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Dear Keith

Consultation on Ofwat's Section 13 proposals to modify company licences

Response by Lloyds Bank's Utilities Team, Commercial Banking

Thank you for advising us of the current consultation process. We continue to follow regulatory developments in the sector with great interest and thought it may be beneficial to provide a lender's view.

Competition amongst lenders to the water sector remains strong and financing terms obtained by water companies continue to be at the finer end of the corporate scale. But the industry structure is not without its credit challenges. There is no escaping the fact that the long-term cash flow negative characteristics of the sector run contrary to basic principles of lending and investment.

This does not always make for a straightforward credit decision and our credit approval function relies heavily on the certainty provided by the regulatory regime with respect to the evolution of future cashflows. This is also the case for the institutional investors with whom we place bond issuance, particularly since the long-term nature of network assets has naturally led the Water Sector to focus on issues with maturities of 30-years or longer.

We note the restatement of your commitment to "financeability", but lenders and investors require confidence in the durability of the RCV construct, and in this respect your current proposals do cast doubt on previously held certainties.

In addition to their continuing need to raise new finance, all companies in the water sector, regardless of leverage or ownership, remain wholly dependent on refinancing existing indebtedness for decades to come. Hitherto the overriding assurance for lender and investor alike is the confidence maintained in the predictability and continuity of the regulatory regime.

On balance we consider that your proposals will contribute, over time, to greater uncertainty for providers of debt capital, both commercial banks like Lloyds and longer-term investors. Uncertainty will very likely result in a greater risk premium being assigned to the sector and, all other factors being equal, cost of debt is likely to increase. This may be a risk you are willing to take for driving through regulatory/structural reform, but the risk of unintended consequences appears quite high.

We appreciate that considerable effort and focus has been directed for some years by your office and others towards the introduction of greater competition in the sector. As we understand your current proposals, you intend to open up to competition up to 10% of the current cost value of a water company's asset base. This appears a small percentage, but it does represent a much more meaningful proportion of RCV – perhaps 50% – that would be removed from the current RPI-linked Wholesale control. It still remains unclear how much of RCV will transfer to a non-Wholesale non-contestable RCV-based price control, and what will be placed in a contestable, non RCV-based form of regulation.

Virtually all the companies we are aware of in the sector are bound by restrictions on their leverage (net debt/RCV) and interest cover (generally on a cash basis). Any transfer of assets outside the Wholesale RCV implies the assumption of additional risks for lenders/investors – no certainty over RPI-linkage, no certainty over future maintenance capex on pre-2015 assets being included in RCV, and greater revenue risk in the contested segment. Hence we believe lenders and investors will seek a higher risk premium. Furthermore the encouragement of competition may require the regulator to set higher returns to investors than in the non-contestable business, and this would not necessarily be in the interests of consumers.

We are not in a position to judge from the information available whether the measures to introduce competition will succeed in offsetting the higher cost of debt capital. We are mindful of the experience of consumers in the electricity and gas sectors. Moreover water is a unique commodity.

We therefore infer that it may become progressively less attractive for a financier to maintain the same level of commitment to a water company in the future.

Lenders and investors place enormous reliance on the regulator's Section 2 duties to enable water companies to finance their functions, and ultimately on the robustness of the Special Administration regime. We have summarised our main comments on the proposals in the table below and conclude that the proposals will be credit-negative for the sector.

We support the aim of encouraging efficiencies across the sector and offering value to the consumer, but believe that your proposals may add to the perceived riskiness of the sector for debt providers and investors. The erosion of regulatory certainty for lenders, and the increase in regulatory complexity if these measures are implemented, may lead to an increase in risk premium, and the resultant rise in financing costs may need to be recovered through higher charges to consumers, thus negating the potential consumer price benefits of Retail competition.

Yours sincerely,



Nicholas Walker
Director, Utilities
Lloyds Bank

Issue	Comment
Retail Competition	Funding of the retail business appears inherently riskier to banks/bond investors in view of its contested nature, and we believe that creditors may seek to differentiate between (i) Non-contestable Wholesale, (ii) Non-contestable Retail, and (iii) Contestable Retail. This may make itself felt in higher credit spreads, reduced funding capacity, and more restrictive covenants for Retail. In order to stimulate competition in the contestable element a higher equity return may need to be set by regulators, which would, in addition to higher credit premia, result in higher prices to consumers.
Section 2 statutory duty	Financeability is a 'sine qua non' from a lender's perspective. However the lack of visibility over exactly how regulatory price setting will apply to activities moving outside the Wholesale RCV-based price control is of concern ("the licence will not specify how we will regulate retail activities" – we assume this statement applies to both Non-contestable and Contestable activities). We do not see how this statutory duty can be easily applied.
RPI-X linkage	All "material" wholesale activities will continue to be index-linked to RPI. This is extremely important to investors, and no doubt a more palatable choice for the regulator and the public than the other alternative, namely the prospect of nominal price increases. Further definition of what constitutes "material" is required.
RCV protection	Capex incurred "efficiently" up to 31/3/2015 will continue to be included in RCV. We had understood that all capex in the current AMP will go into RCV (with a CIS adjustment for incentives) with no qualification. However pre-2015 assets will require future maintenance spend and there is no indication as to whether this will be added to RCV to protect the pre-2015 RCV. We had understood previously that this would be the case. Furthermore, if in the future an asset is transferred into Non-contestable Retail or Contestable Retail, is there a risk of this asset becoming stranded and no longer determined to have been "efficiently" incurred? Beyond 2015 there is no clear undertaking as to the amount of RCV that will be safeguarded. Splitting a water company's business into separate asset bases subject to differing regulation will certainly complicate analysis and make the projection of future performance more uncertain.
Future flexibility	The ability over time to remove up to 40% of revenues from the Wholesale control seems a high figure without clearer visibility of the assets involved. We are, frankly, confused as to the mention of sludge treatment and other 'above-ground' Wholesale assets being transferred out of Wholesale. Income cover covenants could be significantly impaired over time if contested business is lost and credit spreads will inevitably increase as predictability of performance decreases.
Increased regulatory risk	Under the proposed modifications, the judgement as to when and by how much business will transfer out of Wholesale (be it by RCV or revenues), together with the duration of a particular price control period, lies solely with the regulator. Whilst ultimate parameters have been proposed beyond which a further s13 licence modification would be required, we believe that the increased regulatory risk and complexity may lead to higher all-in credit spreads.