Ofwat

Water 2020
Cost of debt workshop

10 October 2016

Consultation on the approach to the cost of debt for PR19

Published – 6 September

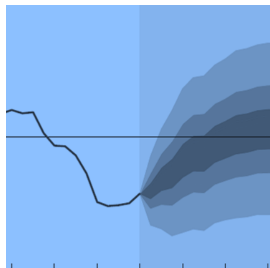
Responses due – 17 October

Views from interested parties will help us to finalise our price review methodology consultation proposals, to be published in July 2017

Agenda		
1. Welcome and introduction	David Black	10:30 – 10:35
2. Outline of the proposals included in our consultation	Elinor Mathieson and Andy Chesworth	10:35 – 10:55
3. Questions about the proposals	Elinor Mathieson and Andy Chesworth	10:55 – 11:10
4. Discussion groups – session 1	Groups	11:10 – 11:45
5. Feedback from discussion groups – session 1	Elinor Mathieson	11:45 – 12:00
6. Discussion groups – session 2	Groups	12:00 – 12:35
7. Feedback from discussion groups – session 2	Andy Chesworth	12:35 – 12:50
8. Closing remarks and questions	David Black	12:50 – 13:00

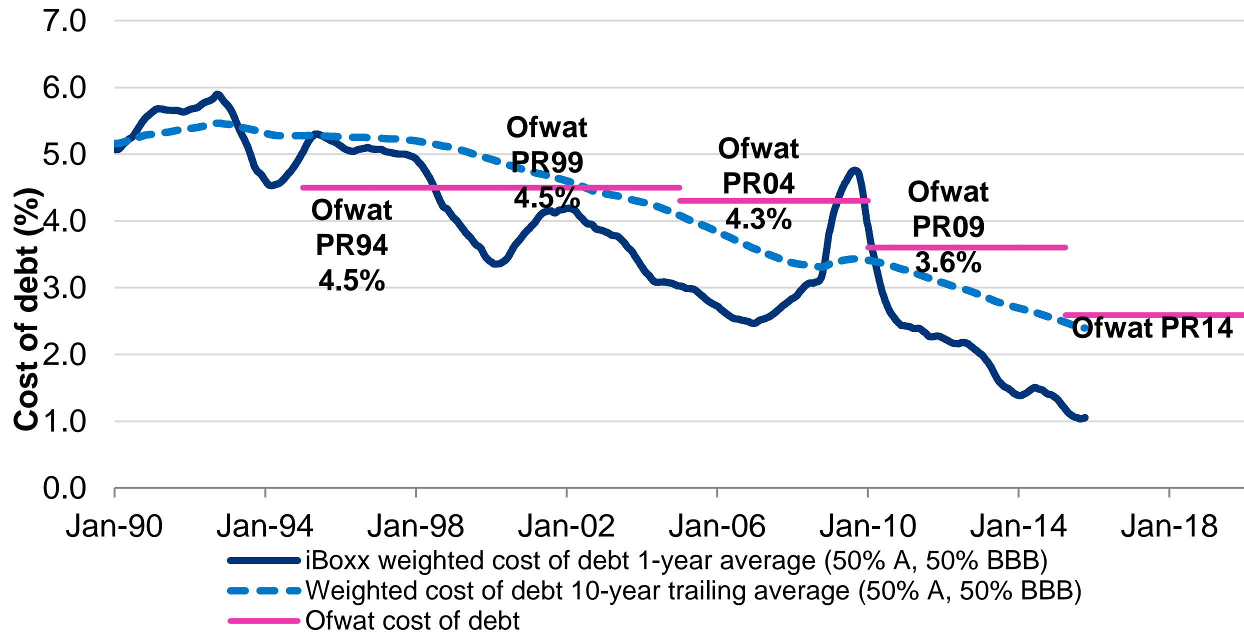
Cost of capital set on a notional basis

Embedded debt based on mix of sector evidence and historical market benchmark



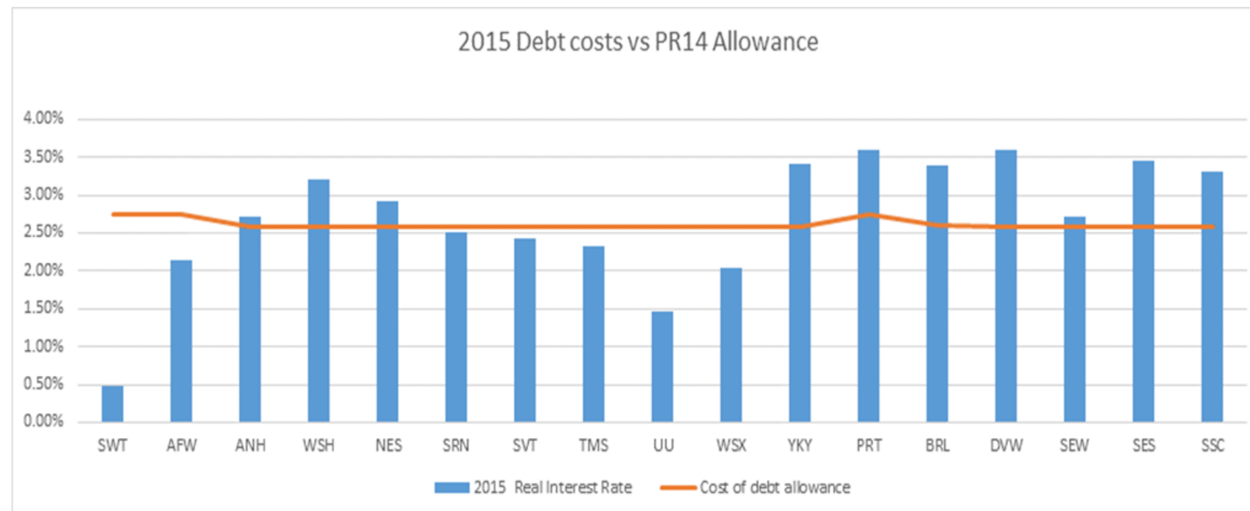
New debt cost based on forecast from forward curves

Nominal assumptions deflated to real using long term inflation rate of 2.8%



Price controls have tended to overstate market rates

Performance differs across companies

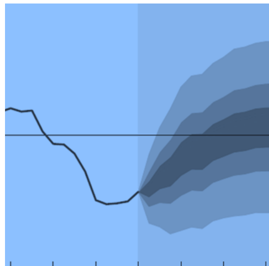


Forward rates have not been a good predictor of new debt costs

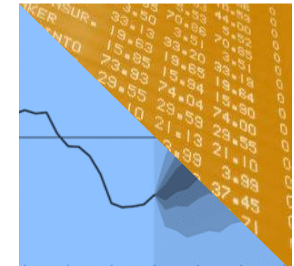
Forward rates have tended to overstate market rates

Continue to use notional basis

Embedded debt unchanged



New debt adjusted for actual market movements against market index and for inflation



Company proposals on risk sharing arrangements considered as part of the risk based review

