factors

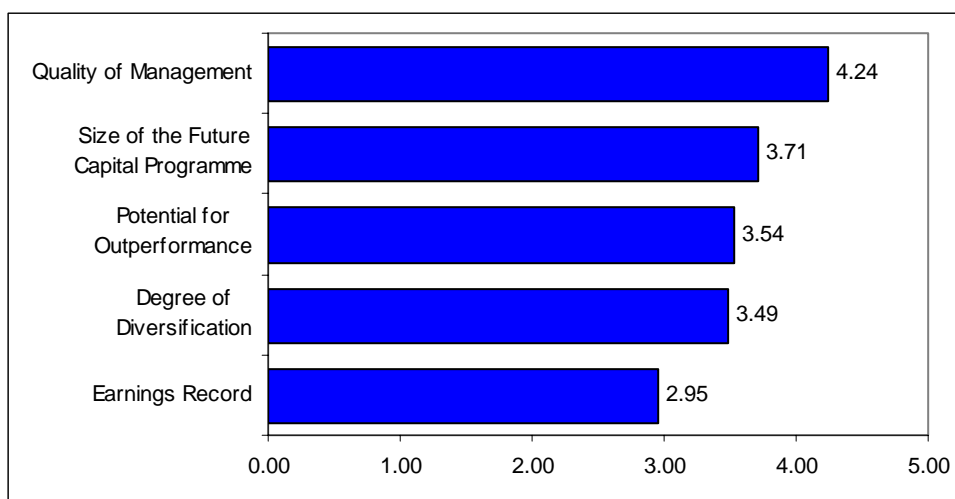
Q4A General Factors: earnings record; degree of diversification; quality of management; potential for outperformance against the Regulator's determinations; size of the future capital programme

We asked investors to rate the extent to which these general factors were important relative to one another when making investment decisions using a scale of 1 to 5:

1	2	3	4	5
Not at all	Occasional Relevance	Relevant Determinant	Significant Determinant	Dominant Determinant

Figure 6 illustrates investors' responses to this question. It represents a ranking of the relative importance of general factors included in the survey.

Figure 6: Impact of general factors on investment decisions – all investors



Note: Figure 6 includes responses from 41 investors (22 equity and 19 debt)

The majority of investors (87 per cent) responded that the quality of management was a significant or dominant determinant in making an investment decision. Its relative ranking¹ was a score of 4.24. This factor's score has increased since the 2004 investor survey. The results in 2004 indicated that the degree of diversification (score: 4.06) was relatively more important than quality of management (3.94).

The size of the future capital programme, potential for outperformance and degree of diversification all received relative rankings between 3.49 and 3.71. The size of the future capital programme was considered a significant or dominant determinant by 65 per cent of investors surveyed. The potential for outperformance (against the Regulator's determination) was considered significant or dominant by 59 per cent of investors surveyed.

¹ An arithmetic average of investors' relative scores on each factor

The degree of diversification was considered a significant or dominant determinant by 56 per cent of investors. With a relative ranking of 3.49, this factor has decreased in importance since the 2004 investor survey where it had a relative ranking of 4.06.

Investors said that a company's earnings record was the least important of the general factors about which we asked although the majority (68 per cent) considered it to be at least relevant. However, only 24 per cent of investors surveyed considered earnings record to be a significant or dominant determinant in investment decisions.

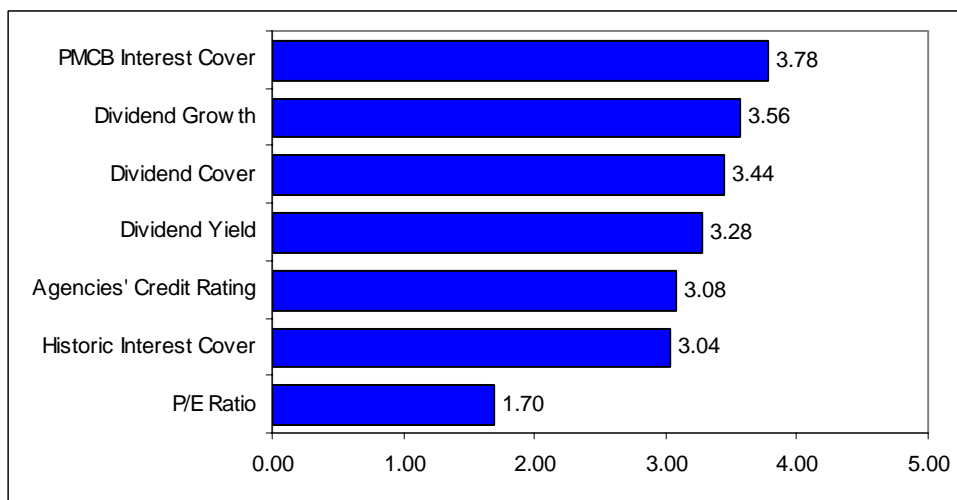
In general, debt and equity investors had consistent views on the relative importance of these general factors in considering investments, with no major differences in relative rankings.

Financial measures

4B Financial Measures: historic cost interest cover; post-maintenance cash-based interest cover; agencies' credit rating; price/earnings ratio; dividend yield; dividend cover; dividend growth; other measures

Using a similar 1 to 5 scale as for the general factors, we asked investors to rate the extent to which they took account of financial measures when making investment decisions. Figure 7 illustrates investor responses to this question and shows a ranking of the relative importance of the financial measures included in the survey. Post-maintenance cash-based (PMCB) interest cover was the highest ranking factor and price/earnings (p/e) ratio was the lowest ranking factor.

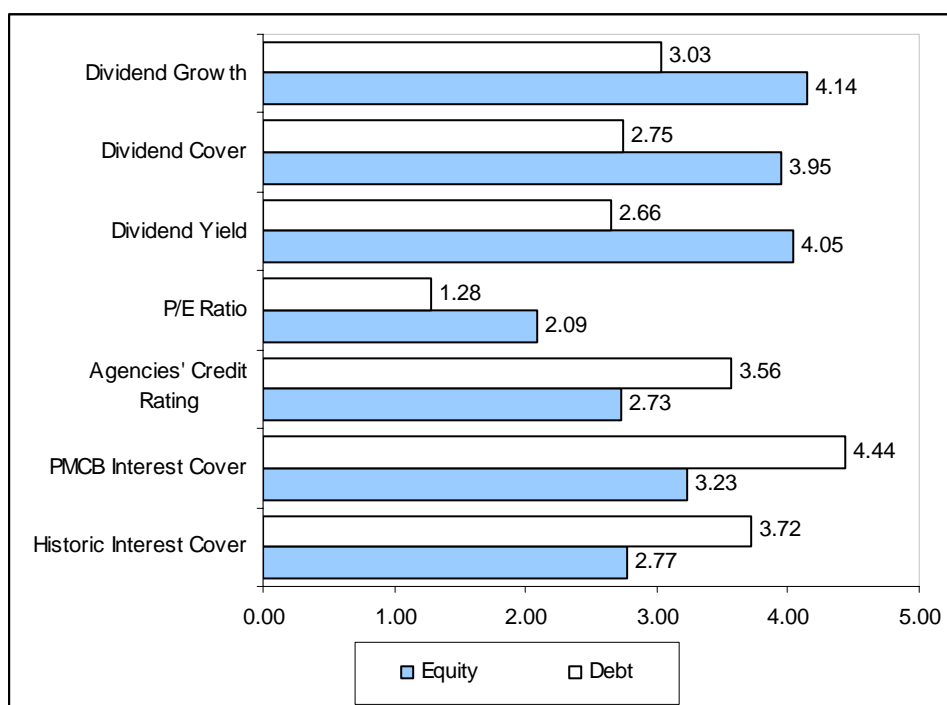
Figure 7: Impact of financial measures on investment decisions



Note: Figure 7 includes results for 41 investors (22 equity and 19 debt)

Post-maintenance cash-based (PMCB) interest cover is a ratio used by Ofwat and defined as the net cash flow from operating activities after tax paid and maintenance charges plus gross interest receivable divided by gross interest payable. 70 per cent of investors surveyed considered the PMCB interest cover to be a significant or dominant determinant, although there was a significant difference between debt investors (94 per cent) and equity investors (55 per cent).

Figure 8: Impact of financial measures on investment decisions - debt and equity investors



Note: Figure 8 includes results for 22 equity investors and 19 debt investors

The three dividend measures (dividend cover, dividend growth and dividend yield) received reasonably equivalent relative rankings: between 3.28 and 3.56. However, equity investors placed greater importance on the dividend measures than did debt investors, with over 80 per cent of equity investors considering the dividend measures to be significant or dominant determinants compared with between 13 and 31 per cent of debt investors.²

Less than one third of investors considered a company's credit rating to be a significant or dominant determinant, although almost half of the respondents considered it to be at least a relevant measure. There was a significant difference between debt and equity investors, with 50 per cent of debt investors considering credit ratings to be a significant or dominant determinant compared with 14 per cent of equity investors.

Just over one third of investors thought that historic interest cover was a significant or dominant determinant. Just over 60 per cent of investors considered historic interest cover to be either relevant or occasionally relevant. More debt investors (63 per cent) than equity investors (14 per cent) responded that historic interest cover was a significant or dominant determinant in making investment decisions.

