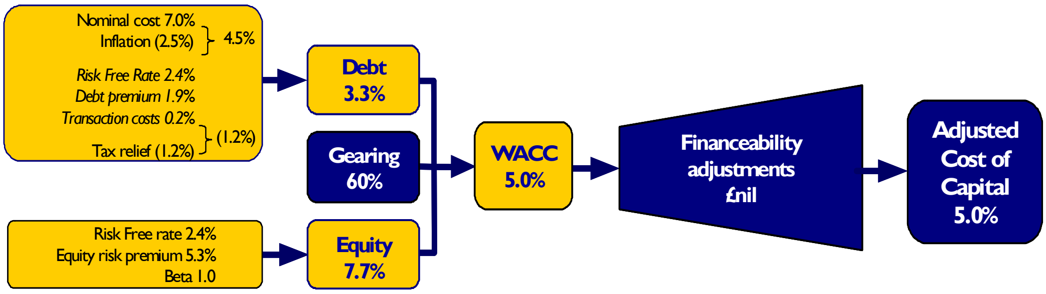
'Decision time approaches'

'The World has turned: but which way?' Update, June 2009

On 23 July, Ofwat will announce its Draft Determinations for the water industry in England and Wales to cover the period from April 2010 until March 2015. One of the key decisions will be the Cost of Capital to be used in the pricing model. Markets have experienced unprecedented volatility in the last two years. There are sharp differences between short and long term interest rates. The cost of equity has risen above long term trend rates. Access to capital is still uncertain, particularly for companies with low credit ratings. Deflation remains a concern.

In April, Severn Trent argued for a Cost of Capital of 5%, based on long term market factors.



Macro economic conditions uncertain: global capital flows unpredictable

- Recession has arrived in most developed economies. Some commentators claim 'green shoots' of recovery have been spotted, although long run depression remains a risk.
- The bulk of recent data suggest that the recession in the UK is likely to be the deepest for many decades.
- Oxford Economics' base case suggests that positive growth will resume in spring 2010.
- There are clear signs that the recent trend of foreign reserves being invested into the UK bond market has slowed.
- Very significant and extraordinary Government borrowing requirements will place upward pressure on real risk free interest rates.

RPI deflation expected in 2009

- The May 2009 BoE Report stated that CPI inflation was likely to drop below the 2% target later this year and more likely than not to be below that target in the medium term.
- RPI is much more volatile and reached a 60 year low of minus 1.2% in April 2009. In his Budget the Chancellor forecast RPI of minus 3% by September 2009. This will impact water company tariffs.
- The May 2009 BoE Report argued that there were significant risks to the inflation outlook in either direction. RPI could rise sharply as interest rates start to rise in 2010 and reflect currency depreciation and VAT increases.
- Alternatively a long term "Japanese style" period of deflation and recession remains a possibility.

Capital markets return

- Bond markets have experienced record new issuance in the first months of 2009. These have been weighted to strongly rated companies and defensive sectors.
- Market liquidity is still poor, as banks are unwilling to hold significant trading inventories of bonds.
- Spreads (over benchmark indices) rose in 2008; however they have been tightening in more recent months as a result of strong demand for corporate bonds from retail funds as well as the asset purchase programme of the BoE.
- Credit quality differentiation persists between single-A and BBB credits – access remains poor for lower rated companies.
- Equity prices have recovered in the second quarter of 2009 but new equity issuance remains uncertain and expensive.

Short term dislocation from medium and long term trends

- Short term nominal interest rates are at 50 year low levels. Long term rates are relatively unchanged.
- The Capital Asset Pricing Model used by Ofwat to test the cost of equity, relies on long term data and is little impacted by current high costs of new equity.
- The so called "Risk Free Rate" is volatile, influenced by Bank of England gilt and bond market intervention (Quantitive Easing), deflation and substantial projected UK public sector borrowing requirements.

Deflation, water prices and RCV gearing

- The UK water sector's RPI-based regulatory pricing model could mean with deflation that nominal revenues fall.
- Under stable and low inflation, there is a linkage between revenue growth and certain costs e.g. payroll and subcontracted labour. Under volatile or negative RPI, this relationship breaks down, increasing business risk.
- 25% of STW's debt is index-linked which helps reduce interest charges to mitigate the impact of lower income.
- Deflation can cause a reduction in Regulated Capital Value, and hence increase debt/RCV ratios.

