

Water meter

Q2 2009 update



Ernst & Young's Water meter

Ernst & Young's *Water meter* provides information and analysis on financing in the UK water sector.

Our share price index – WAT-UK – tracks the UK's four quoted water companies in order to monitor the relative attractiveness of the sector.

The Ernst & Young Water Bond Yield Tracker (WBYT) recognises the importance of debt markets to the sector, tracking the yield to maturity/redemption yield on UK water company bonds over time.

Water meter is published on a quarterly basis and can be downloaded at www.ey.com/uk/water.

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Regulatory risk casts its shadow

In this edition:

WAT-UK loses touch with FTSE100

- ▶ Since the beginning of April 2009, valuations of listed UK water companies have been outperformed by both the FTSE100 and the S&P Global Water Index. In particular the draft determinations, published in July 2009, have led to WAT-UK losing touch with the FTSE100.

Credit spread for WBYT continues to fall

- ▶ Yields to maturity for water sector corporate bonds, as tracked by WBYT, have fallen to their lowest levels since January 2008. At the same time the credit spread for utilities has fallen back significantly, though at around 160 basis points at the start of July 2009 it is still higher than before the credit crunch began. Issuance of new bonds in Q2 2009 has fallen back compared to Q1.

Periodic Review (PR09) capex plans

- ▶ Ofwat reached a milestone in the PR09 price control process on 23rd July with the release of its 'draft determinations'. It is traditional at this point for there to be a gap between Ofwat and the companies but there is clearly a lot to play for between now and the final determinations in November.

Pension contributions: plan now or pain later

- ▶ Water companies could well come under pressure to increase contributions to their pensions schemes. This cost could fall on shareholders rather than customers.

Are you ready for the Carbon Reduction Commitment scheme?

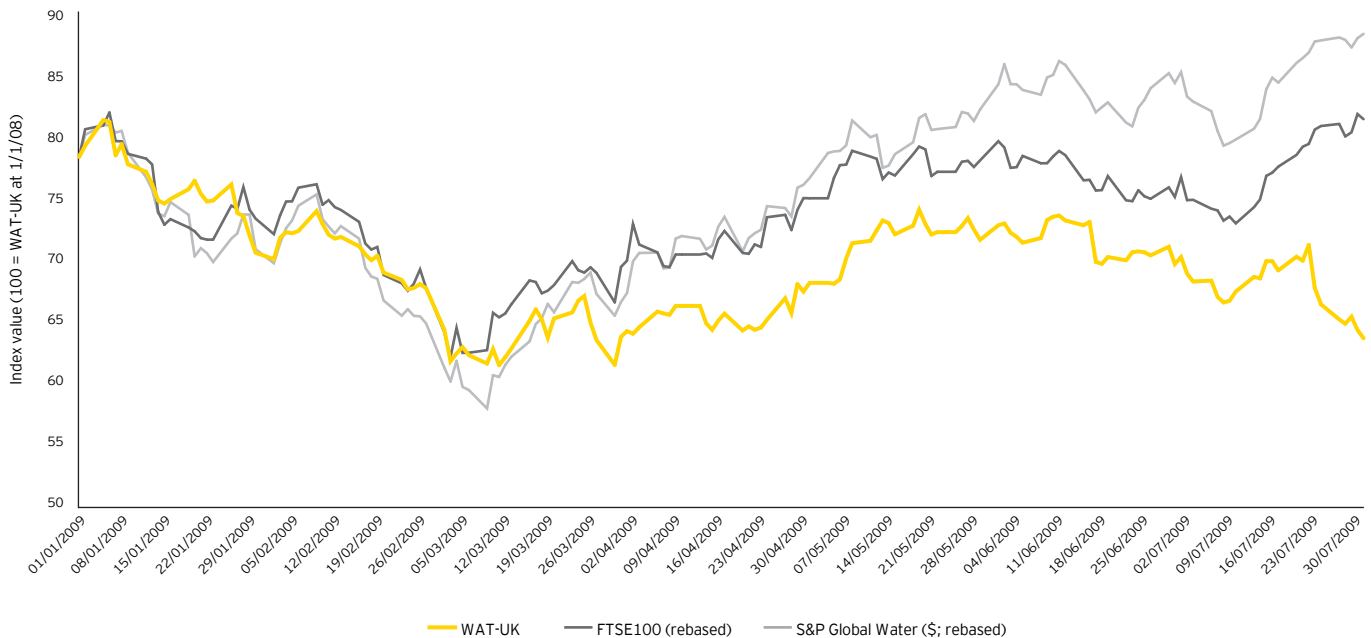
- ▶ Under a new government scheme, organisations will have to buy allowances to cover their carbon emissions from 2010. But what does this mean for the water sector?

With a major capital expenditure programme looming, water companies face a challenging period ahead of them. Significant issues need to be addressed as the sector works through the 2009 Periodic Review (PR09) process and also begins to address the findings of the Cave Review.

If Ofwat is able to find the right balance in its decisions and management teams rise to the new competitive challenges they will face, we believe that the capital expenditure programme can be successfully financed, helping to underpin the long-term future of the sector.

Financing for the UK water sector – Q2 2009

Figure 1: Relative equity performance, January to July 2009



Source: Thomson Datastream; Ernst & Young analysis

UK water stocks feeling the pressure

Ernst & Young's WAT-UK index tracks the share price performance of the UK's four quoted water companies. Figure 1 shows how, since the beginning of 2009, WAT-UK has been comprehensively outperformed by both the FTSE100 and the dollar-denominated S&P Global Water Index.