The price/earnings ratio was given the lowest relative ranking (1.70) of the financial measures included in the survey. Only one equity investor said that the p/e ratio was a significant or dominant determinant. The majority of investors (78 per cent) considered the p/e ratio to be either not at all relevant or only occasionally relevant.

² 13 per cent of debt investors considered dividend yield to be a significant or dominant determinant, 25 per cent of debt investors considered dividend cover to be a significant or dominant determinant, and 31 per cent of debt investors considered dividend growth to be a significant or dominant determinant.

Risks and gearing (net debt/RAV)

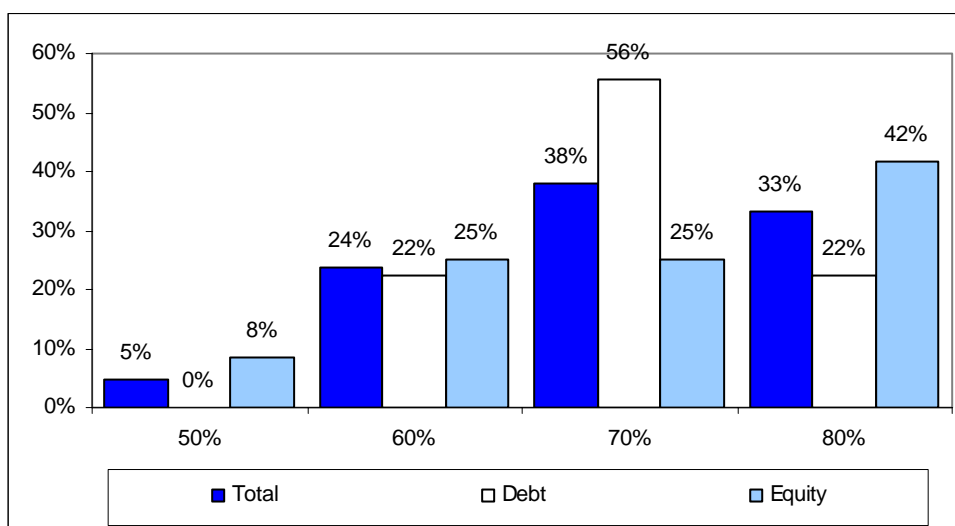
- Q5 A: Is a company's level of gearing as measured by Net debt/RCV an important consideration in making investment decisions? If so, how?
- B: For you, what levels of Net debt/RCV define "low risk", "medium risk" and "high risk" water companies?
- C: Would the existence of debt covenants make any difference to your answer?
- D: If so, which ones do you regard as particularly important?
- E: Do you have trigger levels for any other financial ratios with which you distinguish "low risk", "medium risk" and "high risk" water companies?

Nearly all investors (94 per cent) said that a company's level of gearing, as measured by net debt/RCV, was an important consideration in making investment decisions. This is consistent with the 2004 survey, where 95 per cent of investors said that gearing was important or very important. The main reasons given were that it reflects risk and affects credit ratings. Some investors said that the importance of Net debt/RCV as a measure of gearing simply reflected the fact that Ofwat uses it in the Periodic Review process.

Only 50 per cent of investors offered a view as to whether any particular level of Net debt/RCV gearing as indicated a "high risk" water company.

Figure 9 illustrates the levels of gearing that were perceived as 'high risk' by those offering a specific percentage. This shows that just over 40% of equity investors offering a figure did not think that gearing was "high risk" until it reached 80 per cent.

Figure 9: Level of Net debt/RCV perceived as 'high risk'



Note: Figure 9 includes responses from 21 investors (12 equity and 9 debt)

All debt investors said that the presence of debt covenants influenced their perception of risk, a finding which is similar to those of the 2004 investor survey. Equity investors had more mixed views, with a relatively even split between those investors who said that debt covenants were important and those who said they made no difference to their perceptions of risk.

Covenants that investors regarded as particularly important included interest cover, non-diversification (or ring fencing) and cash flow related covenants. One equity investor noted that changes to accountancy law would affect the type of covenants that investors will regard as

important. Specifically, they said that the changes might cause volatility in balance sheets and earnings, rendering balance sheet covenants less meaningful and shifting the focus to cash flow covenants.

Trends towards higher gearing

Q6 A: What do you think of recent trends towards higher gearing in the water sector?

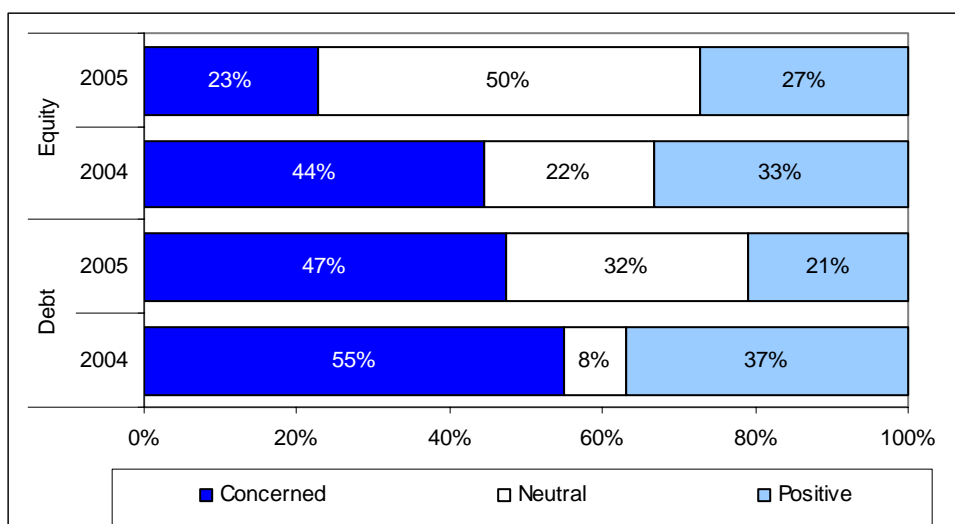
Concerned

Neutral / No view

Regards Positively

Over 75 per cent of investors regarded the recent trend towards higher gearing in the water sector either neutrally or positively, although there was a difference between debt and equity investors. Almost 50 per cent of debt investors expressed concern about higher gearing while the majority of equity investors were neutral or positive.

Figure 10: Attitude towards trends to higher gearing



Note: Figure 10 includes responses from 22 equity and 19 debt investors (2005) and 18 equity and 19 debt investors (2004)

Compared with the 2004 results the main differences are that fewer equity investors expressed concern about the trend (20 per cent this year compared with 44 per cent in 2004.) Equity investors considered that high levels of gearing were appropriate in the context of a stable regulatory environment and that current levels of debt were sustainable.

Fewer debt investors were positive about the trend (21 per cent compared with 37 per cent) but a small number noted that recent performance suggests that highly geared structures are sustainable.

Q7 Is the level of gearing significant to your answers to Q5?

If yes, how would the ratings in Q5 change if the water company under consideration were highly geared?

Just over half of the investors surveyed said that the level of gearing influences the key factors that they consider when making an investment decision. The majority of these said that interest cover, dividend ratios and the size of the future capital programme were more important when deciding whether to invest in a highly geared company.

Investment constraints

Q8	A: When investing in water companies, do you have constraints in the form of levels of any financial indicators beyond which you will not invest?	
	Yes	<input type="checkbox"/>
	No	<input type="checkbox"/>
	B: If yes, how exactly are such constraints used?	
	C: If yes, what are the relevant levels for each indicator (assuming a conventionally geared company)?	
	Post-maintenance cash-based interest cover (times)	<input type="text"/>
	Agencies' credit rating	<input type="text"/>
	Net debt/RCV	<input type="text"/>
	Dividend cover (times)	<input type="text"/>
	Dividend growth (%)	<input type="text"/>
	Others	<input type="text"/>

Most investors said they did not have any constraints, in the form of levels of any financial indicator, beyond which they would not invest. Approximately one third of debt investors said that they would only consider investing in investment-grade companies, while only one equity investor noted any form of threshold constraint.

Divestment decisions

Q9	A: Would your answers to Q5 to Q8 change if you were considering a divestment decision rather than an investment decision?	
	Yes	<input type="checkbox"/>
	No	<input type="checkbox"/>
	B: If yes, how?	

A majority of equity investors said that their divestment criteria mirrored their investment criteria. Those equity investors that did differentiate between divestment and investment considerations responded that they paid more attention to the value of the company relative to its market price when considering divestment.

This was consistent with the responses of debt investors, of whom almost one third differentiated between divestment and investment decisions. One debt investor stated that, if they had serious credit concerns regarding a specific water company they would be more inclined to speak to the Regulator before making a divestment decision.

Investment criteria for water compared with other investments

Q10 A: Do your investment criteria for the water sector differ in any fundamental way from those used for other investments?

Yes

No

B: If yes, how?

Half of the investors surveyed said that their investment criteria for the water sector did not differ in any fundamental way from those used for other investments. Of those investors that did differ between water and other sectors, almost 60 per cent were debt investors.

Some of them noted that they used different investment criteria for water because it is regulated. Specifically, the existence of the RAV and the regulated return meant that a different analysis was required. Some investors stated that they tended to adopt a more positive view of water companies compared with other companies because of the characteristics of the regulatory regime in water.

Influence of different kinds of equity owner (debt investors only)

Q11 Does the presence or absence of different kinds of equity owner affect your debt investment decisions?

