NORTHUMBRIAN WATER INTERNATIONAL

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12 October 2007

Dear Ms Russell

Strategic Review of Charges 2010-14: Methodology

With reference to the above, I am writing specifically to comment on your approach to Public Private Partnerships (PPPs) as set out on pages 14-15 of Volume 1 and Information Paper 9.

You will recall from my letter of 19 August 2005 that Northumbrian Water is involved with two of the wastewater PFI projects, Levenmouth and Meadowhead, Stevenston & Inverclyde, as the major shareholder in the two contracting companies, Caledonian Environmental Services Ltd (CES) and Ayr Environmental Services Ltd (AyrES), as well as their respective operational subcontractors, Caledonian Environmental Levenmouth Treatment Services Ltd (CELTS) and Ayr Environmental Services Operations Ltd (AESOps).

In essence, I think much of the content of my previous letter is still relevant to your continuing concerns about ongoing value for money of the PPP contracts but there is no need to repeat those comments here.

However, as your current interest seems to be focused on refinancing and savings in operating costs, I think it is worth highlighting one or two relevant points with regard to our own projects:

Meadowhead, Stevenston and Inverclyde

With regard to refinancing, the contract already includes provisions for Scottish Water to share in the nett financial benefit of refinancing. Scottish Water's share of the benefit would vary depending on whether the refinancing results in realisation of an upfront lump sum or lower debt repayments over the remainder of the term with the respective proportions being either one half or one third. In either case, the benefit to Scottish Water compares favourably with HM Treasury guidance so I presume that you will have no worries on that score.

However, in view of your confidence about the savings that can be achieved, you may wonder why we have not yet proceeded with refinancing. The simple answer is that our analysis has never shown the potential benefit to be as attractive as you have suggested, particularly as we may only receive 50% of that benefit. It is a fact that the terms of the original loan were extremely competitive and consequently, any gain arising from current lower interest rates is largely offset by the basic transaction costs including breakage costs on the existing loan. On that basis, we have tended to focus on more material and immediate issues, of which there are many during the operational phase given the extensive

degree of risk transfer inherent in PFI contracts. In this respect, it is clear that wastewater PFI contracts differ substantially from for example, roads or accommodation-type PFI contracts where most of the cost, and risk, lies in the construction phase. However, refinancing will continue to be kept under review although our expectation is that it is unlikely to be worthwhile to us without other changes such as extending the term of the loan and/or the contract, either of which would obviously have implications for Scottish Water.

It may occur to you that the equity investors must be making substantial returns in order to be able to forego **any** potential benefits but I can assure you that this is not the case. We have experienced substantial increases in costs in several areas including insurance, energy, chemicals and sludge disposal that are not fully recompensed by the normal indexation of contract payments. These affect both project company and operator and in fact, for the project company, our latest long-term forecast is actually showing the projected equity return to shareholders significantly **below** the comparable figure in the original Financial Close base case model. Whilst we will obviously pursue whatever legitimate contractual mechanisms are available in order to improve our return, in most respects, the situation is simply a function of the extensive risk transfer included in the original contract.

Levenmouth

The Levenmouth plant has been operating since 2002 but completion of the design and construction stage within the terms of the contract was not actually achieved until 2006. Although treatment of wastewater in compliance with the effluent discharge consent was continuous throughout this period, various problems were identified during commissioning that resulted in substantial additional works having to be carried out on the sludge and odour treatment elements of the plant in order to achieve contractual completion.

These additional works resulted in considerably increased capital and operating costs with liability for these costs being disputed because of a series of complex contractual and technical arguments. These arguments have now become the subject of a number of separate but related legal actions involving all of the major project parties (including Scottish Water), any of whom could eventually be found to be liable for some or all of the cost.

However, it is likely to be several years before the legal process runs its course and in the meantime, the additional costs, which continue to accrue, are being carried by the project company, the contractor and the operator. Because of the additional costs, the quantum of the claims and the uncertainty about the eventual outcome of the legal process, the equity investors have been prevented by the funders from distributing any available funds from the project to date and this will continue at least until the potential impact on the project company is clear, that is, if and when the legal actions have been concluded in the project company's favour.

The situation is quite different for Scottish Water. While acknowledging the detrimental effects of the delay on, for example, their relationship with the local community, to date, none of the additional costs has been met by Scottish Water and in fact, Scottish Water has actually benefited from discounted tariff payments for part of the period of delay.

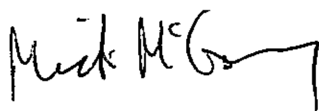
This situation provides a very good example of the extent of the risks that are involved in PPP contracts for equity investors, contrasting sharply with the general implication in your

paper that equity investors are likely to have benefited from excessive returns at the expense of Scottish Water and its customers.

With regard to refinancing, although this is clearly not a feasible proposition in these circumstances, for your information, we have reviewed the likely 'benefits' that could have been achieved via refinancing if the disputes described above had not occurred. The outcome of that review was that rather than any benefit being available, taking advantage of current interest rates to refinance the existing bond would actually result in an additional cost to the project company of more than £20m! We can provide further details of this analysis if required but in any event, the lack of any contractual entitlement for Scottish Water to share in the 'benefits' of refinancing is clearly not an issue in these circumstances.

It seems to me that much of your analysis is based on generic information rather than detailed consideration of the particular circumstances applying for each of the contracts and consequently, there is a danger of misunderstanding or misinterpretation of the data. I would remind you that in my letter of 19 August 2005, I offered whatever assistance we could reasonably provide to help with your understanding of the contracts that we are involved in and that offer remains open. If you have any queries or comments on the above or require our input at any stage in the future, please do not hesitate to get in touch.

Yours sincerely



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