The three indices moved relatively closely in step until the beginning of March. At this point increased guidance from water companies in England and Wales about the financial impacts of the recession (rising levels of bad debt; falling metered revenues as customers reduced consumption) led to WAT-UK losing ground on the FTSE100 in a relatively short space of time. From mid-March the index began to fare worse than the dollar-denominated S&P Global Water Index, as a number of global water stocks started to perform more strongly. In April it also became clear that three of the UK water companies with securitised debt had been forced to call on shareholders for equity injections, in order to avoid any

possible breach of loan covenants as their RPI-linked asset bases fell in value. Anglian Water, Southern Water and South East Water received £220m between them.¹

Through Q2 2009 WAT-UK then actually kept pace with the FTSE100 fairly consistently. This can be seen clearly in Figure 2, where the two benchmark indices have been rebased against the level of WAT-UK at the start of April 2009, rather than the beginning of January. Neither the submission of final business plans by the water companies in England and Wales nor the publication of the final report of the Cave Review appear to have had much impact on WAT-UK's performance in comparison with the FTSE100. This is in contrast to the relative strength of the S&P Global Water Index, which saw Asian and European water stocks posting good growth.²

¹ Source: "£220m equity injection for UK water companies," Global Water Intelligence, April 2009.

² The share price of Veolia Environnement, for example, rose substantially after announcing its first quarter results on 7 May 2009.

However, what can be seen to have had an immediate impact on WAT-UK, was the publication by Ofwat of its draft determinations under the 2009 Periodic Review (PR09). Share prices of the quoted water companies rose significantly in the immediate run-up to the publication. However, when the draft determinations of the water companies' revenue profiles for the period April 2010 to March 2015 were actually published, the valuation of WAT-UK fell sharply in response as commentators digested the implications of a 'tough' review.

We discuss the draft determinations in more detail later in this publication. Nevertheless, it remains the case that the cost of debt remains a critical part of PR09, with a lot riding on the regulator's final decision. Any extended period of deflation will increase the cost of companies' outstanding fixed-rate debt in real terms, at a time when their RPI-linked revenues are likely to be coming under greater pressure due to reduced metered volumes and rising bad debts.

Q2 2009 saw the full year results for quoted UK water companies being published, with the reporting season falling around the end of May. This confirmed the key challenges being faced by the water sector at the moment: declining levels of consumption, rising levels of bad debt and growing operating costs.

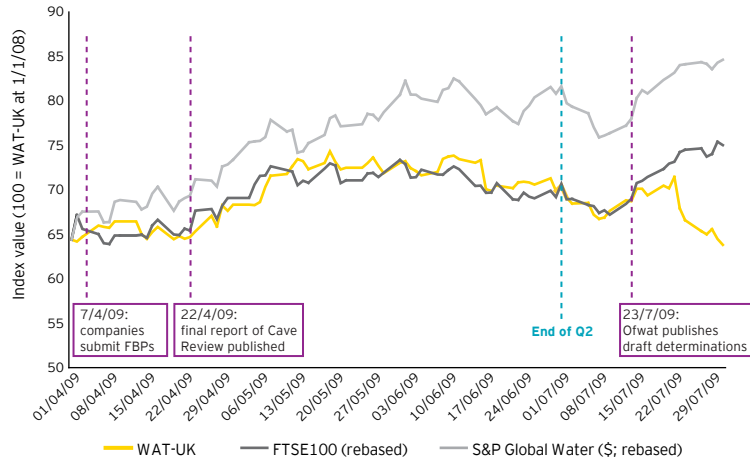
For instance, Severn Trent reported that falling commercial consumption had cut over £20m from its revenue base, at the same time as provisions for bad debts had to be increased by £6.6m.³ Both United Utilities and Northumbrian Water Group highlighted the impact of increased energy costs on their annual performance, among other factors. These underlying messages were reiterated in respect of both Wessex Water and Thames Water as their management teams commented on the companies' annual results. The way in which Ofwat chooses to treat revenue losses, bad debts and energy costs remains an important part of PR09.

Credit spread for water utilities continues to fall

Yield to maturity for UK water sector bonds, as tracked through our basket of corporate water bonds (WBYT), was stable for most of Q2 2009, hovering around the 6% mark before falling through it in the second half of June (see Figure 3). In doing so WBYT returned to levels not seen since January 2008.

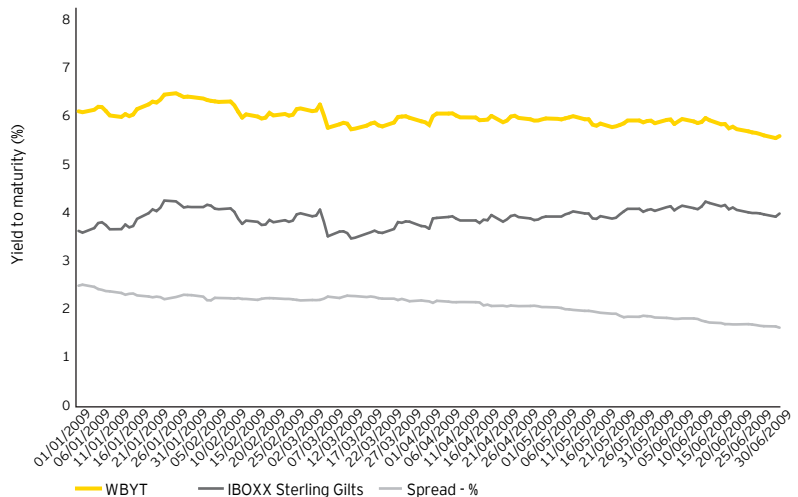
Q2 2009 also saw the continuation of a trend that began at the start of the year – the narrowing of the credit spread for water utilities. The premium in yield to maturity (or redemption yield) between water sector bonds and gilts has fallen steadily since peaking at 259 basis points in early December 2008 (see Figure 4). Q1 saw a reduction of c.30 basis points; in Q2 the utilities credit spread fell by a further 50 basis points or so. In effect, the perceived riskiness of the water sector bonds in comparison to government debt has fallen. But it should also be noted that, at around 160 basis points at the end of

