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PRESENTATION BY

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I'll be covering a number of areas, most of them linked. Starting off with financing covering restructuring, the cost of capital, cash flows and credit quality. Then say something about regulatory capital values and depreciation, finishing off briefly about our proposed consultation on dealing with logging up and where we are with the development of our financial model.

RESTRUCTURING

The pace of restructuring proposals has slowed since our last City briefing although there have been a number of twists and turns on a couple of them.

So far we've seen, in chronological order, Glas; Sutton and East Surrey; Mid Kent; Portsmouth; Southern and Anglian have announced or implemented highly leveraged capital structures. But others (including some of the larger players) are committed for the time being to the conventional equity model – particularly Severn Trent and United Utilities. We believe that the conventional equity model has worked well.

Our position has remained largely unchanged to that set out in our January 2001 paper on Glas Cymru. Ofwat has a duty to ensure that an efficient water company can finance itself. Doesn't favour/endorse a particular structure or approach.

Not for the regulator to dictate the structure of the industry nor reject proposals on the basis that hypothetical alternative structures or buyers might in theory produce a better outcome.

We don't have any formal powers to block restructuring but we can put in place licence modifications that aim to ensure that the regulated business is protected. As happened in the case of Kelda, an adverse public response can kill a proposal.

Regulator needs rather to ensure that customers are protected from any undue additional risk and companies remain able to access the capital markets readily and at reasonable cost to finance present and prospective capital programmes. Situation with Enron and Wessex has shown that ring-fencing works pretty well.

Some issues can be dealt with by licence modifications but some are not so easily solved. Ofwat has two significant concerns relating to highly geared structures – first whether there is a diminution in the incentives for efficiency and second, (and at least as important) whether gearing up restricts the financial flexibility of the regulated business in the long term. These key risks can only be assessed over time.

It is for companies to manage their own capital structure. Adopting higher levels of gearing could reduce the cost of finance at least temporarily– an important aim in an incentive based regime. But it is not costless and could reduce the financial flexibility of companies in the future. Any structure must be consistent with the long-term nature of the industry. If there is increased level of financial risk (eg re-financing risk) it is a matter for the shareholders and lenders who adopt such structures. It is not a risk to be borne by customers and this is where Ofwat needs to play a role by making this clear from the outset to shareholders and lenders.

COST OF CAPITAL

I would like to explain our current thinking on the cost of capital at for the next review in 2004. Ofwat expects to use same general approach to determining cost of capital as used in the last review in 1999. This was broadly set out in MD166. That is it will be forward looking and will be set for the industry as a whole.

All the utility regulators are very close together on cost of capital issues, after allowing for the different circumstances of the regulated industries (eg 'special case' Railtrack). As is the Competition Commission. Still closer if look at risk free element.

At the last review, the Director's assessment relied primarily on the Capital Asset Pricing Model (CAPM) supplemented by the Dividend Growth Model (DGM) which provided a check on the results of CAPM. CAPM is simple and widely used in the financial markets, other utility regulators and the Competition Commission. The approach was endorsed by the water companies. But some have said that CAPM, because it relies on the availability of forward looking estimates, may be underestimating the marginal cost of new equity required to support the financing of new investment.

Not seen anything at present better than CAPM but there is joint work planned for this year with other utility regulators on the approach to the cost of capital that we will let us know if there is. However, when we set price limits we must not only ensure that companies earn an adequate return on capital but that cash flow financial indicators remain robust and stable such that companies can continue to finance their functions and retain stable credit quality going forward. I will expand a little on this particular issue later.

Companies restructuring through gearing up raises issues about what gearing to assume for the next review. Market developments will have a bearing on the assessment of the efficient level of gearing at the next review. But need to be careful about what we mean by efficient. Company proposals talk about gearing up to an efficient level of indebtedness and this is measured against RCV. They are talking about capital efficiency in terms of tax efficiency. But in our book, very high levels of financial leverage are not necessarily efficient. Efficiency is not only a matter of lowering running costs, it is also about diversifying risk.