Over 70 per cent of debt investors surveyed said that the presence or absence of different kinds of equity owner affected their debt investment decisions. Of these, the majority said that they preferred quoted status to private ownership but that the strategy of the owner was more important than the nature of the owner.

This contrasts with the findings of the 2004 investor survey where, in response to a slightly different question, 89 per cent of debt investors said that the holding company influenced their investment decisions significantly.

Regulation

The 2004 Periodic Review

Q12 A: The 2004 Periodic Review has just concluded. What do you think of the Final Determination?

B: What particularly made it good or bad?

Almost 100 per cent of investors surveyed said that the outcome of the 2004 Periodic Review was either favourable or fair. A majority of investors cited the transparent regulatory process as the most positive aspect of the review, with a number noting that it appeared to demonstrate an understanding of the issues facing the water sector and effectively balanced the interests of stakeholders. Another aspect viewed as positive was the 'sensible' cost of capital allowance.

While investors were almost unanimous in viewing the 2004 Periodic Review positively, a majority also acknowledged that some aspects of the outcome were demanding. Investors believed that the efficiency targets were challenging and might limit the scope for outperformance during the regulatory period.

Treatment of equity investors

Q13 How do you think equity/debt investors were treated?

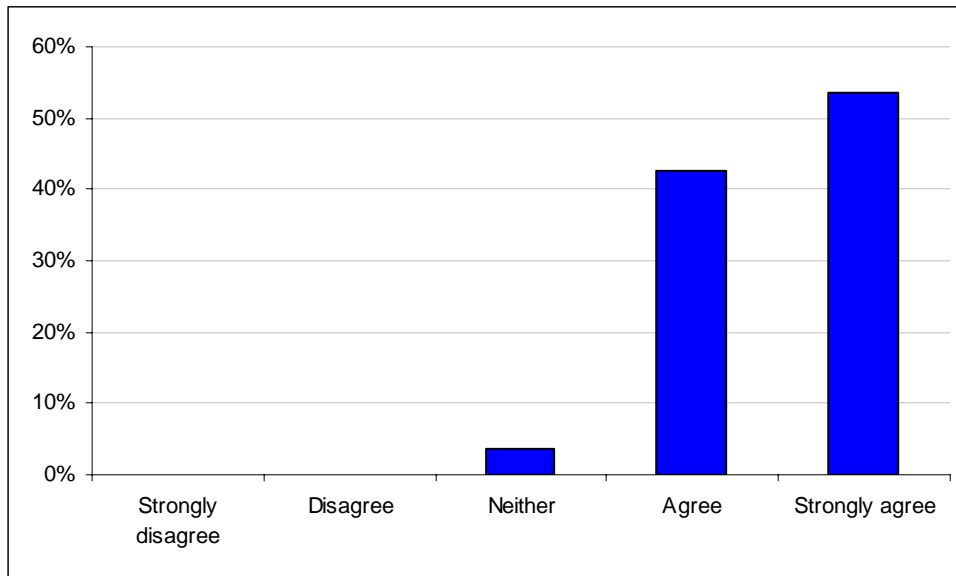
Almost all investors surveyed thought that the periodic review treated investors well or fairly, with the exception of one debt investor who thought that Ofwat should not have a role in determining how companies were financed. A number of investors noted that the City briefings were useful and demonstrated that Ofwat was willing to consider investors' views.

Regulator's performance in 2004

This section of the survey asked investors to assess the Regulator's performance in 2004, referring specifically to the process and outcomes of the 2004 Periodic Review, in response to a series of statements about it.

Q14A The Regulator met his statutory duty to secure that water companies are able to finance the proper carrying out of their functions.

Figure 11: Water companies' ability to finance their functions

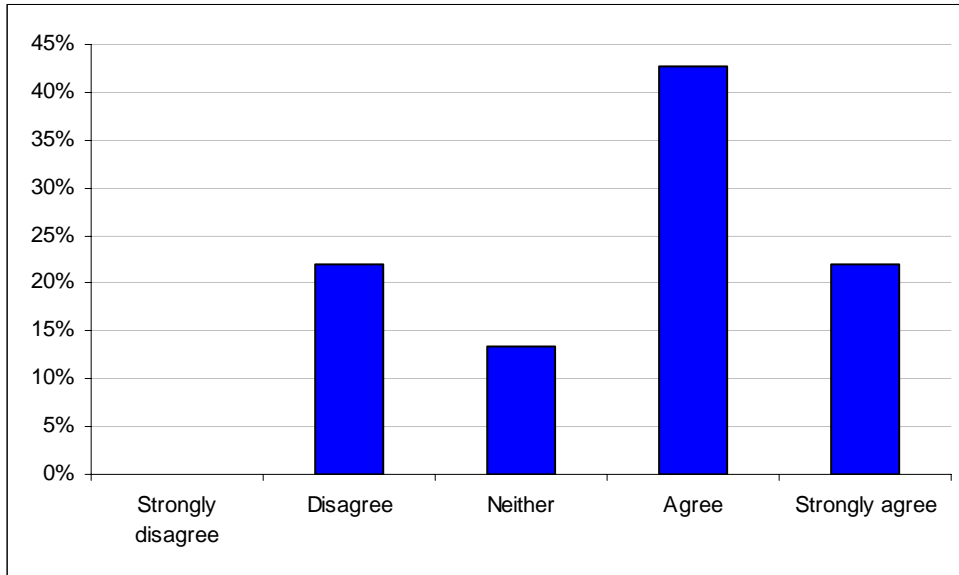


Note: Figure 11 includes results for 41 investors (22 equity and 19 debt)

96 per cent of respondents agreed or strongly agreed with the statement. One investor noted that, the extent to which the Regulator carried out this duty effectively varied from company to company.

Q14B The Regulator was independent of political influence.

Figure 12: Independence of political influence



Note: Figure 12 includes results for 41 investors (22 equity and 19 debt)

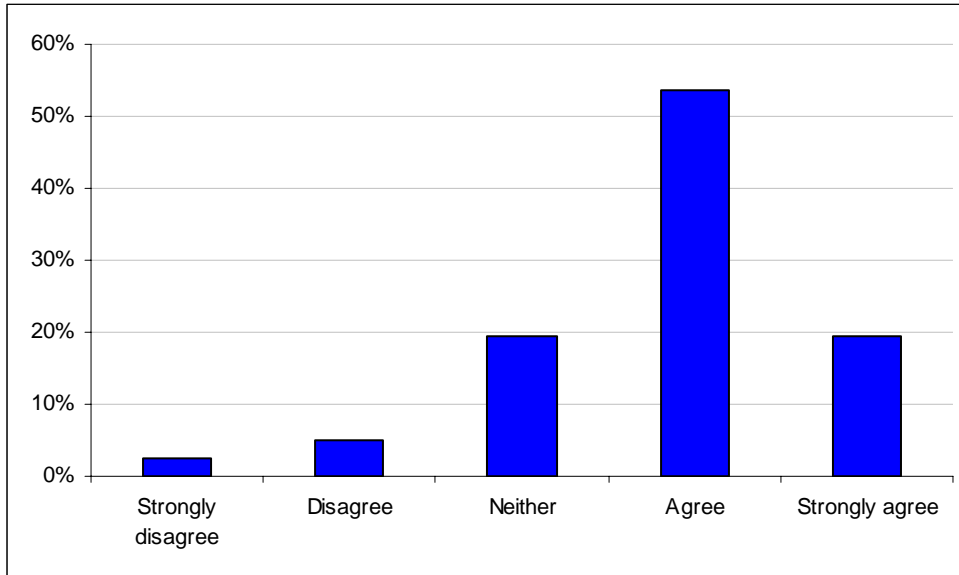
While a number of investors commented that the level of political influence was difficult to assess, 65 per cent of those surveyed agreed or strongly agreed that the Regulator had been independent of political influence. This was an increase on 2004 when only 55 per cent of investors thought that the Regulator was independent of the political process.

Marginally more debt investors (68 per cent) than equity investors (61 per cent) either agreed or strongly agreed that the Regulator was independent of political influence. In 2004, 60 per cent of debt investors and 20 per cent of equity investors believed that the regulator was independent of the political process.

13 per cent neither agreed nor disagreed and 22 per cent disagreed with the statement.

Q14C The Regulator balanced customers' and investors' interests reasonably.

Figure 13: Balance between customers' and investors' interests



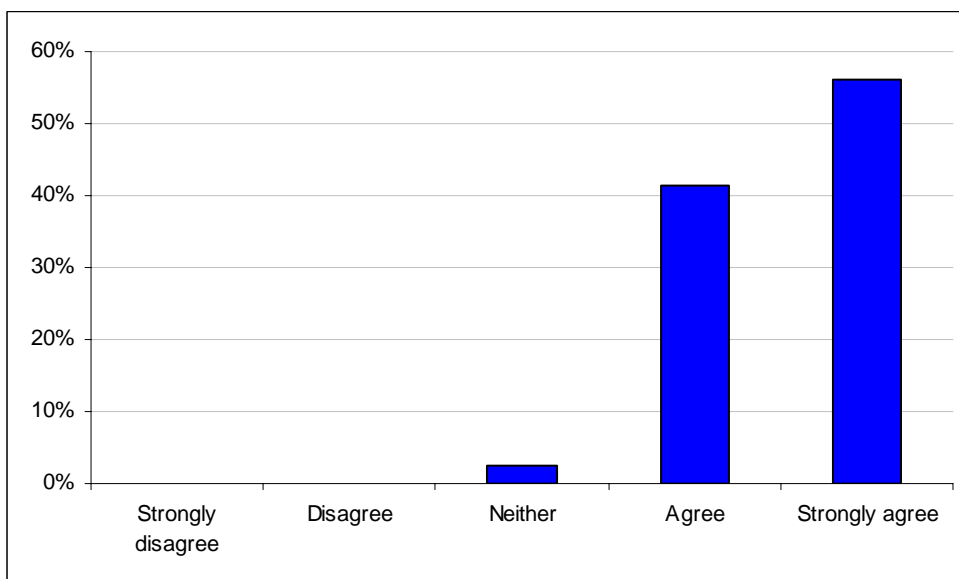
Note: Figure 13 includes results for 41 investors (22 equity and 19 debt)

73 per cent of investors surveyed agreed or strongly agreed that the Regulator balanced customers' and investors' interests reasonably. Debt investors (84 per cent) were more positive than equity investors (64 per cent).