Figure 2: Relative equity performance, April to July 2009



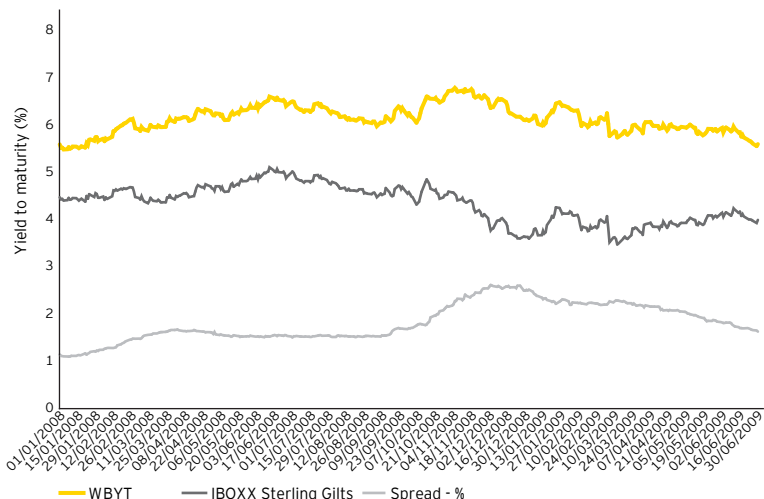
Source: Thomson Datastream; Ernst & Young analysis

Figure 3: Bond performance in H1 2009 (all maturities)



Source: Thomson Datastream; Ernst & Young analysis

Figure 4: Bond performance since start of 2008 (all maturities)



Source: Thomson Datastream; Ernst & Young analysis

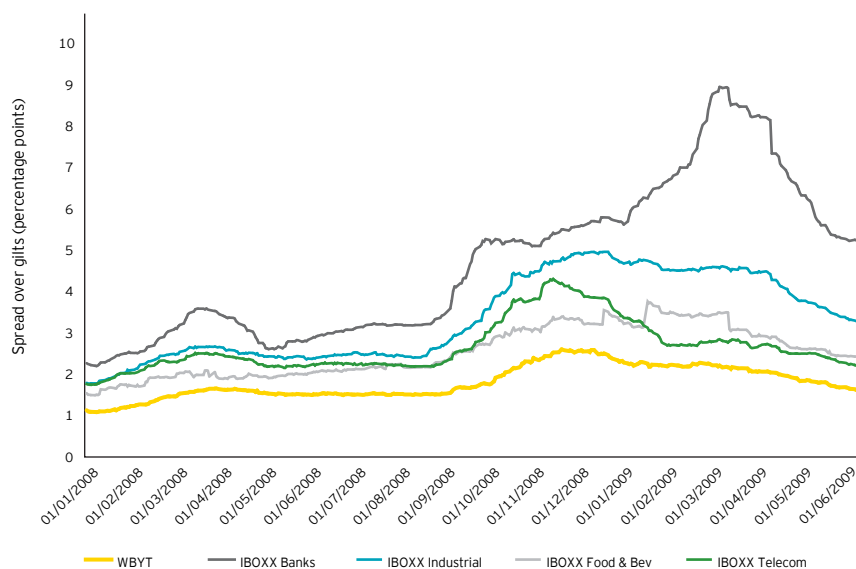
³ Source: Preliminary Announcement of Annual Results, Severn Trent PLC, 29 May 2009.

Q2, the credit spread is still some way from the levels typically seen (100 basis points or less) before the constriction of credit supply began.

Assuming that the constituents and weighting of WBYT do not change significantly following the next quarterly revision, we fully expect the credit spread for water utilities to continue the narrowing that we have seen during Q3.

The credit spread for WBYT and bonds issued by a number of other corporate sectors is shown in Figure 5. Falls across the board in Q2 do seem to reflect growing optimism that the worst of the 'credit crunch' may be behind us. The ongoing advantage enjoyed by the water sector in terms of preferential borrowing rates is also clear.

Figure 5: Sector performance of bonds since 1 January 2008 – corporate spread in yield to maturity vs. gilts (all maturities)



Source: Thomson Datastream; Ernst & Young analysis

Rate of new bond issuance slows

Perhaps unsurprisingly, given the fact that attention was becoming more firmly fixed on the forthcoming draft determinations from Ofwat, there was less interest in undertaking new issues in Q2 2009. This may also be a reflection of hopes that the credit spread for utilities will continue to fall in future. The only major new bond issue came at the end of May, when

Anglian Water successfully raised £100m at medium maturity (see Table 1).⁴

United Utilities also took the opportunity to re-open a number of its earlier issues, including its 6.125% December 2015 notes and its 5.75% March 2022 notes. The overall issue sizes rose to £425m and

£375m respectively. In addition a small private placement of Yen-denominated floating rate notes was made to a single investor.

Overall, this meant that the total issuance of new bonds for H1 2009 stayed just on the pace needed to match the level of funds raised across the whole year in 2007 and 2008. Yorkshire Water's refinancing in July 2009, which included issuing £650m in new bonds, has ensured that issuance in H2 2009 has already got off to a strong start. We will cover this refinancing, whereby Yorkshire Water's existing debt has been transferred into a

⁴ According to Reuters, Anglian Water was also planning to extend the maturity of its existing loans until 2012 by negotiating a £225m forward start agreement in April 2009. Lenders agree in advance to replace existing loans when they mature, in return for increased fees and margins. Anglian's existing facility is due to mature in November 2009, right at the time when the PR09 is due to conclude. Source: "Anglian Water seeks 225 mln stg forward start loan," Reuters, 30 April 2009.

