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Protracted uncertainty in UK water regulation could hinder investment

The stability and predictability of water company regulation in the UK by the Water Services Regulation Authority ("Ofwat"), which is mandated to ensure value for the end consumer, has been a major contributor to attracting private investment into the sector. Since privatisation in 1989, this stable regulatory framework has enabled sector companies to attract over £108 billion of investment¹.

Investors in the UK regulated water industry look for visibility and predictability of earnings growth, based on remuneration against each Company's Regulatory Asset Value ('RAV'). The RAV comprises the capital assets of the Company which evolve in each review period by factors prescribed by Ofwat for capital expenditure, depreciation and outperformance of historic targets, all of which are inflated by UK retail price inflation.

Modifications to companies' wholesale licenses were proposed by Ofwat on October 26th 2012² and clarified by a further paper on November 21st 2012³ which stated that 51% of sector revenue will remain under the current remuneration methodology, and close to 40% of non-network activities will be opened up to wholesale competition from 1 April 2015. Given the lack of detail in the Ofwat proposals, it is still far from certain how utilities and potential new entrants will be remunerated in the next price review (the 2015 to 2020 regulatory period). This has led 11 of the 23 regulated water companies to challenge Ofwat's proposals as they stand, with a Competition Commission referral by year end the most likely next step.

The industry is facing a reduced level of revenue predictability as the difficulty of calculating the future cost of capital has led to concerns regarding asset-based valuation methodologies. Levels of merger and acquisition activity may also reduce and this has attracted substantial investor interest in recent years.

Simon Gottelier, Investment Manager at Impax, commented:

"In line with many other investors, we are concerned by the lack of clarity which could hinder investment if the current situation is protracted. The spotlight does appear to be shifting to other investment opportunities, including the water treatment technology companies and infrastructure businesses. However, Ofwat's clarification paper showed pragmatism and an apparent willingness to listen to both the water companies and to investor concerns."

"We were encouraged by Ofwat's reassurances on remuneration of capital expenditure in the next review period and hope that the Regulator will continue to work with all parties to re-establish revenue predictability, and consequently the attractive dividend yield that comprise key attractions of the UK water industry. We note the recent narrowing in listed company premia to their RAVs but believe that there is substantial long term value in the sector."

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Notes:

¹ Source: *Defra's strategic policy statement to Ofwat: Incorporating social and environmental guidance (Draft)*, November 2012

² http://www.ofwat.gov.uk/industrystructure/lic_pro20121026s13all.pdf

³ http://www.ofwat.gov.uk/regulating/compliance/licences/pap_tec20121121s13additional.pdf

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Notes to editors

Founded in 1998, Impax Asset Management ("Impax") was one of the world's first managers dedicated to exploiting the investment opportunities created by resource scarcity and demand for cleaner, more efficient products and services through listed and private equity strategies.

Impax now manages £1.8 bn* for institutional and high net worth investors globally, and is committed to providing strong long-term risk-adjusted returns. The company's team of 28 investment professionals has been assembled for over 14 years.

Impax's listed equity funds seek out mis-priced companies that are set to benefit from the long-term trends of changing demographics, rising consumption, limited natural resources and urbanisation. Investment is focused on the alternative energy, water, waste, food, agriculture and related markets. Impax's private equity infrastructure funds invest in power generation assets in the renewable energy sector.

Impax is a thought leader in defining the environmental and resource scarcity markets, for example through a partnership with FTSE to develop and manage the classification system underpinning the FTSE Environmental Markets Index Series.

*as at 31 October, 2012.