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anglianwater

Anglian Water Services Ltd
Lancaster House
Lancaster Way
Ermine Business Park
Huntingdon
PE29 6YJ

Tel 01480 323226
www.anglianwater.co.uk
Our ref

David Black
Cost of Debt Consultation Response
Water 2020
Ofwat
21 Bloomsbury Street
London WC1B 3HF

Dear David,

We broadly agree with your position and can understand the reasons for your proposed change. Our response reflects our view to retain what has worked well, and minimise changes to the sector that is already going through complex regulatory developments. We highlight our thoughts in the key areas below, and follow up with answers to the specific questions raised in your consultation.

New cost of debt indexation: We see recent fluctuations in markets as further evidence that companies, not customers, are best placed to manage the interest risk. However, in light of the recent NAO report and PAC recommendation we can see a case for the proposed change, and agree that if debt indexation is introduced, it should apply to new debt only. Further details on the construction and constituents of the index, including the working of the true-up mechanisms are needed to make an informed view. We encourage Ofwat to engage with companies when devising the index to ensure it reflects appropriate costs and that an economic incentive to outperform is retained in the sector. We will be happy to work with Ofwat and explore these issues.

A notional capital structure has been a fundamental basis of price-setting and we see no compelling reason for a change.

Securitised companies: We agree that a mandatory one-sided benefit sharing mechanism is not appropriate. It is for companies, their boards and their customers to develop appropriate ODIs and sharing mechanisms.

THE QUEEN'S AWARDS
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2015

Cost of equity: We agree that in theory the introduction of indexation will share market risk with customers. However, the cost of equity reflects overall risk facing investors. The industry is going through significant changes with upstream reforms, CPI and potentially household competition in the mix: it is too early to conclude that the risk in the sector has fallen.

Menu based equity: A menu based approach to equity is clearly innovative and has some advantages. However, in our view, it has practical limitations in how it can be implemented fairly and transparently. The water industry is diverse in terms of the size and challenges faced by the companies and it seems difficult to make an informed judgement on the equity risk built in a plan and compared against other companies. Moreover, given the amount of change going through the sector, another menu will add further complexity. Existing incentives (enhanced/standard/basic) work well and reputational benefits themselves carry sufficient weight. The approach followed at PR14 was successful as it also offered reputational benefits to be seen as an Enhanced company. Companies used innovative risk sharing mechanisms, ODIs and were able to influence equity returns built in the plan.

Notional financeability: One of the risks that was not explicitly covered in this consultation (or in Water 2020) is around the impact of current macroeconomic and regulatory changes on the financeability of an efficiently financed notional company. We raised this at the Ofwat workshop and the discussion also came up at the Moody's Water conference (2016) and clearly all investors, debt and equity are mindful of the challenges at the next price review.

The water sector is unique as large capital investments are needed over the AMP periods, investment is made in cash terms whereas the funding for these investments are made in real returns. Ofwat's financing duty enables efficient companies to finance its functions despite this mismatch of nominal cost and real returns. With the introduction of CPI/CPI-H, the gap between the nominal costs and real returns is likely to narrow, however, other macroeconomic and regulatory developments are likely to worsen financeability at the next price review (for a notionally financed company). Set out below are key price-review financial assumptions and their relationship to the financeability of a notional capital structure:

Real returns/WACC: Lower WACC reduces financeability.
CPI WACC: Move from RPI to CPI will improve financeability.
Inflation: Higher expected inflation reduces financeability.
Inflation-linked-debt: Increased use of ILD improves financeability.

During PR09 and PR14, the use of RPI linked debt helped the notional company to pass the financeability tests – albeit with little or no headroom. Rating Agencies are diverging in their use of credit ratio's and we are now

seeing wider variances in ratings for the sector depending on how they consider individual companies are more financially resilient to changing levels of interest rates and inflation. Financial markets can change quickly, however as it currently stands, indicators point to tight financeabilty during PR19, despite the expected help from higher real CPI based returns – this was also noted at Moody's Water event (2016) and highlighted in their paper 'lower for longer'. With WACC likely to fall as debt rates remain low, inflation expected to rise (due to sterling devaluation and loose monetary policy), and no tangible existing market for CPI linked debt, Ofwat's financing duty is likely to come into focus as credit ratios are expected to be tight. This, combined with added complexity of introduction to CPI/CPI-H and upstream reforms, consideration needs to be given to market concerns and the implications of these challenges on financeability. We are willing and happy to work with Ofwat in this area.