Table 1: UK water company bond issues, Q2 2009

Issuer	Size	Coupon	Yield	Maturity date	S&P's rating/ Moody's rating	Date issued	Notes
United Utilities Water plc	£50m	6.125%	n/a	29 December 2015	na/na	17 June 2009	Further tranche related to original issue on 18 December 2008
United Utilities Water plc	£100m	5.750%	n/a	25 March 2022	na/na	05 June 2009	Further tranche related to original issue on 18 March 2009
Anglian Water Services Financing plc	£100m	6.750%	6.957% (est.at issue)	11 June 2024	BBB/Baa3	28 May 2009	Fixed to Floating – three months GBP LIBOR +10.90% from June 2014
United Utilities Water plc	JPY5bn	Floating	Not known	30 October 2017	na/na	26 March 2009	Sold to single investor as private placement
United Utilities Water plc	£75m	6.750%	n/a	25 March 2022	na/na	24 March 2009	Further tranche related to original issue on 18 March 2009

Source: Ernst & Young; Thomson Datastream

securitisation structure, in more detail in our next edition.

Appetite for UK water sector bonds may still remain high, if activity in the European bond market is anything to judge by. At the end of March overwhelming demand for paper issued by Suez Environnement meant that the group was able successfully to price €1bn 5-year paper and €0.8bn 10-year paper in a dual-tranche bond issue. This was followed in April by Suez issuing a further €0.3bn of the 5-year paper, while in the same month French rival, Veolia Environnement, issued €1.25bn of short-term and €0.75bn of medium-term bonds.

Towards the end of May Moody's placed the credit rating of Severn Trent, at both a group and regulated water company level, under review for a possible downgrade. This was triggered by Severn Trent's final business plan and a resulting fear that gearing level might have to rise over the period 2010–2015. In the event, the rating was downgraded one notch in September.

Methodology for Ernst & Young's water bond yield tracker

WBYT tracks the yield to maturity/redemption yield on UK water company bonds over time. It represents the average yield to maturity or redemption yield on a basket of bonds, weighted by the amount in issue. This weighting is rebalanced on a quarterly basis.

Not all bonds issued by the UK water sector are included in WBYT. To be eligible for inclusion bonds must meet the following key criteria:

- ▶ Investment grade bonds issued by UK water companies or their proxies.
- ▶ At least £50m (or currency equivalent) in issue. Non-sterling bonds converted to sterling for assessment against this criteria at each quarter-end date and are given this weighting for the succeeding quarter.
- ▶ At least one year left to maturity on quarterly rebalancing date.
- ▶ Redemption yield data is available from Thomson Datastream (typically hybrid and asset-backed bonds excluded as a result). Long-dated inflation-linked bonds are included when redemption yield data is available.
- ▶ Regularly traded.

Eligible bonds are included in WBYT from the start of the quarter after that in which they are issued or in which redemption yield data becomes available.

With major capital expenditure on the horizon, raising new capital is going to be a major issue for many water companies. In today's turbulent financial markets, independent advice may be critical in making decisions when seeking to raise new finance, refinance existing facilities or renegotiate funding covenants.

At Ernst & Young we have a team dedicated to advising on optimising capital and debt structures; debt and capital re-organisation (debt for equity swap); credit ratings advice; raising debt and equity; advising on the full range of market options – comparing bank, bond, private placement and alternative debt providers; and advising on Treasury strategy.

For further information, please contact: Dougald Middleton on 020 7951 0945 or email dmiddleton@uk.ey.com and Gary Davison on 0161 333 2767 or email gdavison@uk.ey.com.

Make up of WBYT in Quarter 2 2009

As at 1 April 2009, the components of WBYT had the following characteristics:

- ▶ Number of bonds included: **51**
- ▶ Total amount in issue (sterling equivalent): **£14.8bn**. Includes:
 - ▶ £523m denominated in US\$ (two bonds)
 - ▶ £2.64bn denominated in euro (four bonds)
- ▶ Average amount in issue (in sterling equivalent): **£290m**
- ▶ Average life remaining: **17.3 years** (longest: 49.0 years, shortest: 1.0 year)

▶ Credit ratings by level:

Standard and Poor's rating	Number
AAA	4 (8%)
A	8 (16%)
A-	22 (43%)
BBB+	14 (27%)
BBB	1 (2%)
Not rated by S&P	2 (4%)
Total	51

▶ Although the number of bonds in WBYT stayed constant at 51, there were a number of changes in its make-up. Four bonds issued during Q1 2009 joined the index at the start of Q2 and the same number of bonds left the index. The exits were due to the remaining life of the bond falling below one year or the amount in issue falling below £50m.

PR09 update

Ofwat reached a key milestone in the PR09 price control process on 23 July with the release of its 'draft determinations' on price limits for water and sewerage companies in England and Wales, for the 2010–15 period.

Ofwat has played a canny game, catching the political mood at a time when the economy is in recession and consumers want to see bills held down. The proposed revenue for water companies is substantially below the level most asked for in their business plans. A significant number argued for above inflation rises in consumer prices over the next five years but Ofwat's determination implies price reductions for all but two companies. This reverses the historic trend of increasing water prices and will be welcome news for customers in the short term. It is also in line with the draft determination for Scottish Water recently issued by the WICS.

It is difficult to see how Ofwat could have adopted a different strategy at this time, although there is a risk that it may come back to bite them. For example, some commentators are worried that there could be non-financial consequences as companies struggle to meet the required outputs on less money. Others believe that there may need to be a compensating price rise in five years time as companies catch up on investments that would otherwise have been made now. The initial reaction to Ofwat's draft determination on the stock market was a fall in share price for all of the quoted water companies, as shown by the fall in WAT-UK in Figure 2 on page 3. Investors are particularly worried that resulting equity returns will be materially lower than expected.