Well all other things being equal, an efficiently financed company needs overall to fund net additions to RCV in broadly constant proportions of debt and equity, so that gearing remains broadly stable. Any other course will lead to an increasingly inefficient outcome. If earnings retentions are insufficient to fulfil the requirement for equity, gearing will rise and credit quality fall. Unless equity is adequately remunerated by price limits, companies will be under intense pressure to overdistribute, and debt will progressively be substituted for equity. At some point, credit quality will fall to unsustainable levels.

In setting cost of capital at the next review, we will not be guided simply by the most highly geared companies – can't assume that the current market conditions will persist indefinitely. Highly leveraged structures entail significant financial risk, especially refinancing risk.

Companies which are efficient in the sense I have just described should not have to fear that the way in which the weighted average cost of capital is assessed at future periodic reviews will push them into over-risky structures. On the other hand, companies that choose to skew their risks, in pursuit of out-performance, will get no special treatment. Such skewed risks by definition increase the risk of under-performance and investors must understand that they will have to bear this risk – we are not inclined to accept it on behalf of customers.

We have just commissioned work as to what might be a long term sustainable capital structure for infrastructure based industries. We hope to publish this research.

We follow companies' share prices and the relationship to RCV. It is not a precise science and the results are very dependent on assumptions used. We will continue to follow the trends and this will form part of the evidence in our assessment of the cost of capital. It will be interesting to see what difference, if any, that Wednesday's publication of the future RCVs makes. There were some very minor ripples in the last two days but two days don't make a trend. The price struck by First Aqua's recent bid for Southern is at RCV but we will have to wait for the trend to pan out.

IMPORTANCE OF CASH FLOW AND CREDIT QUALITY

We fully recognise the importance of cash flow as a key factor in assessing the financial risk profile for the water companies. Although there is usually a strong relationship between cash flow and profitability there may be timing issues for example in relation to capital maintenance expenditure and its accounting treatment. We recognise that cash flow analysis is probably the single most critical aspect of all credit rating decisions.

We also recognise that the capital programmes of water companies will remain substantial for the foreseeable future, so companies are unlikely to be cash positive in the medium term.

As I've said, Ofwat does not have a prescriptive view of the credit rating grade that undertakers should maintain. That is for markets and management to determine. Nonetheless, we are clear about two things. First, we shall continue to base our estimates of the cost of capital on contemporary market evidence. Second, we are quite clear that companies must be put in a position that enables them, provided they remain efficient, to finance the sustained outflow of funds they face without an inevitable decline in credit quality to sub-optimal levels. We will, therefore, continue to analyse the position and, if necessary, adjust price limits at Periodic Reviews - as we did at the review in 1999 - to preserve reasonable prospects that sound, broadly stable financial ratios can be maintained. This means that in stable market conditions, companies would be able to access additional finance readily and at reasonable cost.

At PR99 we consulted to ascertain which financial indicators are most commonly used in credit assessment or in financial covenants. These included cash flow based indicators as well as accounting based indicators such as interest cover. We will review this package in light of market developments. The rating agencies have already indicated that post maintenance expenditure ratios might be appropriate.

We didn't design the package of indicators to be a target or to achieve a particular credit rating. But because of the capital programmes, we want them to be seen as good quality credits and try to set price limits in a way that enables companies to be seen as such.

Ofwat has not specified what the rating should be within the investment grade envelope because the views of what is acceptable by markets might change over time. It's not for the regulator to decide the specific credit quality of water companies

Nonetheless, as has been said elsewhere, it is not Ofwat's job to protect inefficient companies or their investors. If managements choose to over-distribute, allowing their credit ratings to drift down, it will be up to markets to protect themselves. Further regulatory relief in such circumstances could not be justified. Ofwat regards step-up coupons, restrictive covenants, indeed the full armoury of investor protections, as broadly helpful disciplines in managing regulated businesses.

Clearly, however, an overly cautious approach can equally lead to inefficient outcomes, and we would counsel against overreaction to the decline in average credit quality that has been seen in the past. To a degree this was inevitable, indeed deliberate - the privatisation dowry of exceptionally strong balance sheets were explicitly designed to allow investment to be largely if not wholly debt funded in the first ten years, so it really should have come as no surprise to investors that gearing has subsequently risen. But times have now changed. The industry's capital structure is now generally much more efficient. Of course, that it is ultimately a matter for the markets to judge, not for us, but for what it's worth, we don't agree that a downward trend in ratings is inexorable.