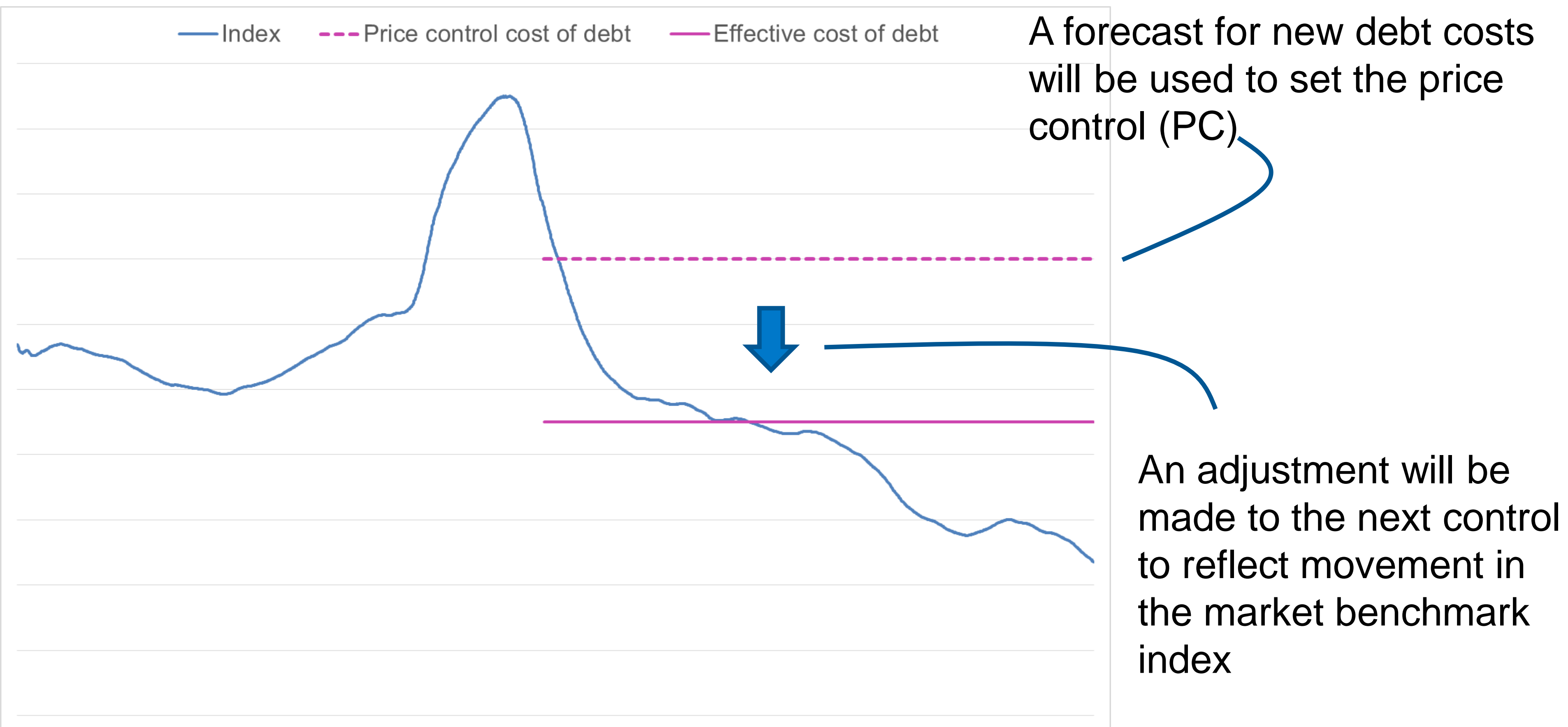
We intend to continue to set an efficient allowance for the cost of embedded debt for the industry based on:

- actual debt raised by companies in the past
- evidence from existing market benchmarks

This will enable us to calculate an efficient average rate for the industry, however individual companies may out or under perform against this allowance.

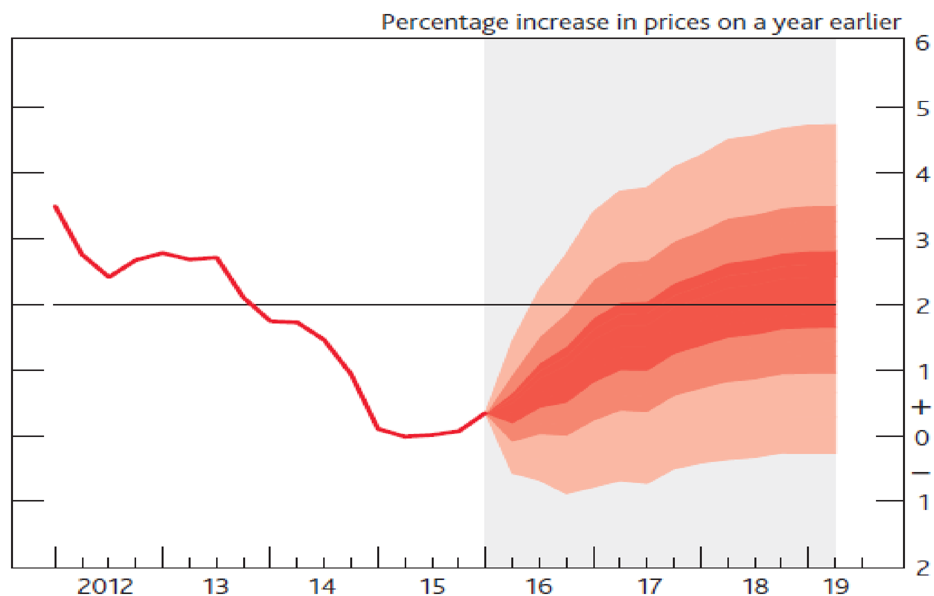
The use of evidence from actual embedded debt reduces the risk to customers from using a purely mechanical benchmark which may not reflect the actual costs which companies face.