Ofwat has had to strike a difficult balance between the interests of consumers, the companies and investors. Ofwat has made cuts across the board – aggregate allowed revenues are around £1bn a year less than in the companies' business plans and allowed capital expenditure is £3.5bn lower than suggested over the five years.

Ofwat argues that many of these cuts are focused on expenditure that is not

supported by a positive cost-benefit analysis or that can be deferred. It has also been particularly severe on capital expenditure for water network enhancements and extensions. A particular area of concern for companies (and potentially the public) is Ofwat's decisions around sewer flooding where fully £600m of the companies' proposed expenditure of £1.5bn has been disallowed.

The allowed cost of capital, a key component of the determination, is below all the companies' proposals at 4.5% post tax. Companies are also unhappy with the associated package of proposals to mitigate risk. The determinations propose a need for only limited reopeners, and companies will be expected to deal with potentially major issues such as energy costs and pensions in the same way as other commercial risks.

However, looking beyond the headlines at the various sub-components suggests that the degree of pain that this will impose on companies is not as great as it might first appear.

At the industry level the £1bn revenue gap is roughly split one third each between the impact of a reduced cost of capital, disallowed capex and disallowed opex. Ofwat has also reduced many companies' claims to increased current cost depreciation charges in the light of the recent asset revaluations, which will have a short term impact on revenue but a more limited impact in the long term.

On capex, companies can take the view that since the regulator has not approved the enhancement spend, they do not need to make those investments in the period. On opex, Ofwat has allowed an overall increase of 3% whereas the companies asked for 12%. However, around a quarter of this difference reflects reductions in expenditure on enhanced services which follows the reductions in capex. While companies have expressed disappointment with the proposed cost of capital, one analyst published a review indicating that 4.5% was very close to their own expectations. Others suggested a sector

consensus of 4.6% to 4.8%. Depending on which assessment is an accurate reflection of investors' expectations, this could mean that only a third to a half of the revenue gap is truly painful for the companies.

This judgement is somewhat tempered by the fact that averages do not tell the whole story. There are some important differences between the companies.

We believe that some companies received determinations that they will be able to live with in overall terms, and have now turned their attention to how to deliver and outperform on consumer and shareholder expectations. They are recutting their business plans to fit the new cloth they have been given, while continuing to argue for an improved settlement on key items in November.

Others have a different view: for example Thames Water and the Water Only Companies (WOCs).

Thames Water is by far the largest of the water companies and is exposed to the largest revenue shortfall. It alone accounts for 23% of the industry total capex and Ofwat's capex baseline adjustments indicated that even adjusting for size, it is seen as something of an outlier, especially on its water programmes for leakage and mains replacement.

Thames also broke ranks on the cost-of-capital, arguing for a level of "at least 5.25%" whereas the other WASCs were all around 4.7% to 4.9%. The shortfall is therefore correspondingly larger. It also stands out as the only company where Ofwat has made adjustments to maintain satisfactory financial ratios. The company is likely to be particularly unhappy that Ofwat has chosen to do this by assuming a further injection of shareholders funds (a signal to the other highly geared water companies perhaps?).

Southern Water also appears to have come off relatively poorly on a range of measures, with £0.6bn of its £2.2bn capex programme having been rejected combined with a significant efficiency challenge.

At the other end of the spectrum, small companies also appear to have fared poorly. The small companies had argued for a premium on the cost-of-capital of between 0.4% and 1.4%. Ofwat has largely rejected this and offered adjustments of only 0.1% for the two largest WOCs and only 0.4% for the others.

Ofwat's assessment of the small companies' capex plans also shows a significant difference of view. Eight of the 11 small companies had a capital incentive scheme (CIS) ratio against the Ofwat baseline of over 125, with four of 11 in the range 150–165. For example, Sutton & East Surrey's ratio of 165 means that Ofwat is effectively rejecting 40% of its proposed capex. And because of the way in which the CIS rules work, if the company spent what it proposed, fully 35% of it would not be funded in the current price control period. We are concerned about the incentives this places on the companies that are at the extreme end of the CIS matrix.

Taking the draft determination together with the challenges arising from

implementation of the Cave Review, we wonder whether this could be the beginning of the end for some of the smaller companies. Will they welcome the opportunity to merge or be acquired if and when the special merger regime is relaxed sometime over the next few years?

With so many of the key judgements made by Ofwat tending to the downside it remains to be seen whether the industry will be able to meet or outperform the determination, and how the relationship with Ofwat will evolve over the coming five years, particularly where individual companies are struggling to meet the outputs or are sailing close on financing.

Ofwat is also continuing to signal that PR09 may be the last price control on a fully vertically integrated basis; it is pushing ahead with accounting separation and a project to move towards disaggregated price controls for each element of the value chain at PR14.

The determination is only draft, and it is traditional at this point for there to be something of a gap between Ofwat and the companies. It has recognised

that uncertainty remains around the economy and conditions in financial markets, and some of the open issues (such as the impact of business rates revaluation and customer debt) may be addressed before the final determinations. There is clearly a lot to play for between now and the final determination in November, with the companies and other stakeholders now in the process of making representations to Ofwat. But if there is not some movement by both sides (and the markets are betting that there won't be), there is a strong chance that ultimately one or more companies will challenge Ofwat's judgements at the Competition Commission come January next year.

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Comparison with electricity

Although technically the water and electricity distribution price control processes are entirely separate, with the respective timetables running almost exactly in parallel, it is inevitable that comparisons will be drawn between the approaches and judgements being followed by Ofwat and Ofgem.

Both regulators have caught the political mood around the recession, placing great emphasis on the need to protect customers and challenge companies hard. Both have scaled back the proposed capex plans, although the mechanisms used are rather different. Ofwat focuses on reducing the volume of capex for enhancements and extensions. In contrast, Ofgem has made smaller adjustments on capex volumes but has largely disallowed the above inflation unit cost increase the electricity companies forecast.