Some of the water and sewerage companies have a licence condition to maintain an investment grade credit rating. We have as part of our licence consistency review (more on this later) proposed that this should be a condition of all companies' licences (apart from the small water only companies).

It is designed to provide a trigger for regulatory action in the event that a company's financial position falls below a minimum acceptable level but should be seen as a floor for the protection of customers and lenders. It is an early signal that a company's ability to raise future finance is at risk.

Currently there are two forms of this condition. One refers to maintaining an investment-grade credit quality for its borrowing – an **issue** credit rating is an opinion of the credit worthiness of a business with respect to a specific financial obligation. The other refers to maintaining an investment grade 'corporate credit rating' – this is an opinion of the company's (**issuer**) overall capacity to meet its financial obligations. Companies with the more complex financing structures that we have seen emerging recently are required to comply with the later form. More recently we have asked the company to obtain this rating before the transaction is brought to market – as an indication that the refinancing does not create undue strain on its financial position.

I've used the term 'corporate credit rating' because that encapsulates the general idea but the rating agencies use different terms – for example Moody's equivalent would be its 'Senior Implied Rating'.

EMBEDDED DEBT

We have noted the importance to some companies that we take account of embedded debt costs. There cannot be any automatic cost pass through to customers and there won't be a need to if companies are efficiently financed and managed ie they retain the flexibility to respond to changing conditions and have a balance debt portfolio. In this case, embedded debt should not be an issue but we will consider any cases that are put to us. Companies will have to demonstrate why such debt was part of an efficient financing structure with broadly stable real interest costs and that they have explored the options available to them for refinancing any high cost fixed rate debt still in their balance sheets at the time of the next review.

REGULATORY CAPITAL VALUES

The regulatory capital value (RCV) is one of the more important parameters underlying price limits. I continue to emphasise that they are only one number amongst other assumptions and the genuinely critical numbers are the price limits themselves – that's what's embodied in price cap incentive regulation. But we've recognised the increasing importance attached to them and that it wouldn't be sufficient in the future just to publish historical RCVs each year in our annual report on Financial Performance . The investment community indicated that they would like future RCVs to be published. They believe that this would increase not only the transparency of regulatory decisions but also their consistency and predictability.

Having consulted with companies and others on the proposal in general and on the format in particular, we published RCV's for all companies this week (20 March 2002) in the form of a RD letter. The RD letter includes a reconciliation of the opening and closing RCV for each of the years from 2001-02 to 2004-05 for each company and a simple explanation of and commentary on the role of RCVs and their calculation. This includes a description of the adjustments to be made at periodic reviews.

At an industry level, the movements are shown on this slide. The RCV increases from £30bn at 31st March 2001 to £34bn at 31st March 2005 – note this is all shown in constant prices and obviously the outturn figure for 2005 will be increased by four years of inflation.

We intend to update and issue this every year. Obviously since the RCVs were set in 1999, the only changes will be for inflation and any Interim Determinations.

DEPRECIATION

Depreciation is a dreadfully dull thing to have to talk about but it is a very important element in price setting – accounting for about 20% of an average bill.

I recall the MMC report on British Gas from the mid nineties where they described one of the adjustments on depreciation which they decided against making as 'an ….. adjustment that would give a spurious aura of precision to what are essentially subjective estimates'. You may feel like that about depreciation as a whole. Now they were probably right in general but by not making the adjustment they ended up with a flawed answer.

Many of the assumptions companies make to calculate their depreciation charges are subjective. They also vary across the industry. We want the depreciation allowed for in price limits to reflect the use of assets to provide the water and sewerage services. We want to make sure that price limits are not unduly influenced by the company's choice of accounting policies. We took account of this in our approach to depreciation at PR99.

Depreciation and the regulatory capital value are linked. Consequently depreciation is concerned with the timing of recognising capital expenditure and hence the balance of bills between current and future customers.

Our hypothesis was that, over the long term, for a pool of assets which is neither growing or declining in terms of outputs generated, the depreciation charged should be comparable to the capital expenditure required to maintain and replace the assets.