20 per cent neither agreed nor disagreed and seven per cent, all of whom were equity investors, either disagreed or strongly disagreed.

Q14D The Regulator adopted transparent processes.

Figure 14: Transparent process

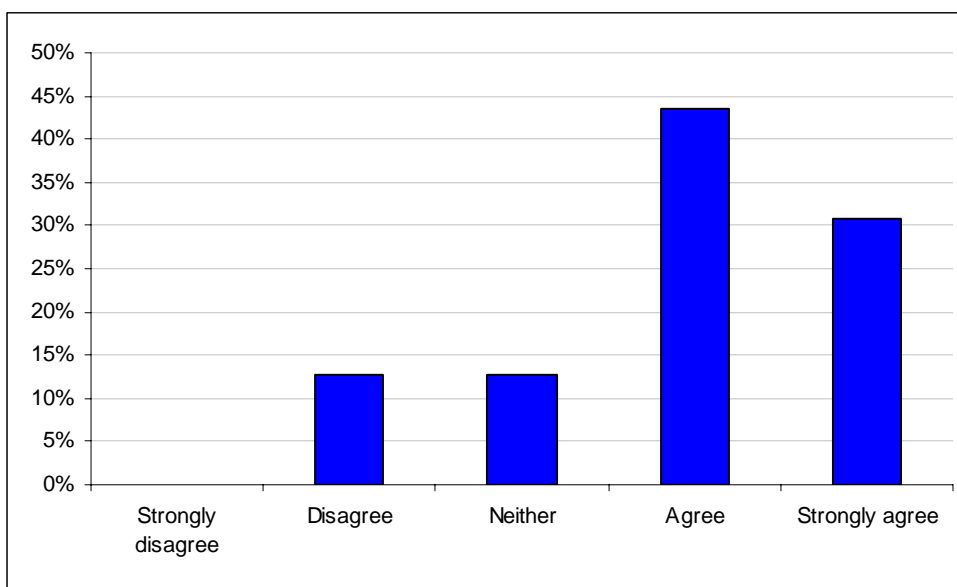


Note: Figure 14 includes results for 41 investors (22 equity and 19 debt)

98 per cent of investors surveyed agreed or strongly agreed that the Regulator had adopted transparent processes. A number commented that the City briefings conducted by Ofwat throughout the Periodic Review contributed to this transparency. This is consistent with the 2004 survey when over 90 per cent of investors agreed that the Regulator was developing policy in a transparent manner.

Q14E The regulatory outcome was transparent.

Figure 15: The regulatory outcome was transparent



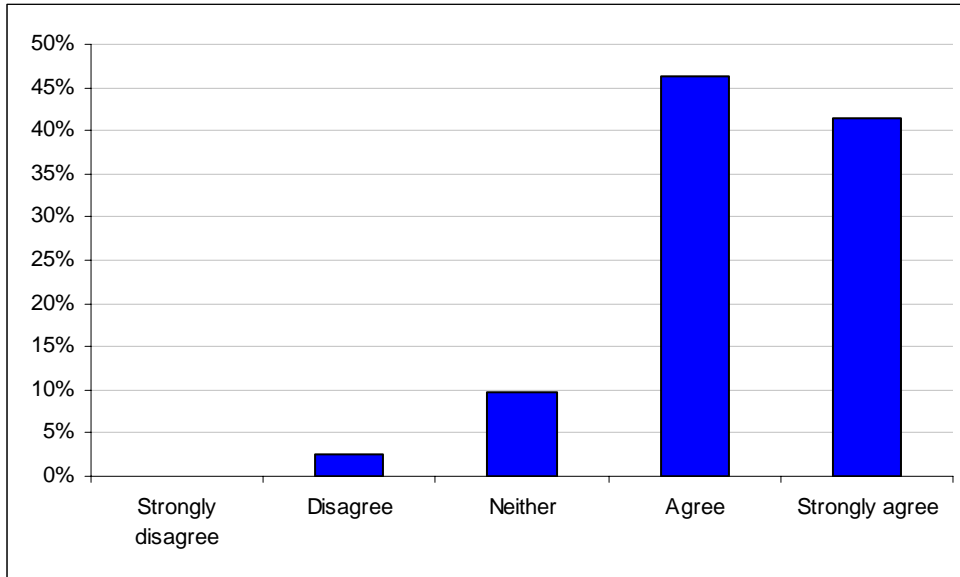
Note: Figure 15 includes results for 39 investors (21 equity and 18 debt)

74 per cent of investors surveyed either agreed or strongly agreed that the regulatory outcome was transparent. It was notable that this proportion of investors, while almost three quarters, was substantially less than the unanimous agreement expressed in relation to the transparency of the Regulator's processes. Around a quarter of investors did not positively agree outcomes were transparent. Investors cited three main reasons for this:

- the way that Ofwat determined and applied financeability uplifts to the cost of capital was not transparent
- Ofwat's position on dividends was not clear
- the change between the Draft Determinations and the Final Determinations was greater than expected. Some investors said that they had been surprised by this change in the light of the Regulator's comments at the time of the Draft Determinations.

Q14F The Regulator's policies were well signalled and consistent.

Figure 16: Policy signalling and consistency

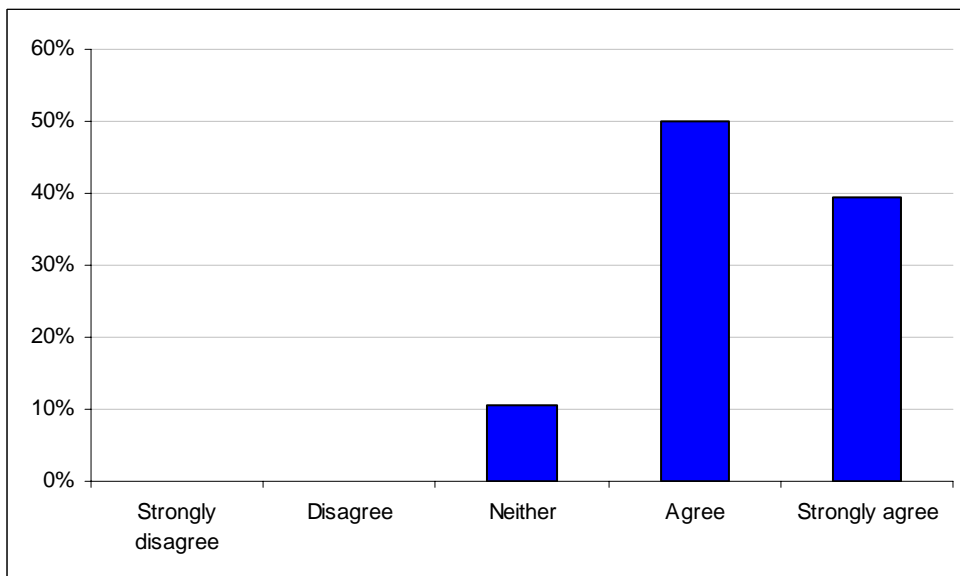


Note: Figure 16 includes results for 41 investors (22 equity and 19 debt)

Investors were asked whether the Regulator's policies were well signalled and consistent, both between Periodic Reviews and during the 2004 Periodic Review. 88 per cent of investors surveyed either agreed or strongly agreed that the Regulator's policies were well signalled and consistent. 10 per cent neither agreed nor disagreed and two per cent disagreed.

Q14G The Regulator listened to investors.

Figure 17: Listening to investors



Note: Figure 17 includes results for 38 investors (20 equity and 18 debt)

89 per cent of investors agreed or strongly agreed that the Regulator had listened to investors. This was consistent with the outcomes of the 2004 investor survey, where almost 90 per cent of investors believed that the Regulator listened to investors.

Financeability uplift

Q15 Looking towards the end of the five-year period, Ofwat allowed 'financeability uplifts' for some companies because they have large capital programmes which are expected to continue after 2010. Do you have any views about this?

Most of the investors surveyed were positive about the financeability uplifts and expect them to continue in subsequent periodic reviews. The majority of debt investors surveyed was supportive of the uplifts, believing that they appropriately reflected the long-term nature of the water sector.

Some equity investors believed that there should be no need for financeability uplifts if the cost of capital was adequate, while others thought that it was a sensible approach.

Some investors, both debt and equity, acknowledged that they had difficulty understanding how the financeability uplifts were applied due to a lack of transparency about the methodology and calculations.