On operational expenditures, Ofwat has significantly reduced what companies asked for, but still allows an overall increase of 3%. Ofgem has also significantly reduced the companies' forecasts, but even so this results in an overall increase in opex of close to 6%. However, whilst at first sight this might appear to suggest a less challenging stance from Ofgem, at least some of this discrepancy reflects differences in the detailed definitions of opex used.

Where Ofwat and Ofgem have clearly diverged is over their approach to the cost-of-capital. Ofwat has set their views out very clearly, arguing for a post-tax cost of capital of 4.5%, substantially below the 5.1% set for PR04. Ofgem has chosen to avoid the decision on the cost-of-capital for now, using a planning assumption identical to the DPCR4 level of 4.9% post-tax. However, they have published a consultant's report which cites an enormous potential range, almost all of which lies below the planning assumption and goes as low as 3%.

In previous price controls, the cost-of-capital for water has been slightly above that in electricity, based on the higher levels of capex in water and the need to make the sector attractive to investors. However, with future investment in electricity having risen, such a differential may no longer be appropriate. Given the continued level of uncertainty in financial markets, the debate on the cost-of-capital promises to be one of the most fascinating aspects of the two price controls.

Pension contributions: plan now or pain later

Water companies could well come under pressure to up their contributions to their pension schemes over the coming year. This cost could fall on shareholders rather than customers. Pensions partner Iain Brown explains the issues and why it may pay to start acting and planning now.

Ofwat's draft determination in July certainly brought some surprises, with price reductions implied for most companies and cutbacks in both capital and operating expenditure. In addition, Ofwat rejected some companies' arguments for pension's deficits to be treated under a Notified Item, and instead opted for continuation of the PRO4 deal on shared funding of existing deficits.

Coupled with the draft determination, finance directors should also be alert to the impact of the pension scheme on company financials. With the next rung of pension scheme valuations in 2010 almost upon us, it is possible that pension fund trustees will put upward pressure on contributions and ignore the inability for immediate pass-through to customers. While the Pensions Regulator would seem to be understanding of the difficult economic circumstances faced by companies, trustees will still be looking to secure the best funding deal for pension scheme members.

The time to act is now

Experience has shown that companies should not wait until their pension fund trustees come to them for significant additional contributions on the back of prudent actuarial assumptions and aggressive recovery periods. Companies need to get on the front foot: planning now for what would be acceptable to them, and then taking a proposal to the trustees. Once trustees have received their advice

it is generally difficult for them to retreat without very good reason. To accept less than advised could be seen as not acting in the best interests of members.

Developing a plan

Since the last valuation, funding deficits are likely to have increased sharply. For most schemes, falling stockmarkets have decreased asset values and liabilities have edged up due to higher long-term inflation expectations. If, reflecting these uncertain times, trustees look to adopt an even more prudent set of assumptions, then the new funding deficit could be very different. Importantly, last time, up to 50% of the old funding deficit could be passed through to customers. This time round, companies will have to fund all of any increase in deficit requested by trustees, and quite possibly over a shorter recovery period.

This is not meant to be a 'glass half empty' view. It is intended to paint a picture of how things could so easily be in 2010.

Water companies could start thinking now about how the actuarial valuation could look in 2010, depending on the range of stances trustees could take. This will help create a foundation for early negotiation, possibly even with a proposal being taken to the trustees in advance, providing the opportunity to gain an advantage and take an active role in influencing outcomes. It is a fact that UK pension scheme trustees have a lot of power, particularly in setting

investment strategy. However, it should not be forgotten that the scheme sponsor can influence events significantly because they pay the contributions.

Whatever amount you decide to commit to meeting the financial needs of the scheme, remember that there are alternatives to direct cash funding. These range from parental guarantees to the grant of a prior charge over specific assets. Even a simple escrow account can help with security and investment freedom – and possibly give you access, after a market recovery, to funds that might otherwise have been fully locked up in the pension fund.

And it is not unusual for companies to want to avoid confrontation with the scheme trustees. As a consequence, the trustees' actuarial advisors' assessment of the "appropriate" contribution rate (perhaps stated as being "what the Pensions Regulator will require") is often accepted with minimal challenge. But negotiation and professional challenge does not have to mean confrontation nor loss of face – and may well produce a more commercially palatable outcome for the company.

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Example

The Trustees of a £500m fund were pushing for agreement on the size of the funding deficit, and for recovery payments of £50m pa over four years. They claimed support for this stance from a Covenant Review (which reported that

the company was not strong) and that the Pensions Regulator would not accept a slower pace of funding.

We helped the company to successfully negotiate a smaller annual payment over a longer term (£30m p.a. over eight years). Our detailed knowledge of the

Pensions Regulator, the market and, in conjunction with the company, the ability to recognise fault in the conclusions of the Covenant Review enabled the company to achieve the outcome it wanted.

Are you ready for commitment?

At a recent Water UK Energy Management Forum, held in Edinburgh in July 2009, Ernst & Young's Phil Dominy and Cat Watkins explained the basics of the new Carbon Reduction Commitment (CRC) scheme being introduced by the Government from April 2010.

The following Q&As help explain how the scheme will work and what it will mean for UK water companies.

"Big businesses unaware of looming emissions bill: About 5,000 businesses... are largely unaware they will soon have to pay £600m a year for their greenhouse emissions"

Financial Times, 12 March 2009

Q: What is the CRC?

A: Starting in April 2010, the Carbon Reduction Commitment (CRC) is a mandatory emissions trading scheme that aims to improve energy efficiency and reduce the amount of carbon dioxide emitted in the UK. The scheme is central to the UK Government's strategy to achieve greenhouse gas emission reductions of 80% by 2050 (compared to 1990).

