

Bridge over troubled waters? Summarising the debate at the 2009 Water UK City Conference



Key speakers included:

Kevin Whiteman
Executive Chairman,
Kelda Group

Pamela Taylor
Chief Executive,
Water UK

Regina Finn
Chief Executive,
Ofwat

Tony Wray
Chief Executive,
Severn Trent

Chris Loughlin
Chief Executive,
South West Water

Chris Jones
Finance Director,
Dwr Cymru Welsh
Water

Martin Hurst
Water Directorate,
Defra

Doug King
Vice Chairman,
Deloitte

Set in the backdrop of a volatile and challenging economic environment and with PR09 looming, Water UK's 9th City Conference held on Thursday 26 February attracted over 170 representatives from the sector, including key stakeholders and investors. Deloitte were once again delighted to be involved as one of Water UK's Partners and listened with interest to a fascinating array of speakers. The diverse range of industry experts and stakeholders present were also involved through the various panel discussions, allowing a wide forum for analysis and discussion, as well as time to explore some of the views expressed by the speakers. This report summarises the key issues discussed through the course of the day.

Back to basics

Opening the conference, Pamela Taylor introduced many of the themes that were to recur throughout the day. Her proposal of a "back to basics" strategy highlighted the need to focus on getting the basics right in an industry that has made huge progress since privatisation. She outlined five key tenets, which require a focus on the two stakeholders that matter most – customers and investors; building on the success of the past and the industry's proven ability to deliver; planning for long-term quality and resilience; acceptance of the diversity of the industry; and encouraging innovation. By taking these areas on board, the industry will focus on the pre-requisites for success and will ensure that the sector has a sustainable future, supporting the country as the economy starts to revive.

Building on success

The effectiveness and strong past performance of the industry was a fundamental premise of comments from all stakeholders including Ofwat, the Consumer Council for Water (CCW) and investors. Positive words were spoken in respect of improvements in performance, achievement of targets and the investment in infrastructure maintenance. The importance of continuing to invest in the industry and to ensure all the lessons of this success are learned, are key elements to ensuring a balanced outcome for PR09.

Putting customers first

Throughout the day, customers were clearly at the forefront of everyone's minds. Both Regina Finn and Tony Smith, Chief Executive of CCW, commented on the detailed research and consultation that underpinned the PR09 process, and the progress made since the previous review in understanding customers' needs and expectations.

And, both stressed that the biggest ever customer survey had been performed, with 85% of responses indicating positive support for the sector. The survey highlighted that above all else, customers want an "efficient, safe, reliable supply of water at a reasonable cost". The need to ensure affordability and manage local requirements and differences, highlighted that a "one size fits all" approach would not reflect an appropriate response to their needs. However, there was general confidence that the industry was well placed to meet customer expectations and ensure an appropriate and affordable result to the price review.

Managing risk

Regina Finn's speech concentrated on the need to deal with these uncertain times in a focused and calm manner, whilst remembering past achievements. She highlighted the progress made by the sector since privatisation, the level of investment made in the industry and the importance of continuing to build on these going forward.

Ofwat's vision of ensuring a sustainable sector was emphasised, despite the challenge of the financial markets and general economy. Regina also placed focus on customers, innovation and resilience. Whilst understandably she didn't give anything new away in advance of the Draft Determinations expected in July, she agreed that a "one size fits all" approach would not be appropriate and she stressed that she is acutely aware of the difficult financial debt market conditions and the fact that investors would need a return that reflects the appropriate level of risk.

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Focus on investors

Seeking the views of investors – through the investor survey conducted by Indepen and sponsored by Water UK – is particularly critical in a year of financial turmoil and a pending price review. Investors continue to view the water sector's regulatory regime broadly positively, although unsurprisingly in such testing times investors have concerns about how Ofwat will respond to market conditions. On some key parameters, investors' views of Ofwat's performance have declined notably, with only 45% believing Ofwat was transparent in their approach to developing policy, and only 48% indicating they believed Ofwat was listening to investors, compared with 90% on both measures in 2004.

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Getting the numbers right

Significant time was spent on investigating key inputs to business plans, not least of which is the weighted average cost of capital. Dr Richard Hern, Associate Director at NERA, discussed what cost of capital was appropriate in the current climate and concluded that the deterioration in the credit markets and resultant increase in the cost of debt meant that an increase of 0.2% was needed compared to his assessment in June 2008, giving a range of 4.6 to 5.1%. He took the opportunity to challenge regulatory lore on the calculation of cost of capital, and again raised the recurrent theme that "one size does not fit all" and that consideration needs to be taken of particular risks and issues.