The cost of capital

The questions in this section were asked only of equity investors, except where indicated.

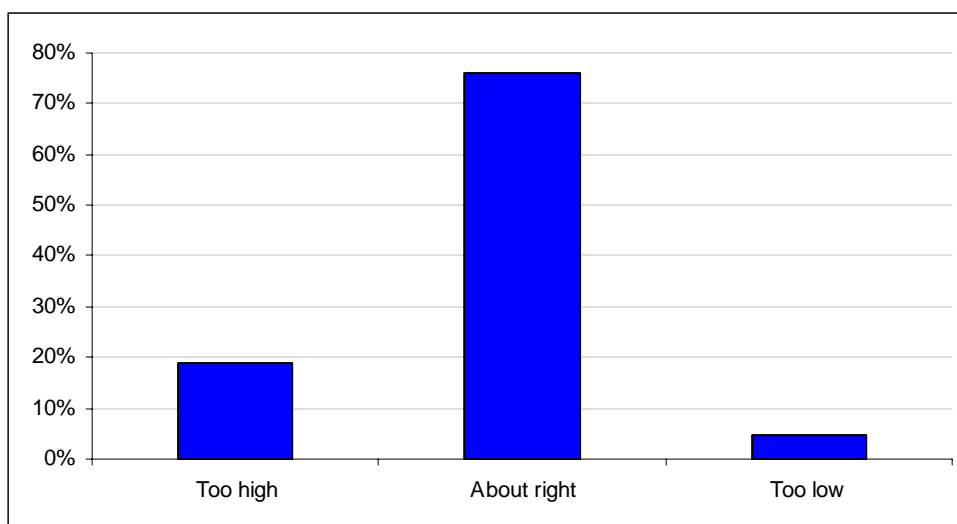
Q16 In the 2004 Periodic Review, the Regulator allowed a real post-tax cost of capital of at least 5.1%. Do you think this figure was appropriate?

Too low

Too high

About right

Figure 18: Cost of capital



Note: Figure 18 includes responses from 21 equity investors

Just over three quarters of equity investors said that the cost of capital allowed by the Regulator was 'about right'. With the exception of one investor, who thought that the cost of capital was 'too low', the others (four of those surveyed) thought that the allowance was 'too high'. In giving

reasons for these views, some of these investors contrasted the allowed cost of capital with that recently allowed by Ofgem for electricity distribution companies.

Q17 A: At the next review, should the Regulator set pre-tax or post-tax costs of capital?
B: Why?

The majority of equity investors responded that the Regulator should continue to set post-tax costs of capital to maintain consistency, both between Periodic Reviews and with other regulators. The rest said that they were indifferent whether he sets pre-tax or post-tax costs of capital, as long as the Regulator's methodology was clear. This was consistent with the 2004 survey.

Q18 A: Do you think the Regulator should adopt a different method of determining cost of capital?
B: Why do you hold this view?

Almost two-thirds of equity investors thought that the approach currently taken by the Regulator, combining technical analysis and investor input, is appropriate. 14 per cent thought Ofwat should take more account of investor views and other market observations. Equity investors acknowledged that estimating the cost of capital was problematic and, as a result, they attached importance to the transparency of the process.

In 2004, investors were almost unanimous in the view that the Regulator should not rely solely on a technical calculation.

Q19 A: In future, should the Regulator continue to apply the small company premium?
B: Why do you hold this view?
C: (debt investors) National costs of capital set by the Regulator were adjusted for individual companies. What do you think about this?

Almost 70 per cent of investors surveyed thought that the small company premium was appropriate and should continue. They said that the premium was justified by the fact that smaller companies were likely to have more difficulty raising finance and fewer opportunities for efficiency gains.

This is consistent with the 2004 survey where, of the 50 per cent of investors who responded³, over 80 per cent of equity investors and over 90 per cent of debt investors believed that water only companies had higher overall costs.

³ In the 2004 investor survey, 50 per cent of investors did not have a view on the small company premium on the basis that they did not invest in 'water only companies'.

Ways in which the regulatory process could be improved

Q20 Do you have any suggestions for improving the processes by which UK water companies are regulated? Do you have any specific suggestions for the 2009 Periodic Review?

In response to this unprompted question, the majority of investors had no suggestions or responded that the current process was working well.

A number suggested that the Regulator should consider lengthening the review period. Another suggestion was to increase consistency with other regulators, such as Ofgem, or explain why differences exist between different regulatory bodies on issues such as the cost of capital.

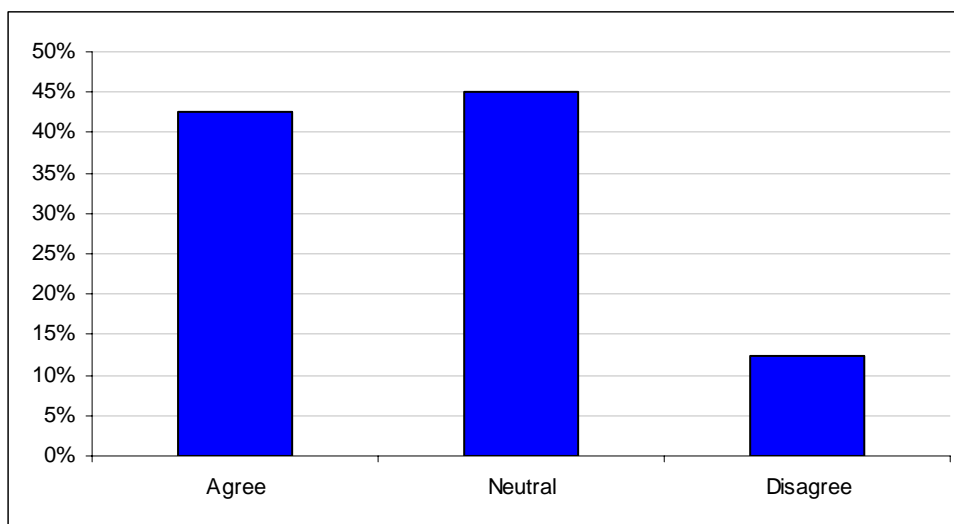
Investors were then asked whether they agreed or disagreed with a number of specific suggestions for improving the process by which UK water companies are regulated.

20A: Shorten the 2 ½ year review process.

43 per cent of the investors surveyed agreed that the review process should be shortened. A number commented that the current review process effectively leads to the market for investment in the UK water sector being closed for one year in each five year period. More debt investors (47 per cent) than equity investors (38 per cent) thought that there was merit in shortening the review process.

A number of investors noted that, while the length of the current process is not ideal, it should become shorter and more focused as the industry matures. Investors acknowledged that, while the length of the process created uncertainty, the Regulator could not ignore the complexity of the process and the requirement to include all stakeholders.

Figure 19: Shorten the 2 ½ year review process



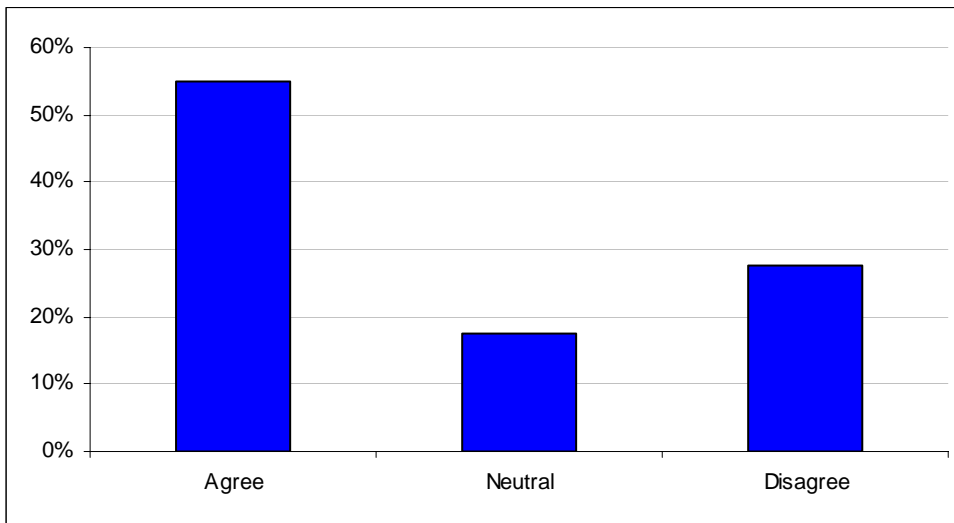
Note: Figure 19 includes responses from 40 investors (21 equity and 19 debt)

20B: Lengthen the period between reviews.

Just over half of those surveyed agreed that that regulatory period should be lengthened on the basis that this would reduce uncertainty and regulatory risk. This contrasts with the 2004 survey when 80 per cent of investors said that they would prefer a longer regulatory cycle.

Those investors who disagreed with a longer period between reviews thought that this would create additional uncertainty. Investors commented that too many factors can change over a longer period and that it would be difficult to set financials for more than five years.