Outline of our proposals – cost of new debt



Companies retain individual outperformance so keep incentives to manage debt costs effectively

Allowed return = Vanilla WACC + RPI on revenues and RCV



In setting a real cost of debt, we make assumptions about inflation

While revenue and RCV reflects actual inflation in period, cost of debt remains fixed to our assumption about inflation – this can be a source of out- or under-performance – eg inflation assumption that underpinned the PR09 real cost of debt was 2.5%, but actual inflation was c.3.5% on average in 2010-15

Analogous forecasting risk with cost of new debt

We propose an adjustment for actual inflation for **new** debt compared to our initial assumption when cost of debt was set

End of AMP	In period adjustments
Reduced bill volatility – movements between price review periods can be managed through bill profiling	Year on year bill volatility
Allows within period positive and negative movements to be offset	No offsetting of positive and negative effects

Consultation proposal – allows cost of debt to reflect changes in the market, but would not increase risks faced by customers

Outline of our proposals – use of pain/gain share mechanisms

Historically we have encouraged companies to share financing gains with customers, but this was not mandatory.

We considered introducing a mandatory pain/gain sharing mechanism but do not consider that is the best approach for PR19.

Companies are best placed to consider how they should service the needs of their customers and to share any out or under performance with them via:

- Adjustments to bills
- Improvements to services
- Additional investments

Any pain/gain share mechanism should:

- Ensure that risks are efficiently allocated between companies and customers
- Be robust to changing markets and financing arrangements
- Provide an incentive to raise debt efficiently; minimise long-term debt costs
- Be transparent and avoid undue complexity

We would assess company proposals as part of the risk-based review

A possible approach to setting the cost of equity

Under the proposals of the Essential Services Commission, Australia the cost of equity reflects

- The transfer of risk from customers to companies;
- How effectively the company has incorporated customers' views;
- How well management justifies the proposals in the business plan;
- The outcomes in service and operations.

Water company's self assessment

Regulators assessment of submission	Leading	Ambitious	Standard	Basic
Leading	5.30%			
Ambitious	4.70%	4.90%		
Standard	4.10%	4.30%	4.50%	
Basic			3.90%	4.10%

Companies self assess their plan and select the cost of equity from a menu

If regulator agrees, company receives relevant return. If regulator disagrees returns are reduced.

Regulator has scope to revisit in period based on delivery against business plan

At this stage we are not consulting on a preferred approach. We are simply seeking stakeholder views as to how this might work in the UK. The approach has not yet been fully implemented in Australia and has not been tested in practice.

Q1: Do you agree that the cost of debt allowance should be set on the basis of a notional capital structure and notional cost of debt for all companies as opposed to being based on the actual capital structure and debt costs of each company?

Q2: We do not propose to introduce a specific benefit sharing arrangement for companies with securitised capital structures. Do you agree with this approach?

Q3: Do you agree to the introduction of indexation for the allowance for the cost of new debt?

Q4: Do you agree that indexation of the new debt allowance should have an end of period adjustment?

Q5: Do you agree to an adjustment to the inflation estimate to reflect out-turn inflation and so mitigate inflation forecast error for new debt only?

Q6: Do you agree that we should leave companies to develop their own risk company specific risk mechanisms on a voluntary basis for the 2019 price review and we should not mandate a company specific risk sharing mechanism?

Q7: What are the potential advantages and disadvantages of a menu based approach to the cost of equity, compared with the approach adopted by Ofwat at PR14?

Questions on our proposed approach

Discussion groups – session 1

There are four topics for discussion in this session

1. Should we index the allowance for the new cost of debt?

2. Should we make an adjustment in respect of our inflation assumption?

3. Is it appropriate to make adjustments for both indexation and inflation at the end of each AMP, or should adjustments be made more frequently?

4. How will our proposals impact the way in which you finance your business?

Feedback from discussion groups

There are two topics for discussion in this session

1. Is it appropriate for Ofwat to mandate a pain/gain share mechanism or is it more appropriate for companies to propose bespoke pain/gain sharing mechanisms following engagement with their customers?

2. The Essential Services Commission in Victoria Australia has proposed the use of a matrix for setting cost of equity. How do you think that this could work in England and Wales and do you think that Ofwat should give further consideration to this approach?

Feedback from discussion groups

www.ofwat.gov.uk

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