Richard Bartlett, Head of Corporate & Structured Debt Capital Markets – Western Europe at Royal Bank Scotland, and Callum Mitchell-Thompson, Managing Director – European Head of Utilities at JP Morgan, tackled the thorny subject of raising investment in the current economic climate. Whilst as a defensive stock, water companies are still seen as a good investment in a difficult market, Callum made it clear that equity would be a scarce commodity, sandwiched as it currently is between a deteriorating economy and the debt market. Raising new equity on the markets is no longer seen as positive but rather as a necessary evil to rescue companies in difficulties. Similarly, infrastructure funds are constrained by the difficulties in raising debt to fund investment, and sovereign wealth funds are retrenching having been burned by investments in financial markets or in the light of falling financial markets.

Similarly, Richard Bartlett outlined a pessimistic view of the debt sector and did not see the recent increase in bond issuances as a long-term or sustainable phenomenon. Rather his view was that there would be a significant deterioration in the economy and further bad news to come, impacting pricing during the course of 2009 and further impacting credit and equity spreads. He also drew attention to the fact that whilst a resurgence of bond issuances had been seen in early 2009, this reflected the ability of A rated companies to raise funds. It remains difficult for others with weaker credit ratings to raise debt at a reasonable price, perhaps explaining why certain companies are beginning to look for equity – with South East Water raising funds via equity rather than debt and others being expected to follow suit.

The threat of deflation

As well as events in the financial markets, the difficulties facing the wider economy provided ample topics for discussion. The spectre of negative RPI, and the impact a prolonged period of deflation might have on investors' views and approach to the sector, was clearly a concern for both debt and equity investors. Chris Jones, Finance Director at Dwr Cymru, was confident that the industry was well placed to deal with it for a short period; however others were more concerned that whilst it might not be an issue in the short-term, if the situation lasted longer, it would become a significant threat to the financeability of the industry.

Ray Barrell, Director of Macro Economic Research and Forecasting of the UK and World Economies at National Institute of Economic and Social Research (NIESR), could only be "95% confident that inflation in three years' time would be between -2% and +5%".

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However, his insightful analysis of the impact of the current financial crisis on gross domestic product (GDP) and future predictions for inflation were helpful in showing that recent events would have a long-term negative impact on prospects for the economy, signalling the end of the "great moderation", the period of unusually benign economic conditions before the credit crunch.

His commentary however, highlighted the challenge Ofwat faces in estimating returns for a five year price review period. Peter Bucks, Non-Executive Director at Ofwat, confirmed that this was not a challenge they would shy away from, and that this would indeed be performed in due course as part of the price setting process. Indeed, whilst the idea of Ofwat taking a shorter-term view on cost of capital was floated, it was rejected by almost all the speakers as not being in the interests of the stakeholders.

Managing uncertainty

Throughout the day it became clear that whilst substantial progress was being made in many areas of PR09, the impact of the economic position, government action and changeable inflation levels, meant that there was an increased level of uncertainty over the ability to get all these aspects right in the current financial climate. In these volatile times, the importance of tools to manage uncertainty – such as the substantial effects clause, interim determinations of k and notified items – become particularly critical to managing investors' attitudes to risk and confidence in the regulatory regime. Whilst in "listening" rather than "broadcasting" mode, Regina Finn made it clear that she considered there to be sufficient tools available to Ofwat to manage the economic uncertainty, and would not be creating "any new toys to play with". She did acknowledge that there appeared a demand for further clarification of these mechanisms to ensure investors and stakeholders understood how they would be utilised to manage the relevant risks.

Her reliance on these measures to manage the current risks was clear, although whether these mechanisms (including one historically referred to as ‘the shipwreck clause’) will be seen by the industry and investors as an appropriate means to manage the current financial uncertainties, rather than a fall back in terms of significant stress, remains to be seen. Martin Hurst had a reassuring closing message in his keynote speech at the end of the conference, highlighting the long-term challenge climate change posed to the industry, and the need for the sector to take a long-term perspective. He noted that investors have always recognised the long-term regulatory certainty of the sector and that the government viewed this regulatory certainty as a valuable asset which should in no circumstances be undermined.

Summary

In a period of unprecedented market turmoil and change, the themes of the day focused on dealing with the resultant issues, whilst remaining calm and ensuring that the sector’s past successes were remembered and built upon. A balanced outcome for PR09 is clearly the industry’s immediate need, and a level of confidence emerged that the environmental requirements, customer needs and regulatory tools were in place to move towards this outcome. More uncertain however, was the key financial aspects of the regulatory settlement which is still to be decided upon. Only time will tell if Ofwat will reach its goal and avoid a referral to the Competition Commission, in what has to be the most testing of regulatory determinations.

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