Figure 20: Lengthen the period between reviews

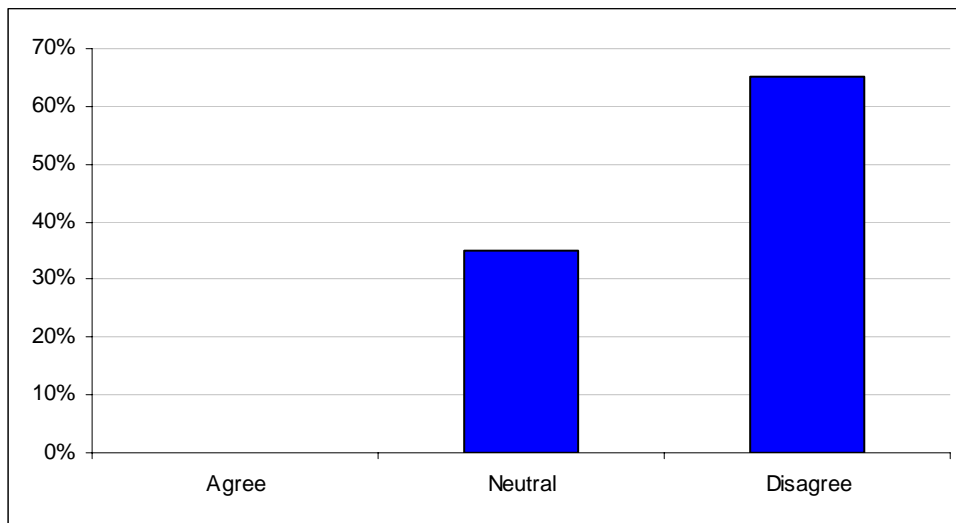


Note: Figure 20 includes responses from 40 investors (21 equity and 19 debt)

20C: Make IDOKs harder to obtain.

The majority of investors surveyed disagreed with the suggestion that IDOKs should be made harder to obtain. Some said that the materiality threshold was already tough enough. Others offered suggestions for improving the current process, such as making the process more formulaic and widening the selection criteria. A number of investors believed that the current IDOK process was unclear and stated that they would welcome more clarity about how the process works. This is consistent with the outcomes of the 2004 investor survey, where the majority of investors commented that they would prefer the IDOK process to be more transparent and mechanistic.

Figure 21: Make IDOKs harder to obtain

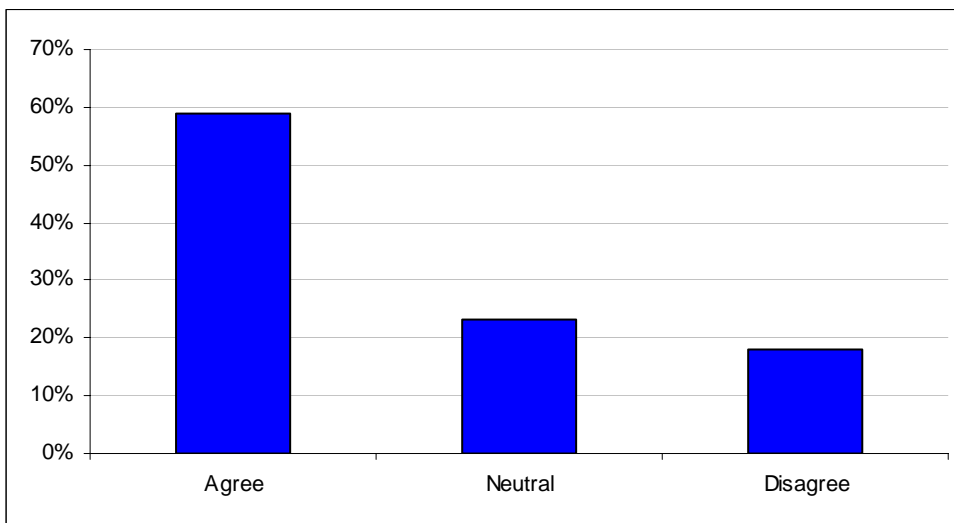


Note: Figure 21 includes responses from 40 investors (21 equity and 19 debt)

20D: Publish more financial data about future years.

More than half of the investors surveyed agreed that the Regulator should publish more financial data, generally on the basis that more information is always better than less. Those who were neutral or disagreed commented that it was difficult to look too far ahead without creating uncertainty and that it therefore would be difficult for investors to use such financial data in making into their investment decisions. In general, investors were more sceptical about the benefits of publishing forecast financial data about years beyond the regulatory period under review.

Figure 22: Publish more financial data about future years

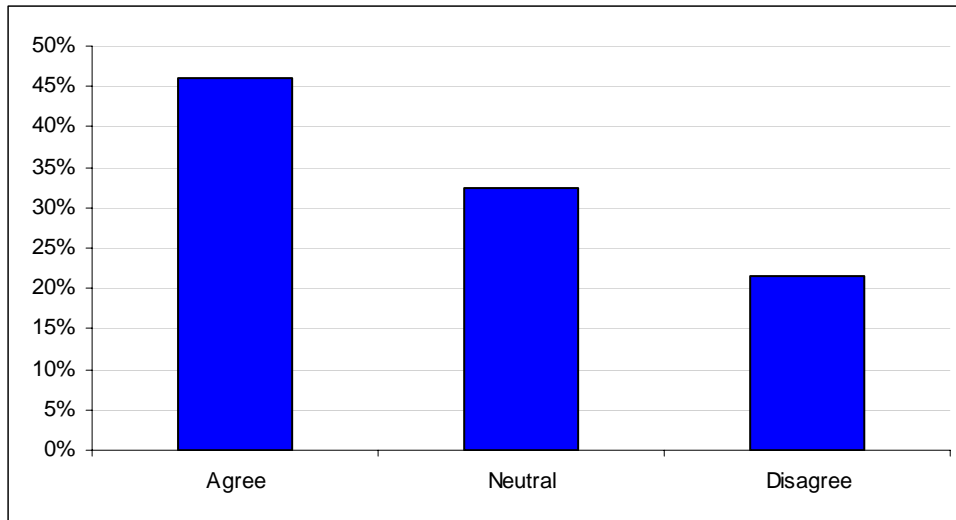


Note: Figure 22 includes responses from 39 investors (20 equity and 19 debt)

20E: Clearer business plans.

The majority of investors surveyed agreed that business plans should be clearer. A number of these suggested the inclusion of additional information, particularly relating to capital expenditure programmes, and enhanced consistency of information between companies. Some of those who disagreed with this suggestion commented that there were clear and justifiable reasons for differences in business plans.

Figure 23: Clearer business plans



Note: Figure 23 includes responses from 37 investors (18 equity and 19 debt)

Publication of a government framework

Q21 Would publication of a government long-term framework on water increase the industry's attractiveness?

A majority of the investors surveyed thought that publication of a government long-term framework on water would increase the industry's attractiveness. A number acknowledged that this would depend on the content of the framework. Some investors suggested that the framework would be useful if it addressed the role of the European Union (EU) and discussed how EU directives relating to the water industry should be interpreted and implemented at the local level.

Some of those who did not think a Government publication would help were against political intervention generally. Others questioned the value of such an initiative and were sceptical over whether Government's statements in this area could be credible given that given that British politicians cannot bind their successors, and that the market's main concerns will begin in 2010.

Current merger regime

Q22 A: What do you think about the current water merger regime?

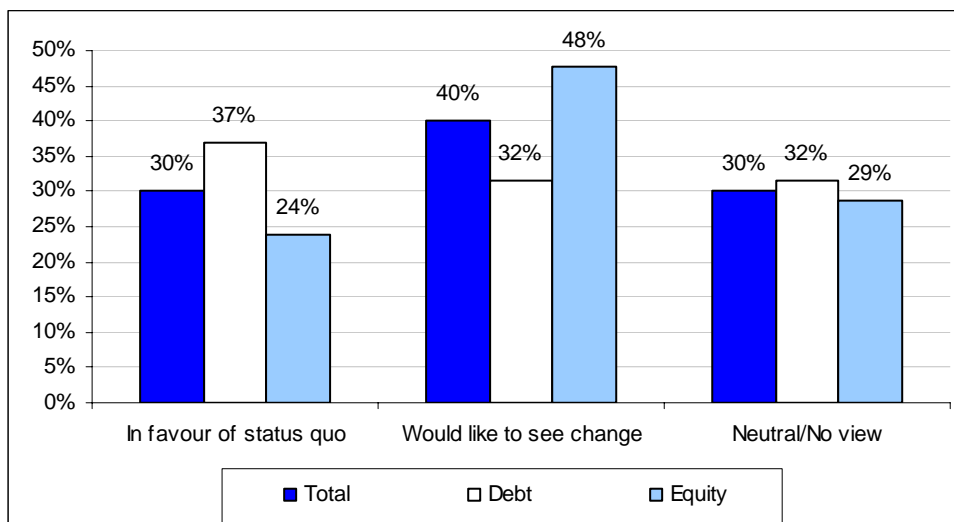
In favour of the status quo

Would like to see change

Neutral

B: Why do you hold this view?

Figure 24: Current merger regime



Note: Figure 24 includes responses from 40 investors (21 equity and 19 debt)

There was no clear consensus view about the merger regime. Around 40 per cent of investors would like to see change with 30% neutral and 30% in favour of maintaining the status quo. However, there was a difference in the views of debt and equity investors with more equity investors in favour of change compared with debt investors. This finding is consistent with the 2004 survey, which highlighted debt investors' attitude to event risk. However, the findings of the 2004 survey also showed that nearly all equity investors that expressed a view were negative about the merger regime. Views of equity investors are more variable this time, with some equity investors viewing the merger regime positively.