The new scheme requires organisations to buy a carbon allowance from the government for each tonne of CO₂ that they will emit. It covers UK-based 'indirect' CO₂ emissions resulting from electricity consumption⁵ as well as 'direct' emissions from other fuel types such as gas, LPG, oil and diesel. It does not include emissions from transport, those already covered by the EU Emissions Trading Scheme (ETS) or by the Climate Change Agreements (CCAs).

Each year a Performance League Table will be published, ranking the relative carbon emission performance of all organisations included in the CRC.

⁵ Green electricity is not considered carbon free under the CRC – all electricity, regardless of source or mix, is evaluated using the same carbon emission values. Embedded generation can only be included as zero-carbon if the associated ROCs and LECs are not claimed.

The year's allowances will then be 'recycled' to all participants six months later – with either a bonus or a penalty, depending on the organisation's final ranking in the Table.

Q: Will my company be affected?

A: Encouraging energy efficiency by emissions trading is increasingly being pushed down to smaller individual emitters. The EU ETS was introduced in 2005 and targets emissions from utilities and large industrials; the CRC introduces carbon reduction targets to other large organisations in the public and private sectors and will be based on 2008 electricity consumption.⁶

The highest parent organisation qualifies as a full participant in CRC if:

- ▶ It had at least one half hourly meter (HHM) settled on the half hourly market.
- ▶ Its annual electricity consumption through all HHMs was at least 6,000MWh (an energy bill of at least £420,000).

Those organisations that consume less than 6,000MWh through HHMs still need to provide data on their electricity consumption in an 'information disclosure.'

Q: How much will it cost?

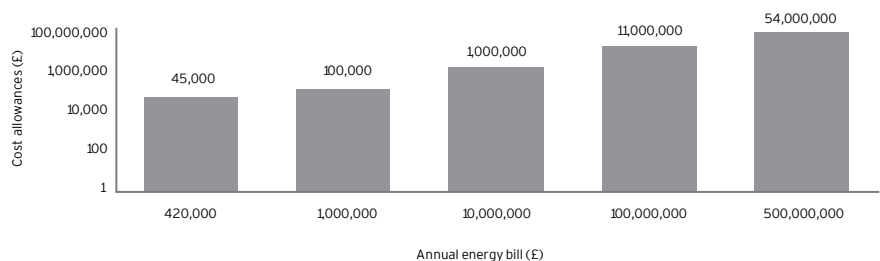
A: For the first year, allowances are to be purchased in arrears based on consumption in 2010–2011. Following this introductory period, allowances are purchased in April for the coming year. This could lead to significant cash flow implications in April, particularly for 2011.⁷

For the first three compliance years (April 2010 – March 2013), allowances will be sold at a fixed price of £12 per tonne CO₂. Thereafter allowances will be sold by auction, and there will be a cap on the total number of allowances available.

The cap will reduce year after year, which is expected to increase the cost of carbon allowances.

The mandatory purchase of allowances could lead to significant cash flow implications.

Estimated cost of carbon allowances based on annual energy bill at £12 per tonne CO₂ emissions vs. gilts (all maturities)



Source: Thomson Datastream; Ernst & Young analysis

⁶ Information packs will be sent out by the Scheme Administrators in September and October 2009

⁷ For more detailed information on the potential impact of the CRC, download our CRC information sheet at www.ey.com/uk/water

Are you ready for commitment?

Q: How does the 'recycling' of allowances work?

A: The government 'recycles' all of the allowance payments in October with each participant receiving payments back plus or minus a bonus or penalty, dependent on league table position. The recycle mechanics are designed to ensure that the CRC is revenue neutral to the Government, not to participants.

Q: What are the bonuses and penalties?

A: The penalty and bonus percentages increase by 10 percentage points every year: from 10% in October 2011 to 50% in October 2015. Percentages could increase further after 2015 if more incentive is needed.

Bonus/penalty percentages will not equate exactly to the quoted rates, for example, maximum exposure is not just the quoted percentage of purchased allowances.

Q: What is the league table and how will organisations be ranked?

A: Each year (from 2011) a performance league table will be published. It will rank the relative carbon emission performance of all 'full participants' included in the CRC.

The league table is calculated from performance based on three metrics:

1. Early action metric: this metric is based on two equally weighted factors, for good energy management undertaken prior to the start of the scheme:
 - ▶ Percentage of electricity and gas emissions which are covered by voluntarily installed automatic metering (AMR) by 31 March 2011.
 - ▶ Percentage of emissions covered by valid Carbon Trust Standard or Energy Efficiency Accreditation Scheme certificate.