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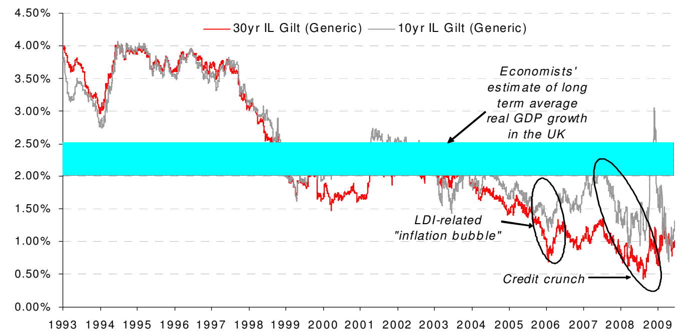
CONSISTENCY FOR SHORT OR LONG TERM FACTORS

- Short term cost of debt is lower than long term.
- Due to planned capital expenditure and refinancing needs, new water industry loans typically should be longer term, even if short term debt appears temporarily cheaper.
- There remains a significant cost to pre-funding or holding undrawn bank facilities required to ensure liquidity.
- Short term cost of equity is calculated to be higher than long term; recent market experience of rights issues is even higher than our 8.8% calculation.
- Considering long term or short term factors results in a similar WACC of around 5%.

	Long term %	Short term %	AMP4 %
Nominal Cost of Debt – Pre Tax	6.8	6.0	6.8
Fees, and Cash Holding Costs	0.2	0.2	
All-in Cost of Debt	7.0	6.2	6.8
Assumed RPI	2.5	2.5	2.5
Real Cost of Debt – Pre Tax	4.5	3.7	4.3
Real Cost of Debt – Post Tax	3.3	2.7	3.0
Cost of Equity	7.7	8.8	7.7
Gearing	60	60	55
Post Tax Cost of Capital	5.0	5.1	5.1

Source: ST Final Business Plan

Real yields – 10 and 30 year gilts



Source – HSBC

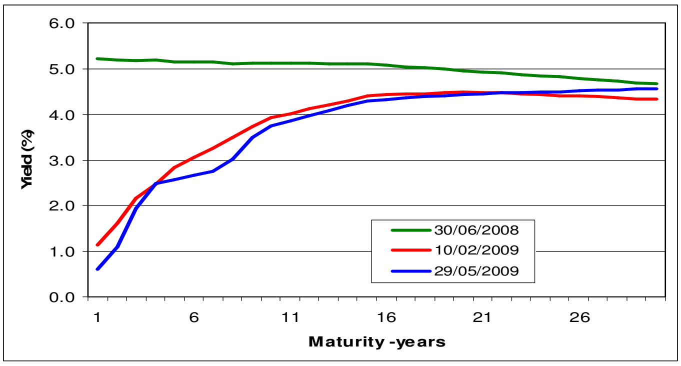
RISK FREE RATE RISING BUT VOLATILE

- There is significant volatility in the so called "risk free rate".
- The effect of increased government borrowing is likely to exert upward pressure on the risk-free rate.
- Long term risk free rates are expected to be in line with economic growth rates.
- On the other hand, downward pressure may result over the next two years from a low growth, low inflation environment.
- Quantitative easing adds further uncertainty as the Government intends to buy back gilts for new liquidity.

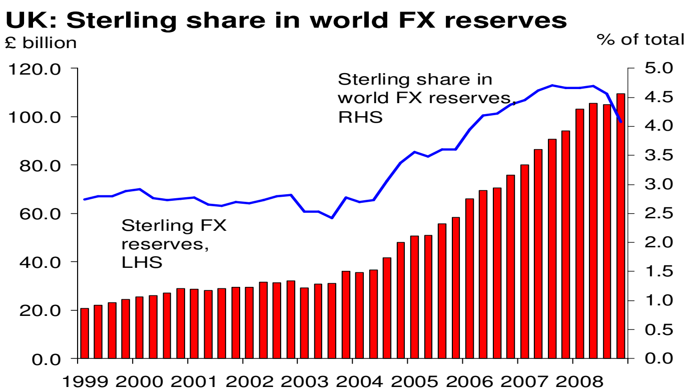
GOVERNMENT BOND YIELDS LOWER AT SHORT END

- Short end yields have collapsed since the summer of last year, partly due to low inflation.
- Long term interest rates are close to pre-credit crunch levels.
- Bank of England intervention in the gilt markets and "Quantative Easing" has reduced short term interest rates this year.
- There is growing concern at the scale of projected Government borrowing - £238 billion in 2009/10 (source: HMT Debt and reserves management report).
- This could crowd out companies seeking to borrow.

Government Bond Yields



Source – Bloomberg/Severn Trent



Source : Oxford Economics/Haver Analytics

UK SHARE OF WORLDWIDE RESERVES FALLING

- Until 2008, there were strong foreign inflows into UK bond markets, which has slowed since the credit crunch began.
- There has been a decline in share of world wide reserves, arising in part from the decline of sterling.
- Fears about the recession and low UK interest rates may have caused foreign companies to repatriate funds.
- The decline in commodity and energy prices has reduced trade and foreign government surpluses which were previously invested.
- Furthermore, doubt remains about the future behaviour of UK pension funds.