The majority of those who would like to see change thought that the rationale for the current regime was the Regulator's desire to have comparators and that this limited the potential for water companies, particularly the smaller ones, to achieve further efficiencies. Some debt and equity investors continue to question why Ofwat continues to require such a high number of comparators. A number of investors believed that mergers are inevitable and that the Regulator should acknowledge the potential benefits of consolidation.

Those that were in favour of the status quo commented that comparative competition brought benefits as managements strove to outperform each other.

Effectiveness of the ring fencing of the regulated business

Q23 A: Is ring fencing of the regulated water business effective?

Yes

No

B: If no, what suggestions do you have for improvements?

C: Would enhanced ring fencing further reduce the risks of investing in a water company?

All the debt investors surveyed thought that ring fencing was effective, with the majority not having any suggestions for further improvement. In contrast, some ratings agencies, while saying that ring fencing was broadly effective, suggested areas where the current arrangements might be improved for example to address holding company cash holdings and monitoring of effectiveness of governance arrangements. In the 2004 investor survey, debt investors were also unanimous in their view that the ring fence reduced the risk of lending to a water company.

Of the equity investors surveyed, 43 per cent believed that ring fencing was effective while the remaining 52 per cent offered no view. The main suggestion for improvement was for increased consistency across water companies but most did not consider that enhancements would add to the attractiveness of the sector.

Prospects for the water sector

Questions in this section were only asked of equity investors.

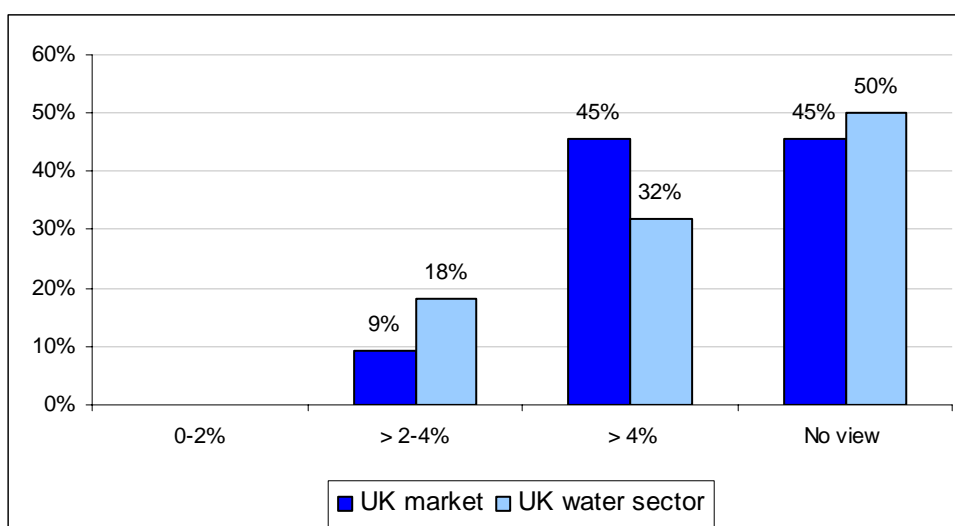
Expectations about earnings and dividend growth

Q24 A: What annual real earnings per share growth do you expect the UK market to achieve over the next five years?

B: What annual real earnings per share growth do you expect the water sector to achieve over the next five years?

C: What real dividend growth do you expect the water sector to deliver over the next five years?

Figure 25: Expectations about real earnings per share growth

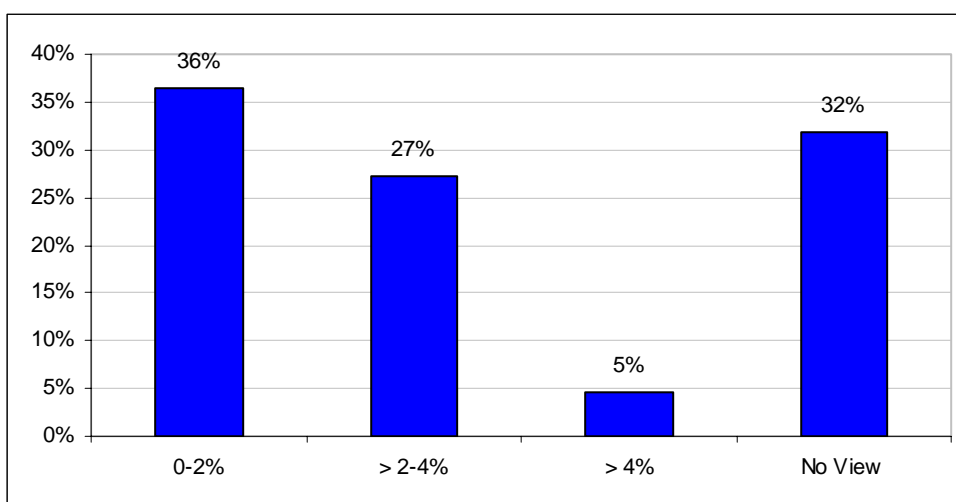


Note: Figure 25 includes responses from 22 equity investors

Overall, equity investors expect real earnings to grow more slowly in the water sector than in the UK market as a whole.

45 per cent of equity investors expected growth in annual real earnings per share in the UK market to be greater than four per cent over the next five years while only nine per cent expected slower growth. In contrast, for the water sector, only 32 per cent of equity investors expected earnings per share growth to be more than four per cent over the next five years but 18 per cent expected slower growth.

Figure 26: Expectations about real dividend growth



Note: Figure 26 includes responses from 22 equity investors

Equity investors generally expect real dividends in the water sector to grow more slowly than real earnings per share over the next five years. 36 per cent of equity investors expected real dividend growth by the water sector over the next five years to be less than two per cent while 27 per cent expected it to be between two and four per cent.

There was no consensus of views about the reason for this although some investors noted the impact of dividend cover requirements for more highly geared companies.

The results indicate that equity investors are more optimistic about the dividend growth in the water sector of the water sector over the next five years compared to the 2004 survey: at that time the majority of equity investors expected real dividend growth to be in the range of one to two per cent.

Q25 A: Do you generally regard water as an “income stock” (low growth, high yield)?

Yes

No

B: If yes, what are the consequences?

Over 60 per cent of the equity investors surveyed regarded water as an “income stock” due to its relatively high yield (compared to interest rates and bonds) and secure income stream. This view did not appear to have any consequences for investors other than that water is seen as a low-risk, high-yield, “defensive” stock.

RCV and market value

Q26 A: It has been estimated that the ratio of quoted water companies’ market values to their RCV is currently about 105%⁴ (i.e. a small premium to the regulatory asset value). In your opinion, why is this so?

B: How do you expect this ratio to move over the next five years?

⁴ This estimate was made at the time the survey was designed.

Investors expressed different views about what the relation of market value to RCV might be for the industry on average and for specific companies. Sector share prices also moved considerably over the period of the survey, which influenced investors views.

The majority of equity investors we surveyed said that the ratio of quoted water companies' market values to their RCV was currently greater than 100% due to the outcome of the 2004 Periodic Review. Specifically, investors cited market perceptions that the Review was fair and the reduction in regulatory risk for another five years as the primary reasons for the premium. Some investors suggested that general market conditions, including an appetite for income stock and low interest rates, were contributing factors.

Equity investors had mixed views about how the market values would move compared to RCV over the next five years. Over 30 per cent of those surveyed offered no view or said that it was too difficult to predict. 32 per cent of equity investors expected the ratio to move to 100%, while 23 per cent expected the existing small premium to remain and 14 per cent expected market values to fall below RCV. A number commented that the movement was likely to reflect the regulatory cycle.

Future funding of the water sector

Concerns about future long-term funding

Q27 A: Do you have any concerns for the long-term funding of the UK water industry?

B: If so, what are they?

The majority of investors surveyed did not have any concerns for the long-term funding of the UK water industry. This is in contrast to the results of the 2004 investor survey where almost 70 per cent of investors surveyed believed that there were funding risks associated with the capital programme from 2004 onwards.

32 per cent of debt investors and 18 per cent of equity investors had concerns about the long-term funding of the UK water industry. Concerns included the impact on funding of the increasing trend towards higher gearing levels, management issues and large capital expenditure programmes. A number of investors commented that UK water companies cannot continue to be cash flow negative without affecting future funding.

Future rights issues

Q28 A: Over the next five years do you expect any water companies to announce rights issues or reduce dividends to fund their capital programmes?

B: If one were announced, what would your reaction to a potential issue be?

C: Will it be a major source of funds?

Aside from the second tranche of United Utilities' rights issue, the majority of investors surveyed did not expect companies to announce rights issues or reduce dividends to fund their capital programmes. The majority said their reaction to any rights issue would depend on the reasoning behind it. A number stated that they would react negatively to a rights issue to fund capital expenditure, on the basis that this should be addressed through the IDOK process. None of the investors surveyed believed that rights issues would be a major source of funds over the next five years.

Funding from debt markets

Q29 A: Can you conceive of circumstances in which debt markets might not provide all the remaining funds needed by water companies?

Yes

No

B: If yes, what are the circumstances, why might they arise and what are the consequences?

Just over half of the investors surveyed could not conceive of circumstances in which the debt markets might not provide the funds needed by water companies. Another quarter of investors said that these circumstances would be remote. Thus 78% of investors said that debt markets would provide funds under reasonably foreseeable circumstances. In the 2004 investor survey, 70 per cent of investors surveyed (79 per cent debt and 61 per cent equity) believed that the debt market could be relied upon to fulfil future funding requirements. Just over 20 per cent of debt investors

said that that they could conceive of circumstances where debt markets might not provide the funding required.

