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Cost of debt consultation
Water 2020
Ofwat
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By email: water2020@ofwat.gsi.gov.uk

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Dear Ofwat,

Thank you for the opportunity to comment on the Water2020: consultation on the approach to the cost of debt for PR19. Bristol Water welcomes the early opportunity to provide our views on Ofwat's emerging thinking on the cost of debt indexation and other finance-ability issues in the process of setting the PR19 methodology.

We broadly agree with Ofwat's emerging thinking that the indexing of debt should be placed on new issuance only and existing debt should continue with a fixed allowance approach. We look forward to the emergence of the further detail on the actual index and the approach to be used as these will be the main determining factors of whether the mechanism is appropriate. We are also supportive of the continued use of notional industry capital structures with continued additional recognition of industry structural asymmetries.

With regards to the application of risk reward mechanisms we believe that it is important that Ofwat are clear early in the PR19 process on its expectations of where the boundary between industry common mechanisms and company specific mechanisms should apply. In PR14 companies, in consultation with their customers, have proposed and have implemented a number of risk/reward sharing mechanisms ranging from an overall RORE approach to specific mechanisms for individual components of the business plan (e.g. Cost of Debt). Companies are in the process of engaging with their customers on the scope and extent of these mechanisms for PR19 and we look forward to further early clarity on Ofwat's proposed approach.

I hope that you will find our response helpful and we have provided a number of detailed comments in the attached appendix against each of the consultation questions. If you have any further questions please do not hesitate to contact me.

Kind regards

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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?

It is usual for regulators to set a cost of debt allowance using notional gearing. Indeed, the CMA "considered that using an industry average (hence notional level) for gearing was an appropriate method in principle for calculating gearing in the cost of capital calculation, since it is for companies, their shareholders and management to determine the most efficient financing structure (including gearing level) to meet their circumstances."[1]

If Ofwat proceeds with the plans outlined, it would be of benefit to stakeholders to have an early opportunity to comment on proposed assumptions for such a capital structure, including:

- Debt to equity ratio;
- Embedded debt to New debt ratios, including any yearly profile
- Levels of index-linked debt per indices; and
- Definitions (and examples) of which instruments Ofwat considers to be debt, (to ensure consistency of cost of debt and assumed capital structure)

We accept that the practicalities of regulating an industry comprising many companies mean that the use of notional cost of debt bands is an appropriate way to ensure each company's efficiently incurred debt is reflected in allowances. This is in line with the CMA's approach as it noted " the primary consideration in setting the cost of capital was whether efficient companies could finance their functions. Ofwat accepted that small companies have, on average, a higher cost of capital. While this remains the case, our starting point would be that this should be taken in to account in the assumption on the cost of finance."[2]

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 with Ofwat's findings on this matter. We concur with the comments on page 18 of the consultation, that the choice by companies to adopt a different capital structure to the notional structure is a balance of risk and reward and there is little evidence that customers would benefit when all effects are considered. In addition, any mechanism to share benefit would likely be very complicated.

We also note that customers benefit from the lower taxation costs that result from such structures, leading to lower bills.

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

We agree with Ofwat that the introduction of indexation for the allowance for the cost of embedded debt is not appropriate. In line with our answer to question 1, such an approach would likely lead to an allowance that did not take into account the true cost of financing.

The use of an indexation mechanism for the allowance for the cost of new debt has been adopted by other regulators. As noted in the consultation document, the approach attempts to pass the risk of

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[1] Competition and Markets Authority (CMA) (2015), Bristol Water plc, A reference under section 12(3)(a) of the Water Industry Act 1991 para 10.27

[2] Competition and Markets Authority (CMA) (2015), Bristol Water plc, A reference under section 12(3)(a) of the Water Industry Act 1991 para 10.75

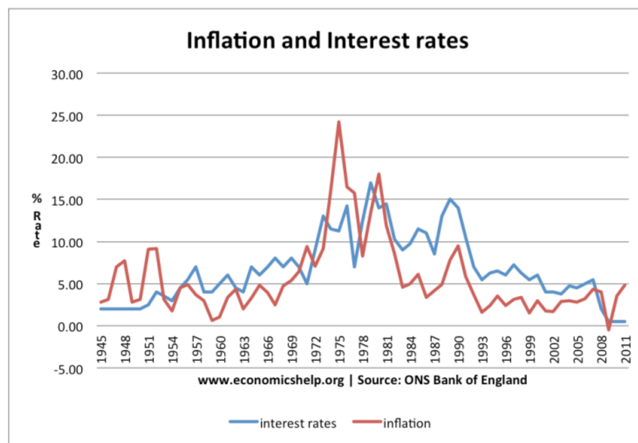
forecasting interest rates to customers. Depending on the mechanism implemented, companies will likely still bear significant risk to interest rates due to:

- The timing that debt is required relative to the index-linked assumptions;
- The size of debt assumed; and
- The availability of debt with terms matched to the index.

