Workshop discussion summary

Friday 20th January 2017
Centre City Tower, 7 Hill Street, Birmingham B5 4UA
10.30 to 13.00

Cost of debt workshop – consultation follow up

Attendee	Organisation
Andrew Cottrell	Thames Water
Colm Gibson	Thames Water
Matt Greenfield	Wessex Water
David Peacock	Wessex Water
David Martin	Northumbrian Water
Crawford Winton	Northumbrian Water
Jon Latore	United Utilities
Rachael Wray	United Utilities
Mike Davis	Welsh Water
Simon Westbrook	Yorkshire Water
James McLaughlin	Severn Trent
Gagan Gulati	Anglian Water
Jane Pilcher	Anglian Water
Steve Collins	Southern Water
Louise Rowe	South West Water
Judith Corbyn	South West Water
Oliver Martin	South East Water
Aubrey Slade	Bristol Water
John Chadwick	Sutton East Surrey
Nagi Suzuki	South Staffs Water
Shaun Kennedy	Affinity Water
Tim Charlesworth	Affinity Water
Helen Orton	Portsmouth Water
Helen Smith	Tideway
Steven Hobbs	Consumer Council for Water
Gordon Hutcheson	Ofwat

Andrew Chesworth	Ofwat
Elinor Mathieson	Ofwat
Martyn Andrews	Ofwat

Workshop purpose

The purpose of the workshop was to help Ofwat develop policy on the cost of debt for PR19. Specifically Ofwat wanted to build on its September 2016 consultation on the cost of debt by:

- Explaining some of the areas in more detail – how indexation of new debt could work, some potential debt indices, how to take inflation into account

- Gathering further feedback from stakeholders on these areas to inform future decision making on the cost of debt

Ofwat noted that no decisions had yet been taken on its approach to the cost of debt for PR19.

Ofwat also summarised responses to its September consultation as part of the introduction.

Further details on all of the points discussed are outlined in the workshop presentation slides, published on Ofwat's website.

Note of discussion points

1. How new debt indexation mechanism could work

United Utilities presented four possible options for how the indexation of new debt only could work, if Ofwat decides to pursue this option. These are articulated further in the workshop slides.

Feedback from workshop attendees was:

- Different options have different effects of either over or under representing the observed benchmark cost of debt for any given year in the AMP
- None of the options is going to represent the reality for all companies at all times, so the notional company should be the benchmark

  - On this basis Option 4 is likely to be the most reflective of how the notional company would profile new debt issuance - typically with fixed debt - and the basis of assumptions around new debt
  - However, simplicity, as represented by Option 1, is also important given that there is no perfect option. However, some attendees also noted that Option 1 leaves companies and customers most at risk to changing borrowing costs each year.
- Ofwat should consider making any adjustments as mechanistic as possible for transparency, as well as publishing a spreadsheet with the chosen mechanism and updating this periodically. Attendees considered this would address any potential complexity.
  - Even Option 4, the most complex of those presented, was generally not regarded as significantly complex provided details of the workings are available.
- Ofwat also needs to consider how to set the base allowance for companies, including any potential 'risk buffers' that companies might require given the time lag between allowances being set and adjustments being made.
- One stakeholder proposed an alternative mechanism similar to option 4 but rather than use an extended trailing average it would effectively 'embed' a certain amount of debt from a year at that rate. It was noted that this may have the same (or similar) effect as option 4
- Ofwat would need to consider the basis of its assumption for embedded:new debt in the notional balance sheet, and whether the 75:25 assumption made at PR14 remained relevant
- Ofwat should consider setting out the materiality of the cost of debt issue, possibly in terms of the customer bill impact.

Overall most attendees saw the value in option 1 (for its simplicity) and option 4 (for its greater accuracy against a notional company's borrowing profile).

2. Timing of adjustments – in-period Vs. end of period

United Utilities presented their views around the potential merits of in-period adjustments, as well as some possible options for timing (and reducing the potential time lag between a debt indexation year and when this impacts on company revenue). Ofwat noted a continued preference for end of period adjustments; and noted in-period adjustments could only be considered if there were robust evidence of genuine customer support.

Feedback from attendees was:

- There are bill impacts with both in-period and end of period adjustments, as changes will flow through either during the AMP or at the next AMP.

    - The materiality of any potential in-period adjustments is important to consider, particularly in the context of customer impacts and customer engagement
- The whole package of incentives and in-period adjustments is also important – any cost of new debt mechanism should work alongside other adjustment mechanisms
- Timing of adjustments is likely to be related to the way the adjustment mechanism works and the extent to which any ‘decisions’ are needed – the simpler it is then the easier it will be to make adjustsments

Overall most attendees continued to favour end of period adjustment, however some companies strongly favour the flexibility to have in-period adjustments where these have customer support.

3. Choice of index

Ofwat set out some principles (aligned to its statutory duties and cost of debt appraisal criteria included in its previous consultation) that it considers relevant to the choice of index, should it decide to introduce indexation of new debt. These are outlined further in the workshop slides, in summary:

- Transparent
- Legitimate
- Simple

Anglian Water then outlined several possible indices, having appraised these against Ofwat’s principles. Anglian Water noted a preference to use the iBoxx non-financial corporates with 10+ year tenor averaged for both A and BBB credit ratings.

Feedback from attendees was:

- The tenor of the indices is important, particularly to match to industry tenor of debt for consistency and accuracy
    - The iBoxx non-financials for 10+ years is more likely to achieve this than the utilities index where tenor is shorter, or other iBoxx non-financial indices
- Attendees highlighted the importance of the number of bonds in the index to provide a robust source of data to derive benchmarks, especially where an index may be dominated by a small number of bonds or issuers
- Some attendees highlighted the widespread use of the iBoxx non-financials indices with investors, noting that if Ofwat decides to use an alternative index it would add unnecessary complexity

Overall attendees preferred the iBoxx index for non-financial companies with an average of A and BBB credit rating for 10+ years.

4. Adjusting for inflation

Ofwat reiterated its policy around the transition to CPI (or CPIH) to introduce this part of the workshop, specifically noting that it expects CPI (or CPIH) to be relevant for the indexation of new debt.

Anglian Water presented some possible ways to adjust a nominal index observation of new debt for CPI inflation. Anglian noted a preference to use the Bank of England's long term CPI target of 2%.

Feedback from attendees was:

- Long term inflation is the right starting point for consistency with long term debt that companies tend to issue.
- The Bank of England long term CPI target is clear, transparent, avoids market distortions and is less open to challenge than possible other approaches (eg using market derived numbers)
- Ofwat should consider fully whether CPI should be the only measure for inflation to consider, or whether some thought also needs to be given to RPI. If RPI is to be considered, Ofwat should consider fully the basis for the upfront calculation of the RPI-CPI wedge and how that would be consistent over the AMP.
- Some attendees were concerned about how inflation would be applied to embedded debt allowances in future, given the single nominal WACC that Ofwat proposes to set for PR19.
- Some attendees were concerned about the implications of a change to the Bank of England target rate during the AMP and what this might mean
    - However, it was noted the nominal index will in some respects already capture potentially movements in inflation over the period, given that movement in nominal rates should capture changes in inflation expectations.
- Ofwat should consider its approach in light of its decision on whether to move to CPI or CPIH (eg if Ofwat uses an inflation measure which is not the Bank of England target)
    - Some stakeholders however noted the methodological similarities between CPI and CPIH.

Overall attendees noted a preference to use long term inflation assumptions and an understanding of the rationale for using the Bank of England inflation target of 2% as part of a cost of new debt adjustment mechanism.