Water 2020 - consultation on the approach to the cost of debt for PR19

Consumer Council for Water Response **October 2016**

1. Introduction

1.1 The Consumer Council for Water (CCWater) is the statutory consumer organisation representing water and sewerage customers in England and Wales. CCWater has four regional committees in England and a committee for Wales.

1.2 We welcome the opportunity to comment on Ofwat's consultation on changing its approach to setting the cost of debt at the 2019 price review (PR19).

2. Executive Summary

2.1 Ofwat's assumption of a fixed cost of debt within the Weighted Average Cost of Capital (WACC) at previous price reviews has been over generous in that Ofwat overestimated the cost of debt financing and under estimated the trajectory of RPI inflation.

2.2 This contributed to the gains many water companies have made through accessing debt at far lower rates than Ofwat assumed, and by the special dividends several companies subsequently paid out to shareholders. The National Audit Office review of Ofwat's regulation of the sector[1] revealed gains by companies in England and Wales of £1.2bn in 2010-15.

2.3 Ofwat is considering applying an index to the cost of debt assumption, and allowing for the development of mechanisms for companies to automatically share outperformance with customers (though a 'two way' mechanism could also see customers carrying the cost if a company underperforms).

2.4 Our key points in response to the ideas Ofwat has raised are as follows:

a. Ofwat should set a single cost of debt for all companies that is based on a notional structure of an efficiently financed company to help incentivise companies to finance their functions in a way that benefits customers. The notional structure should also take into account the potential for companies to refinance embedded debt at a lower cost than Ofwat assumes.

b. We support the principle of indexing the cost of new debt to a benchmark of debt costs. This could prevent customers from over paying if the actual cost of debt is lower than Ofwat assumes. The reverse is also true. Given the historically low levels of debt that companies have been able to access, customers would quite rightly be concerned if their bills increased because of debt costs rising when they had not benefitted from falling debt costs.

   As such, we suggest Ofwat consider further when it would be appropriate to introduce indexation, and issue a further discussion paper well in advance of decisions being taken for the 2020-25 pricing period. This consideration would require a view on both the financial advantages to companies of the fall to historically low levels, and the long-term forecast, of base interest rates. This may help identify the likely scale and duration of risk being carried by companies, who are best placed to carry it, or by customers, who are not.

c. Given that some risk is likely to be transferred to customers, we would expect to see a related reduction in the risk premia included in Ofwat's Weighted Average Cost of Capital.

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[1] National Audit Office review of regulation in the water sector (October 2015) https://www.nao.org.uk/report/the-economic-regulation-of-the-water-sector/

d. Companies should be encouraged to propose mechanisms in their business plans to share outperformance gains with customers. This could include gains achieved from outperforming the Ofwat set cost of debt, but could include other factors that have generated gains. However, such a mechanism should strike a balance between investors and customers interests to avoid a 'pricing up' of risk in the cost of capital.

2.5 Our more detailed responses to the consultation questions can be found below.

3. Responses to the consultation questions

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 for each company?

We support the continued use of a notional structure and universal cost of debt allowance as long as this is based on a benchmark of leading efficiency.

While companies can make their own financing choices, the notional structure and assumed cost of debt should incentivise companies to finance efficiently. However, companies should not be allowed to use an increase in the 'pay as you go' ratio as a means to increase short term revenue to 'compensate' for the longer term effect of a more efficient notional structure or low cost of debt.

Setting the cost of debt to reflect each company's financial structure could mean companies are protected from risks associated with what could be historic poor or inefficient financing decisions. This also has a risk that customers could be funding an inefficient financing structure, with no incentive on companies to outperform this or change their structure.

Ofwat's assumption within its notional capital structure on the ratio between new and embedded debt should also be considered. At PR14, Ofwat assumed a ratio of 75% embedded debt to 25% new debt. The assumed cost of new debt (2.0%) was lower then the assumed cost of embedded debt (2.65%).

However, for companies that are able to refinance their embedded debt to take advantage of lower borrowing costs in recent months (or have index linked embedded debt), there is an opportunity to make gains at customers' expense from an actual embedded debt cost that is lower than Ofwat's assumptions. The gains that could be achieved from refinancing embedded debt may outweigh any penalties a company may incur from early settlement of those loans.

To achieve a notional capital structure that incentivises companies to finance more efficiently in customers' interests, Ofwat should take into account in its embedded: new debt ratio the level of embedded debt held by companies that could be refinanced due to the availability of lower cost new debt. This may help reduce the risk of the level of gains made in refinancing debt that has been seen in the past.

Ofwat will also need to ensure that customers are protected from risks associated with highly geared financial structures, as a notional structure that has a mismatch between a fixed cost of equity and an indexed cost of new debt could incentivise companies to opt for higher gearing if the cost of borrowing remains low.

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 recognise that some water industry investors are attracted to securitised capital structures as the stable and predictable cash flow for water companies can be seen as low

risk, and that this form of financing can incentivise companies to opt for a more highly geared structure.

Analysis by Ofwat and PwC, summarised in the paper, shows that companies with securitised structures are less likely to strongly outperform the Ofwat assumed cost of debt.