The consultation documentation does not conclude an which index could be used or the mechanisms for implementation. We would welcome an early opportunity to see such detail to better understand the risks that companies and customer will face.

The use of an index is likely to lead to company's financing strategies attempting to match the index. At a time when long-term interest rates are very low, it is arguably in the interests of customers that companies enter into longer-term financing structures. An allowance based on an index may not incentivise companies to follow such a strategy. The incentive to innovate may also be lower.

As companies have access to financial markets, they are better placed to hedge against fluctuations in interest rates than customers and can achieve lower costs of hedging. Post-war analysis of interest rates shows significant spikes over short-time periods, as shown in the chart below. The move to the use of indexation for new debt allowances will expose customers to these effects.



An alternative to the proposed approach would be for customers to bear 50% of the movement in indexation. This would provide incentive companies to lower debt costs and allow some risk to pass through to customers. Such an approach would be similar to the totex sharing mechanism.

Overall, a decision to introduce indexation for the allowance for the cost of new debt will change the risks and costs that customers bear. We therefore consider it would be appropriate for Ofwat to allow further consultation on this matter so that customer groups can reflect on the comments of all stakeholders to this consultation.

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

We believe it would be advantageous for companies to choose how an adjustment should be made, (whether within period, midnight RCV adjustment or to revenues in the next AMP) as long as doing so would not be detrimental to customers. Each option has advantages and dis-advantages and are therefore may be preferred by companies depending upon circumstances. If such flexibility is not

available, an end of period adjustment would be the most manageable, and provide more certainty of bill levels for customers than an in-period adjustment. The existence of an adjustment should not detract from the drive for an accurate forecast in the allowance, to minimise bill fluctuations.

If within period adjustments are preferred by Ofwat, then the profile of the cost of debt would be better forecast reflecting a profile similar to a market curve. If the calculation is simply a flat profiled average across the AMP, it could lead to odd adjustments year on year.

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?

If Ofwat decides that customers should bear full interest rate risk on the cost of new debt, then a revenue adjustment for the movement in inflation would make sense to the extent that it results in companies receiving revenues that match costs. However, due to the complexities set out in our answer to question 3, such a calculation risks inadvertently penalising companies whose debt requirements do not meet a homogeneous set of assumptions. We would therefore welcome the opportunity to comment on detailed examples of such adjustments in advance of methodologies being set.

If the rationale for passing interest rate risks through to customers is to avoid concerns that companies make super-normal profits simply due to market mechanisms, we wonder if it would be better for a pain/gain sharing mechanism to be set for the company as a whole. This would provide customers with a better assessment of the financial position of companies and would avoid focus on one particular cost item without balance. For example, Bristol Water has a mechanism in AMP6 to pass through excessive returns on regulated equity to customers.

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?

If Ofwat believes that risk mechanisms are appropriate, it would be better to set out a specific approach. Alternatively, if Ofwat is fully open to company's agreeing mechanisms with customer challenge groups then we would support a voluntary basis. We believe that different mechanisms are likely to be beneficial to customers of different companies. For example, a mechanism may not be appropriate at all for a company that does not envisage having to raise new debt during a regulatory period.

Any arrangement should be symmetrical, reflecting the nature of the risks of market movements in interest rates and inflation. This would also fairly reflect the transfer of risk from company to customer, if that is the intention. The consultation document suggests an asymmetric adjustment may be appropriate due to interest rate movements in prior regulatory periods. In our view, the risk and reward balance was set at each historic price review and therefore should not be retrospectively adjusted for. In addition, a review of interest movements in isolation is unlikely to reflect the true return on regulated equity in past periods.

BW introduced a gain sharing mechanism with its customers at PR14 based on the RORE.

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?

We welcome Ofwat's further discussion on how companies should be rewarded for taking on higher risk in their business plans and developing high quality plans that deal effectively with uncertainty.

The complexity of implementing a cost of equity menu approach to do this is a disadvantage as it is yet to be fully trialled and implemented in Australia. There remains a high level of regulatory discretion in how companies can be assessed in terms of the relative (to other water companies) level of risk or any other determining business plan quality factor. Revisiting the cost of equity during the review period based on a high level of regulatory discretion could bring further instability to the sector. Stability and certainty is a feature stakeholders wish to retain. The size of differential in the rates presented in the menu is wide and could result in financeability issues that are not driven by the inherent level of risk in a company's business plan but by other regulatory measures of quality.

It remains unclear where the central WACC estimate would be aligned within the cost of equity menu. If the menu is to work effectively "Leading" or "Ambitious" companies who take on a higher proportion of risk should be allowed to earn a higher cost of equity than the central WACC estimate.

In our view, the mechanism in PR14 of providing a small uplift for enhanced companies was sufficient incentive for companies to produce high quality plans.