In general for the water industry at present, the total depreciation over a reasonably long period of time is higher than maintenance expenditure. Much of the difference is explained by the recent growth in the assets due to investment to meet quality obligations. Even when this is taken into account there remains a significant imbalance. At the last review where companies did not provide sound explanations for this difference, a downward adjustment was made to depreciation in determining price limits. This particular element of our approach on average accounted for around 2% of the reduction in customers' bills. Most companies accepted this approach in principle but disagreed with what they perceived as a mechanistic application of the adjustment. The Competition Commission (CC) recommended in its reports on Mid Kent Water plc and Sutton and East Surrey Water plc, following PR99, that our approach to depreciation should be given further study. Their proposal worked for those two small companies but wouldn't for the vast majority of the industry.

Published consultation paper on 12 March. Views required by 26 April. The purpose of this consultation paper is to:

- consider the issues raised following periodic review 1999 (PR99) about our approach to depreciation; and
- to consult on possible approaches for the next periodic review in 2004 (PR04).

LICENCE CONSISTENCY

We consulted in December on proposals to remove some of the inconsistencies between companies' licence conditions, which have evolved over time. This review followed on from our consultation on the re-introduction of the so-called shipwreck clause, which is now in the licences of all companies except Thames and United Utilities.

We believe that greater consistency between companies licences would contribute to greater transparency and provide a clearer starting point for Period Reviews and Interim Determinations of price limits.

In the consultation we proposed that all companies should have:

- Re-introduction of a symmetrical version of the relevant change of circumstance, under which an IDoK can be triggered for capital price inflation;
- A number of elements of the higher financial ring-fence including prohibition of cross-defaults, maintenance of an investment grade credit rating for all but the smallest companies and a requirement to conduct the regulated business as if it were the sole business of the water company;
- A condition imposing obligations on the Appointee's owners to do nothing which would cause the Appointee to breach its licence and to ensure that the Appointee's board has at least 3 independent non-executives.

We also asked for views on whether all companies should: -

- have a procurement condition, which would lie dormant until a specified proportion of activities is outsourced. This condition requires companies to demonstrate how they maintain control over outsourced functions and to submit a procurement plan showing how they achieve fair outsourcing.
- be required to publish separate results for the regulated business and comply with the combined code on corporate governance;

- restrict the activities of the Appointee to the regulated business.

The consultation period for this review closed on Wednesday and we are currently trawling through the responses. In the light of these we will publish our conclusions in the early summer.

CONSULTATION PAPER – CHANGES IN EXPENDITURE/OUTPUTS BETWEEN REVIEWS

Where companies circumstances have changed between price reviews and these changes fall into one of the categories eligible for an interim determination, then providing the changes are, in aggregate, material a company can ask for an Interim Determination to change its price limits. The mechanics for this are set out in companies' licence and are pretty clear. What is less clear, and has really developed through custom and practice in the last two price reviews is where things don't reach the materiality level – how are they dealt with?

This is known in the trade as 'logging up, logging down' and shortfalls – of course the companies only ever refer to 'logging up'. Companies have argued, probably rightly, that it would be helpful to have the custom and practice written down in advance. This could help reduce regulatory uncertainty. Consequently, we will be issuing a consultation paper in order to provide greater clarity on the treatment of changes in expenditure and outputs that have occurred since PR99 or will occur prior to the next Periodic Review. We plan to publish this paper in the early summer.

Final proposals will be set out in the October methodology paper.

FINANCIAL MODEL

Finally I would just like to update you where we are in relation to release of our Financial Model. As you will be aware we have commissioned an upgraded model from Cap Gemini Ernst Young for the next review.

We are committed to sharing this model (and data to run it/with the industry and the model itself will be commercially available (not as an XBOX game).

The upgraded model has been delivered to Ofwat for acceptance testing. We have let a contract for the independent audit of the model to start when acceptance testing completed.

Once these stages have been completed, we will release the model (as flagged in the Forward Programme) and this will be in advance of our October methodology consultation paper.

Model encompasses PR99 methodology and will be revised/re-released if necessary to take account of methodology changes following the PR04 consultation paper.

So as the slide says, you will all be able to do your own versions of the Periodic Review.