However, excluding these companies from the introduction of mechanisms for sharing future financial benefits with customers could appear to these companies' customers that they are not receiving the same 'safety net' as customers of other companies. We think the securitised companies could be subject to benefit sharing mechanisms that take into account the potential effects of additional risk to investors, as described in our response to question 6 below.

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

We support the principle of indexing the cost of new debt to a benchmark of debt costs. This could prevent customers from over paying if the actual cost of debt is lower than Ofwat assumes. The reverse is also true. Given the historically low levels of debt that companies have been able to access, customers would quite rightly be concerned if their bills increased because of debt costs rising when they had not benefitted from falling debt costs.

As such, we suggest Ofwat consider further when it would be appropriate to introduce indexation, and issue a further discussion paper well in advance of decisions being taken for the 2020-25 pricing period. This consideration would require a view on both the financial advantages to companies of the fall to historically low levels, and the long-term forecast, of base interest rates. This may help identify the likely scale and duration of risk being carried by companies, who are best placed to carry it, or by customers, who are not.

If the cost of debt is to be indexed, as this is effectively passing some risk on to customers, we would expect to see a related reduction in the risk premia included in Ofwat's Weighted Average Cost of Capital.

We agree with excluding embedded debt from the indexation, because an index applied to embedded debt could reduce the incentive for companies to refinance more efficiently to benefit customers and shareholders. Index linking embedded debt could also be seen to be protecting companies from past inefficient financing decisions.

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

Yes, though the adjustment should be spread over the subsequent price control period to 'smooth' the impact on customers' bills. If the proposed indexation of the cost of debt is taken forward, Ofwat should ensure that customers do not experience sudden bill 'spikes' due to adjustments made to the cost of debt.

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 adjustment to the inflation estimate used in the assumed cost of debt could help prevent customers over-paying if inflation is higher than the estimate. However, the reverse also applies in that customers could see a bill spike if the inflation estimate (which is likely to be based on CPI in the future) is lower than forecast.

As per our response to Question 4, we would like to see adjustments applied in a way that avoids sudden bill 'spikes' and smooth the bill profile to provide stability for customers.

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

Yes. However, we would welcome Ofwat stating publically that where a company proposes a risk sharing mechanism, it must engage with its stakeholders (including CCWater) in its development. Such mechanisms should also have customer support, with further customer engagement on where to apply the benefits to be shared (e.g. extra investment, help for vulnerable customers or a reduction in customers' bills).

If the cost of debt is indexed, this should reduce the possibility of companies achieving the level of outperformance from lower cost debt financing that has been seen in the past. Therefore, the companies and their stakeholders could also consider extending the terms of the mechanism to include sharing benefits with customers where windfalls may occur from other factors such as tax adjustments or totex efficiencies.

We would prefer to see companies propose a one-way 'gain share only' mechanism to share the benefits of windfalls from the sources we have suggested above. We recognise that such a mechanism could encourage investors to 'price up' risk, so a balance needs to be achieved to ensure:

a. Shareholders continue to invest in the sector through the incentive of returns available from operating and capital cost efficiencies, and service performance improvements (i.e. rewards from outperforming Outcome Delivery Incentives).

b. Customers receive a share of the benefits achieved above a defined threshold (to be decided between the company, its shareholders and stakeholders, and Ofwat) so that risk is not 'priced up'.

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?

The menu based approach allows companies to have an individual 'tailored' cost of equity applied, rather than a universal cost of equity assumption set by Ofwat. Companies would select a cost of equity from a 'menu'. Companies could potentially have a higher cost of equity allowance if Ofwat agrees that the company has produced a higher quality business plan (that is well evidenced, proposed efficient totex, and has effectively incorporated customers' views.)

If a menu based approach is to work in customers' interests the following factors may need to be considered:

a. What incentives are there for companies to opt for a lower cost of equity, and how would these incentives work alongside other regulatory incentives (such as ODIs)? For example, could a company select a lower cost of equity from the menu, but propose a higher rate of reward for their ODIs? Would the current incentive reward for companies with 'enhanced' business plans (which should be both forward-looking and based on historical performance) be replaced by a menu based approach to the cost of equity?

b. How, and in what circumstances, would Ofwat intervene to protect customers if a company failed to deliver commitments that did not have an ODI penalty attached to them? We would expect to see the companies' returns reduced in this scenario.

c. If a company with a high quality business plan and good historic performance is allowed a higher cost of equity, there should be evidence that:
    - customers find the plan (including the proposed bill impacts) acceptable; and
    - the company has a strategy in place to address the concerns of those customers who may find the plan unacceptable or unaffordable.

d. How will the menu based approach be explained to customers? Some customers may view it as another means by which companies gain at their expense. That could dent trust and confidence in the water industry and the regulatory regime.

We note that the consultation question is intended to introduce the concept of a menu based cost of equity with further discussion to follow up to the PR19 methodology being set. We would like to see this proposed approach analysed further to take into account the factors listed above.

If Ofwat is to move way from a fixed cost of equity, there would need to be clear evidence that this would be in customers' interests, and not allow customers to carry risks that companies and their shareholders should bear.

Enquiries

Enquiries about this consultation response and requests for further information should be addressed to:

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