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Rhiannon McHugh,
PR09 Planning Team,
Ofwat,
Centre City Tower,
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Dear Ms McHugh

I am writing in response to the PR09 Methodology Consultation Paper ("Setting price limits for 2010-2015: Framework and approach – a consultation paper") with feedback on the consultation from a credit investor perspective.

AIG is a US-based insurance company whose liabilities are matched with a global portfolio of assets, including significant holdings of the debt securities of several of the UK water companies. AIG operates in a multi-jurisdictional environment and is required by insurance regulators to maintain a certain proportion of single-A rated assets amongst its holdings, which means we can be restricted on owning certain assets in the BBB category or below. As such, the UK Water sector represents a core part of our holdings given its non-cyclical nature, our demand for "A" rated non-financial bonds and the stable and predictable cash flows that result from a robust regulatory framework.

In our view, the existing framework in the UK provides debt investors with a combination of attractive investment characteristics, and we commend Ofwat on the approach taken to preserving a solid credit profile for the sector in PR04. Publication of the key credit ratios used in the pricing assumptions has also allowed good transparency for investors, and gives analysts another tool to compare the Ofwat assumptions with the capital structure models used by the companies themselves.

We welcome similar comments relating to capital structure in the Consultation Paper for PR09. Most of our UK water holdings are intended to be held for longer than just the current price review period, and the long-term stability of the sector's credit profile is central to this.

Clearly, the views of the rating agencies are also critical in this process, and we welcome the statement by Ofwat that it will continue to work closely with the agencies in order to ensure that the "assumptions on capital structure are consistent with ratings comfortably within the investment grade envelope".



Our concerns are centred on the need for the water companies to maintain access to the capital markets throughout the five-year review period, given their significant capex requirements. In our opinion the primary issue for companies, such as the water names, in coming to the bond market is not so much the absolute cost of issuing debt (which of course increases further down the credit rating spectrum), but the ability of a lower-rated entity to come to the market. This has been in evidence particularly during the recent credit constraints, where higher-rated companies have been able to access the markets easier than lower-rated companies.

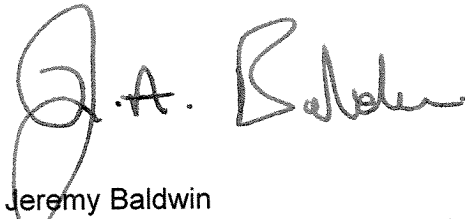
We would be concerned about the possibility that issuers currently rated at A3/A- could face an automatic ratings downgrade, even by one notch, if there were some inconsistency between Ofwat and the rating agencies on the capital structure assumptions. This could potentially cause us to be forced sellers of bonds in some cases, and would also restrict our ability to invest in new issues going forward, given the nature of some of our accounts.

In summary, we believe it is important to highlight the areas of the Price Review methodology where we commend the approach taken by Ofwat. However, it is also right that we should voice our concerns about the potential impact of a deteriorating credit profile in the UK Water sector as a whole.

Yours sincerely



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Jeremy Baldwin
Head of European Credit Research