Answers to specific questions in the consultation:

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?

Agree. A fundamental principle of water regulation has been that corporate structure is a matter for company and its investors. UK water has seen innovative financial structures, such as securitised companies, and customers have benefitted with lower tax costs passed through their bills. We agree that no change is required.

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

We agree that mandatory one-sided benefit sharing mechanism is not appropriate. It is for the companies, their boards and their customers to develop appropriate ODIs and sharing mechanisms to reflect an appropriate risk and reward position.

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

We see recent fluctuations in markets as further evidence that companies, not customers, are best placed to manage the interest risk. However, in light of the NAO report and PAC recommendation we can see a case for the proposed change, and agree that if indexation is introduced, it should apply to the new debt only. Further details on the construction and constituents of the index, including the working of the true-up mechanisms are needed to make an informed view. We encourage Ofwat to engage with companies when devising the index to ensure it reflects appropriate costs and that

economic incentive to outperform are retained in the sector. We will be happy to work with Ofwat and explore these issues.

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

We agree that an end of period adjustment will see through any in-period fluctuations in the markets. An important aspect of this is notional financeability. As the cost of debt index passes market risk on to customers, an end of period adjustment would require that companies still manage the risk over the AMP period. For example - if rates increased much higher than assumed in price limits, leaving companies financially constrained, rating agencies are likely to ignore any end of period adjustment as they take a short to medium term view and such a scenario could lead to rating actions. If Ofwat goes ahead with the indexation, and an end of period adjustment, it is crucial that prices are set in the same way as Ofwat would have done historically i.e. funding should assume mid to high end of forward rates, and not a 'lower end of estimate' with a view that 'it will be trued-up'. Companies should have the flexibility to manage market fluctuations over the AMP period.

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?

An inflation true-up adjustment is a new regulatory development and appears to be in response to the NAO inquiry. We recognise the need to true up to nominal rates however this could lead to significant adjustments at the end of the price-review. Moreover, the inflation component of the financing cost reflects break-even inflation and that has tended to be different to the actual spot rates.

If Ofwat choose to go ahead with the proposal, the inflation factor for true-up should be based on an observable figure such as a nominal spot rate or a break-even inflation rate. As the measure of inflation at PR19 is likely to be CPI/H, and there is no current market to calculate CPI/H break-even inflation, it seems the only realistic option for true-up adjustment is to use the nominal spot rate for CPI/H.

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?

We agree that no change is necessary. PR14 saw companies take innovative approaches to engage with their customers, and reflect customers'

preferences in sharing risk and reward, including through ODI's and the pain-gain sharing mechanisms. The industry has taken big steps in this area, and will continue to do so, and a prescriptive regulatory guidance will impede progress and could be seen as a step backwards.

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?

A menu based approach to equity is clearly innovative and has some advantages. However, in our view, it has practical limitations in how it can be implemented fairly and transparently. The water industry is diverse in terms of the size and challenges faced by the companies and it seems difficult to make an informed judgement on the equity risk built in a plan and compared against other companies. Moreover, given the amount of change going through the sector, another menu will add complexity. Existing incentives (enhanced/standard/basic) work well and reputational benefits themselves carry sufficient weight. And as discussed earlier, given the amount of change going through, a new 'menu' will only add further complexity to the regime. The approach followed at PR14 was successful as it also offered reputational benefits to be seen as an Enhanced company. Companies used innovative risk sharing mechanisms, ODIs and were able to influence equity returns built in the plan.

Jean Spencer
Regulation Director

Anglian Water Services Limited
Lancaster House, Lancaster Way, Ermine Business Park, Huntingdon, Cambridgeshire, PE29 6YJ