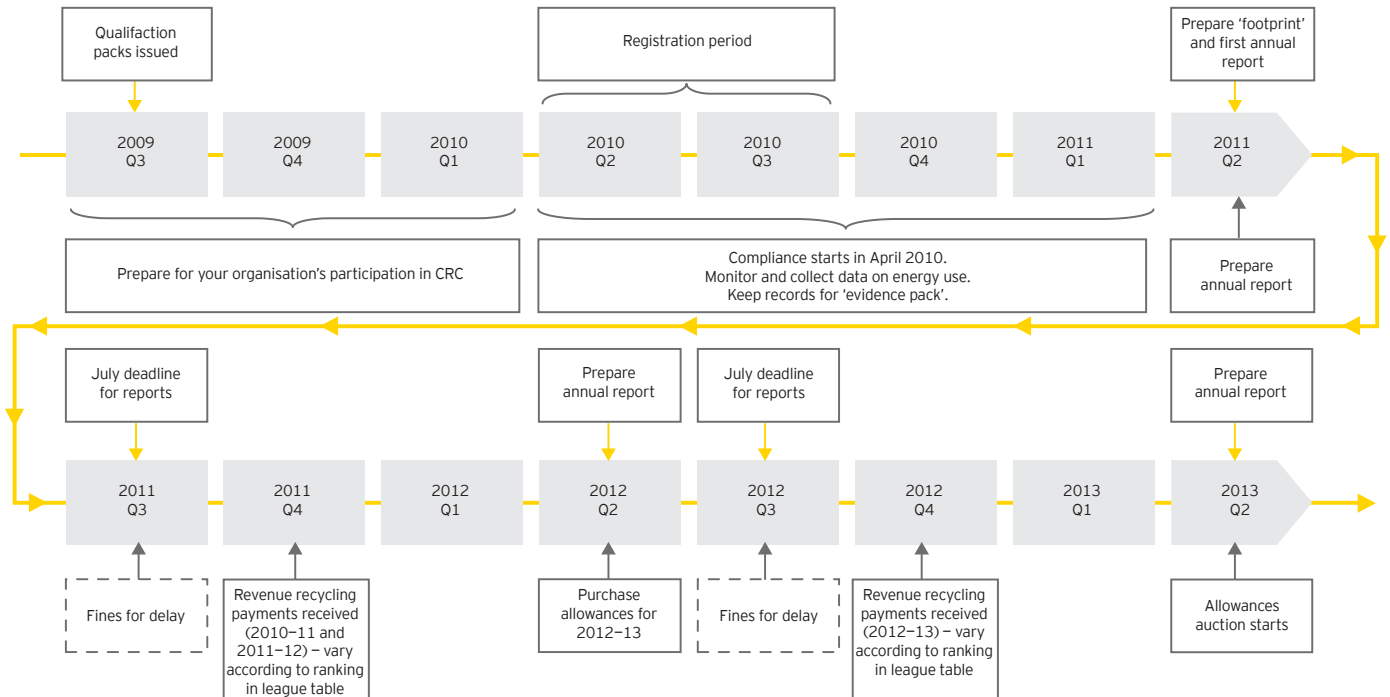
2. Absolute metric: this metric is based on the percentage change in emissions against the preceding five year average emissions.
3. Growth metric: the percentage change in emissions per unit turnover against preceding five year average emissions per unit turnover.

The overall score is a weighted average of the three metrics, with weightings varying depending on which year is being considered.

The cost of doing nothing, and coming last in the league table, could range from £10m to £30m over a five year period per 1m tonnes of CO₂ emissions.

Q: When will it happen?

A:



Q: What should I be thinking about now?

A: What options are available to mitigate CRC risk.

How to fund investment in energy efficiency equipment.

How to link CRC to existing climate change activities and targets.

What improvements in data measurement and reporting can be made.

How to maximise reputation through the performance league table.

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Prepared for the CRC?

A survey carried out in April 2009 among private and public sector organisations highlighted the following:

- ▶ 33% of those surveyed rate their state of readiness as less than moderate.
- ▶ 49% of current energy management programmes are not aligned to the CRC.
- ▶ 24% of organisations have yet to record their carbon reduction measures.
- ▶ 22% do not know whether they will be investing in energy efficiency and carbon reduction measures.
- ▶ 68% believe the CRC will have significant implications on their cash flow.

The main concerns from the survey were:

- ▶ The actual cost (46%).
- ▶ Poor league position (21%).
- ▶ Cash flow (14%).

Source: Camco and 2degrees

Issue update

Accounting separation and competition

Ofwat recently published its requirements on water companies to produce new cost allocation information for the 2009/2010 reporting period (referred to as 'JR10') on a vertically integrated basis for upstream, network and retail activities. In addition, government has published its long awaited consultation on the implementation of the Cave Review of competition and innovation in water markets in England & Wales. The consultation seeks views on a number of proposals around:

- ▶ Deepening the water retail market to include premises consuming greater than 5Ml/year from April 2010.
- ▶ Extending the retail market to include sewerage services.
- ▶ Introducing vertically unbundled water supply licenses for new entrants.
- ▶ Mandating functional/legal separation of the retail activities of incumbent water companies.
- ▶ Reforming the special merger regime.

As part of the competition and price control reform agendas, the introduction of accounting separation is seen as a necessary

step in opening up contestable markets in water and increasing understanding of costs throughout the water and sewerage value chains. The issues likely to be faced by water companies in the short term will include:

- ▶ How to collect and process the cost allocation information.
- ▶ How to interpret the specific accounting requirements.
- ▶ Thinking through the steps from accounting separation to functional or legal separation, especially of retail.

These developments will also accelerate the companies' thinking around competitive strategy. The implications will be far-reaching as these are likely to become codified in (stronger) Regulatory Accounting Guidelines in JR11, and in the proposed operational and market codes, as well as legislative and license changes. In the medium term, we are expecting some companies to consider outsourcing or disposing of their retail and other businesses as government and Ofwat move further towards competition in the sector.

Through our recent work for a number of stakeholders in the sector, we are ideally placed to help water companies navigate these potentially difficult issues. We will return to some of the detail around accounting and functional/legal separation, and competition, in future editions of Water meter.

Ernst & Young contacts

If you would like to discuss any of the issues presented in Water meter, please feel free to contact our contributors.

At Ernst & Young we have a dedicated team of professionals with extensive experience of finding solutions for the specific issues facing the water sector.

By combining our water sector knowledge with that of issues such as climate change, competition, utility regulation and infrastructure investment, we can help to manage the uncertainties and risks that currently permeate the sector.

With strong links to Ofwat, the water companies and investors in the sector, we can offer advice around key events in the water calendar such as PR09, as well as tackling the issues raised by competition, ownership change, regulatory data reporting and meeting operational and customer service performance and expenditure requirements.

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