While most investors acknowledged that funding was reasonably secure over the next five to 10 years, some expressed concerns about changes to the regulatory regime or political environment, continuing increases in the proportion of debt, and mismanagement. A number of investors commented that extreme circumstances are always a possibility.

Emergence of new forms of debt instrument

Q30 Do you think new kinds of debt instrument, or new sources of capital, will emerge over the next five years to provide significant funding for water companies? If so, what and why?

The majority of investors surveyed thought that new kinds of debt instrument, or new sources of capital, would emerge over the next five years to provide significant funding for water companies. However, most of them did not have any suggestions on the specific type of instruments that might emerge. Some suggested that index-linked or euro-denominated bonds might become more widespread.

Index-linked bonds

Q31 How do you think the market for index-linked water company bonds will develop over the next five years?

Strongly

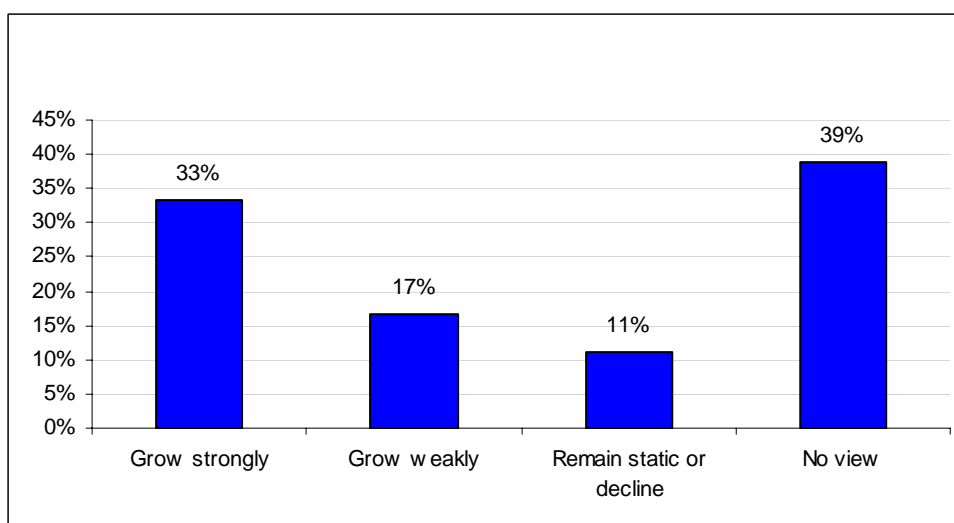
Weakly

Remain static or decline

Why do you hold this view?

Both equity and debt investors were asked for their views on the growth of the market for index-linked water company bonds. Two thirds of equity investors offered no view, but three quarters of both equity and debt investors with a view expected the market to grow either strongly or weakly over the next five years. A number of these said that the water sector was ideally suited to index-linked bonds due to its index-linked asset base and the RPI-X regulatory regime, and noted investors' needs for low-risk investments as a balanced part of their portfolio. However, debt investors noted that the market is currently small, and restricted by a weak appetite for index-linked bonds, as well as an apparent reluctance by water companies to issue them, possibly reflecting current debt market conditions.

Figure 27: Growth of index-linked bonds



Note: Figure 27 includes responses from 41 investors (22 equity and 19 debt)

Long dated bonds

Q32 Why do you think there is no market for bonds from water companies with maturities longer than 30 years?

When asked why there is no market for bonds from water companies with maturities longer than 30 years, the majority of investors who responded said this was due to the uncertainty (regulatory and political) associated with such a long timeframe, coupled with the fact that water company licences only last for 25 years. Several investors suggested that the lack of a government instrument to price against was a key factor preventing the development of a long-term bond market and one suggested that the government should issue 50-year bonds. Another said long-dated non-government instruments might also be used to price water company bonds.

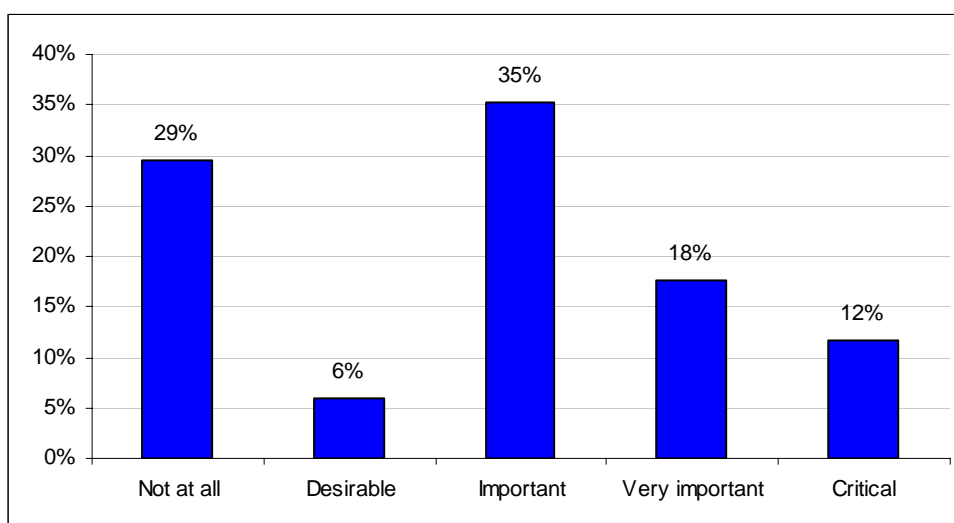
Importance of equity in financial structures

This question was asked only of debt investors.

Q33 As a debt investor, how important is it to you to have a financial structure with at least a thin equity layer?

The majority of debt investors said that it was either important or very important to have a financial structure with at least a thin equity layer as it creates incentives for management. This is broadly consistent with the results of the 2004 investor survey, where investors were almost unanimous in the view that it was very important to have a financial structure that included a layer of equity.

Figure 28: Importance of a financial structure with a thin equity layer



Note: Figure 28 includes responses from 17 debt investors

The extent to which other forms of capital can replicate equity

This question was asked only of debt investors

Q34 As a debt investor, to what extent do you think other forms of capital can replicate equity?

Over 70 per cent of debt investors said that other forms of capital could replicate equity to some extent. Suggested forms of capital that have equity characteristics included perpetual bonds, hybrid structures, convertibles and various forms of subordinated debt.

Scotland and Northern Ireland

Q35 The water businesses in Scotland and Northern Ireland are publicly owned. Under what conditions would you consider investing in an equity stake if it became available?

The majority of investors surveyed responded that they would consider investing in water businesses in Scotland and Northern Ireland if there were a clear financial and regulatory framework. Although some investors said they were comfortable dealing with different regulatory regimes, there was a strong preference for Ofwat or a regulator using similar principles, with several investors stating that using a non-Ofwat regulator would produce a higher cost of capital for Scottish and Northern Irish utilities (because investors would have to learn another regulatory framework). A minority noted the absence of a legal entitlement to revenue in Northern Ireland, and said that the absence of an established, successful record of collecting revenues from domestic customers in both Scotland and Northern Ireland could be a major obstacle for most City investors.

APPENDIX A

List of investors/institutions taking part in the interviews

Equity Investors

Aegon Asset Management	David Griffiths
Aerion/BG Pension Fund	Chris Hart
Bernstein	David Nelson
BP Investment	James Crossley Tony Pike
Capital International Research Inc.	Gina Miscovich
CCLA Investment Management Ltd	Neil Easterbrook
Deutsche Asset Management	Andrew Tusa
Dresdner RCM	Richard Budgett
Ecofin	Bernard Lambilliotte
F&C Management Ltd	Robin Woodall
Fidelity Investment Services	Fiona Davy
Henderson Global Investors	George Latham
Invesco Perpetual	Neil Woodford
Jupiter Asset Management	Mohammed Suteria Suzie Wood
M&G Investment Management	Sachin Oza
Merrill Lynch	Tobias Astor
Newton Investment Management	Robert Canepa Anson Robert Marshall Lee
Schroder Investment Management	Julian Gould
Scottish Widows Investment Partnership	Joel Marks
Threadneedle Investments	Jonathan Barber
UBS Asset Management	David Long
Utilities Trust PLC	James Smith

APPENDIX A

Debt Investors

Aerion Fund Management	Sarang Kulkarni
Barclays Capital	Neil Beddall Agnes de Royere
Deutsche Bank	Paul Malan
European Investment Bank	Liisa Raasakka Robert Schofield
Hermes Pensions Management Ltd	Arabella Duckworth
HSBC Asset Management Ltd	Andrew Aitken Nick Alderman
ING	Geoffrey Smith
Jupiter Asset Management	John Hamilton
M&G Investment Management	Orlando Finzi
MBIA	Lisa Campbell Peter Fiala
Morley Fund Management	Kumar Ghosh
Newton Investment Management	Howard Cunningham
Scottish Widows Investment Partnership	Neil Murray
UBS Global Asset Management	Monika Gmuer

Three participants asked to remain anonymous

Rating Agencies

Fitch Ratings	John Hattan
Fitch Ratings	Steve Durose
Moodys	Monica Merli
Standard & Poor's	Paul Lund
Standard & Poor's	Bill Ferera