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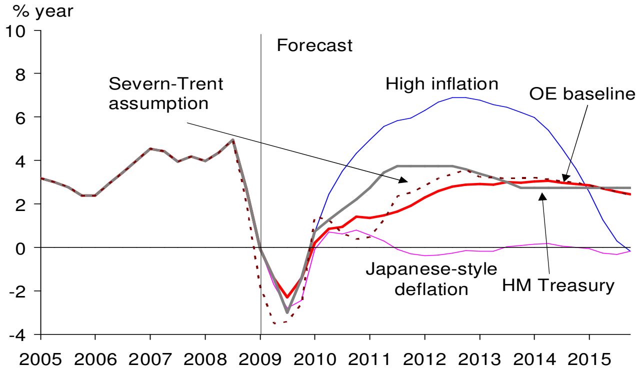
RPI LIKELY TO BE NEGATIVE FOR NEXT 12 MONTHS

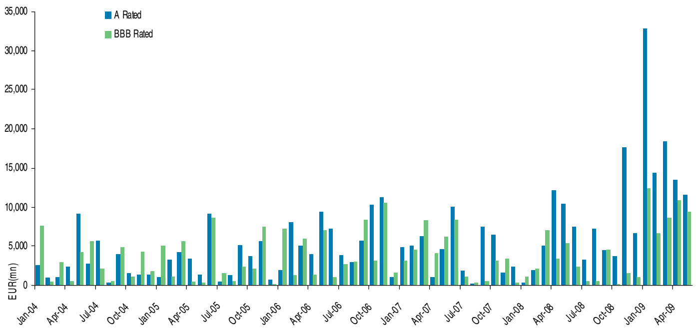
- There is a substantive risk of deflation over the next two years if the recent reductions in interest rates are not effective in spurring demand.
- RPI is more volatile as a result of the recent falls in mortgage and energy costs as well as in VAT – each of these will reverse sharply with the recovery of the economy.
- Oxford Economics illustrate a range of possible inflation scenarios over the next five years.
- RPI is a significant driver of water company tariffs.

RPI



Source: Oxford Economics

Monthly bond issuance EUR and GBP



Source: BNP Paribas

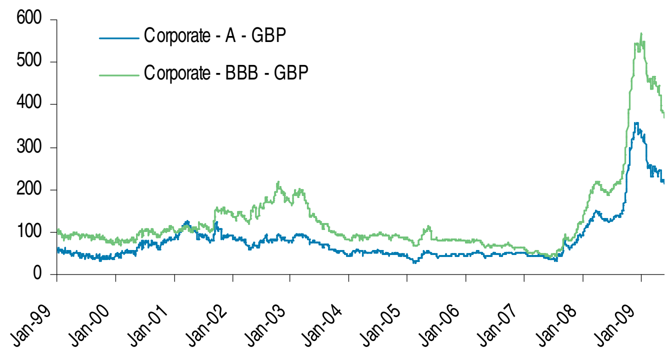
RECORD BOND ISSUANCE IN 2009 SO FAR

- There has been strong bond issuance in 2009, especially from investment grade companies.
- This may be a response to weak bank lending, with companies seeking funds directly from investors.
- Utility companies have issued bonds, some less defensive sectors, such a property and finance have been forced to resort to equity.
- In excess of £2 billion has been raised in six months by UK water companies.
- There have been bond issues from BBB and lower rated companies: in late 2008 and early 2009, there were almost none.

SECONDARY YIELDS HIGHER FOR 'BBB' COMPANIES

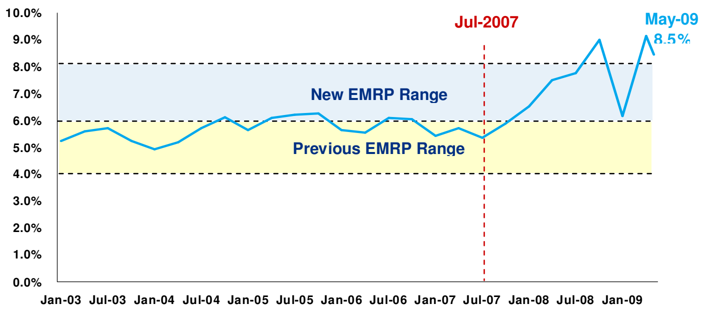
- Credit quality remains important for bond issuers.
- The secondary bond spread above gilts has narrowed in 2009 from a peak of 3.5% to 2.2% for 'A' issuers and 5.6% to 3.5% for 'BBB' issuers.
- In 2007, there was very little discrimination between the spread for 'A' and 'BBB' bonds. Now the premium for BBB is 1.5%, having peaked at 2.3%.
- Secondary bond trading volumes and liquidity are very low: central banks have bought bonds as part of their liquidity management programmes.

Single A versus BBB Corporate spreads



Source: BNP Paribas

Implied Equity Market Risk Premium (EMRP) (2003 – Present)



Source - Citi

EQUITY IS BECOMING MORE EXPENSIVE

- This source of finance remains expensive.
- Since July 2007, the implied EMRP has risen from 5.4% to 8.5% today and has remained above 6% since October 2007.
- Some analysts calculate EMRP from 100 year models and will not adjust for "short term" volatility.
- Quoted water companies shares are trading very close to RCV having traded at a discount in recent months.
- Recent rights issues have been at substantial discounts to market share price.

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