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Consultation on the approach to the cost of debt for PR19

Dee Valley Water would like to thank Ofwat for the workshop held recently in London on this topic and also for the consultation paper. The comments set out in this letter have been informed by both sources.

Background to cost of debt consultation

Ofwat provides funding to the water companies to cover the cost of debt (essentially interest payments). A figure is set by Ofwat at the beginning of the price review period and this does not get altered. However, over the last few years interest rates have continuously declined. The cost of debt (represented by the 10 year trailing iBoxx index) has been falling faster than the allowed cost of debt set in the price controls.

The effect of this is that water companies have been receiving funding at a higher rate than the actual cost of interest on the debt being incurred. Forward rates on UK 10 year Gilts have not been a good predictor of new debt costs, and have tended to overstate market rates.

Another driver of differences between the allowed cost of debt and the actual company debt cost is the forecast inflation rate used to calculate the real cost of debt. The allowed cost of capital is set in real terms, as the RCV is indexed to inflation (currently RPI). For example, if nominal cost of debt is set at 5% and inflation is forecast to be 2%, the real cost of debt allowance is 3%. If inflation is actually 2.5%, then the actual allowed cost of debt would be 5.5% (as the company is allowed a real cost of debt of 3% and the RCV is then indexed to inflation).

Using the notionally efficient company (assumes debt gearing of 62.5%), Ofwat will calculate the amount of embedded debt and new debt that a company should have (75% embedded and 25% new).

The embedded debt will be treated as it is now with the fixed allowance approach. A single cost of debt percentage figure will be set at the beginning of the price review period (PR14: 2.65%).

New debt will be adjusted for market index (actual market movements against a trailing average of the cost of debt over a 10 to 20 year period) and for inflation. This will bring it in line with the way that RCV is calculated (discounted using actual inflation rate).

Consultation proposal: cost of debt should be set on the basis of a notional capital structure and notional cost of debt, as opposed to being based on the actual capital structure and debt costs for each company

Using the notionally efficient view of the world immediately puts DVW in a disadvantageous position. This is because, DVW has a loan agreement running from 2002 to 2032 at a fixed interest rate that cannot be refinanced.

DVW entered into this agreement at a time when a number of other water companies entered into a similar arrangement (known within the industry as the Artesian loan). This was considered good business in that it locked in what looked to be a low interest rate of 3.65% for a period of 30 years.

DVW is unlike the large water companies that do roll over debt and so have been benefiting from receiving a higher cost of debt allowance than the actual interest costs incurred on their debt.

DVW have expressed these views in the period leading upto PR14. In August 2014 Ofwat received a commissioned report from PWC to analyse if company specific adjustments were required to the WACC for PR14.

According to PWC's August 2014 report for Ofwat:

- WoC's and WaSCs are "able to manage finance risk through the timing of debt issuance and the nature of debt instruments used and therefore, that

companies should bear the timing risk and any gains or losses arising from out or underperformance relative to the industry benchmark"[1].
- "(W)e cautioned against a move towards using the use of actual capital structures and actual embedded costs as this could reduce incentives for water companies to finance themselves efficiently." As a result of this analysis PWC concludes that small WoCs face a cost of debt that is 40bps higher than larger WoCs and WaSCs.
- "Our analysis suggests that the timing of Artesian finance issuance is the biggest contributory factor to under-performance".
- "Specifically, bank debt is generally shorter term in nature, and hence would introduce additional re-financing and interest rate risk for companies".

DVW responded to this report stating that:
- DVW is not able to manage finance risk through the timing and nature of debt issuance since it secured the long term Artesian loan in 2002.
- Small WOC's face a cost of debt that is 40bps higher than larger WOC's.
- DVW should have a specific company uplift to its cost of embedded debt.
- The Competition Commission when reviewing the Bristol Water case stated that "Bristol Water's return on its RCV should be equal to its expected cost of capital".

DVW accepts the principle of setting a notional capital structure, however we would welcome significant advance warning and guidance when Ofwat decides to change the notionally efficient structure.

Regarding cost of debt, the smaller companies are effectively being punished by their frequency of the interactions with the market. This creates winners and losers based purely upon size and scale of treasury operations rather than the quality of customer service, which is surely the opposite of what Ofwat is trying to achieve.

In the PWC report, it states that Ofwat doesn't want customers funding themselves solely for each five year cycle. However for small companies the upshot of taking such a rigid view of embedded debt would mean rolling over from AMP to AMP to mitigate the risk of potential losses from capital markets, which is clearly contrary to the advice given by PWC to Ofwat.

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[1] PWC report for Ofwat, August 2014, page 13

Consultation proposal: the introduction of indexation of the new debt allowance for the cost of new debt

The notionally efficient DVW will be assumed to have 25% new debt. At present, DVW does not have any new debt. However, if in future, DVW does raise new debt, then the principle of applying indexation to the cost of debt allowance for new debt is felt to be equitable.

Consultation discussion: when should the adjustment for the indexation of new debt be made?

When debt is indexed, an adjustment will be required between the initial cost of debt allowance and the indexed cost of debt allowance. This adjustment can take place either at the end of each year, at the end of the AMP, or rolled over into the following AMP.

DVW's view is that to maintain the continuity of annual billing during an AMP, the adjustment should not occur during the AMP. Instead, it should be a factor taken into account for the funding of the following AMP.

Consultation proposal: an adjustment should be made to the inflation estimate to reflect out-turn inflation and so mitigate inflation forecast error for new debt

DVW agrees with the principle of this proposal.

Consultation discussion: what impact could these proposals have on the way water companies finance their businesses?

DVW has always taken a long-term view of funding the business. As discussed above, DVW has secured a loan agreement until 2032, so there will be no impact on the financing decisions. However, within the industry, the cost of debt consultations could force water companies to consider shorter term funding cycles that coincide with price review periods.

Background to cost of equity consultation

This relates to two areas: sharing some of the gains of outperformance with customers, and a possible approach to setting cost of equity based on a sliding table as used by the Essential Services Commission in Australia. Ofwat is looking at proposals for PR19, but at present these would not be mandatory only exploratory.

Consultation discussion: introduce a pain / gain sharing mechanism with customers

Consideration was given about whether Ofwat should mandate a pain/gain mechanism to force water companies to share over performance with customers. Two water companies proposed their own mechanism in PR14. Ofwat also raised the possibility of this being an asymmetrical relationship where customers did not suffer the pain of underperformance.

DVW has the fourth lowest water bills in the industry, and we are working hard to maintain this. As such, we consider that customers are already benefitting from the achievement of DVW's business plan. There is an existing framework to control positive or negative achievement of business plans, and so this would only add an extra duplicating layer of regulation.

DVW's clear view is that Ofwat should not make this mandatory. Customers would not understand the mechanism driving this and they are unlikely to care.

Consultation discussion: introduce a menu based approach for the cost of equity

An average cost of equity would be set across the industry (PR14: 5.6%). This would then be flexed against a sliding table based on the assessment of the company's business plan and whether it was leading, ambitious, standard or basic. The sliding scale would also be determined based on Ofwat's view of the business case.

In the example shown at the workshop, there was a variance of 1.4% around the average.

DVW's view is that this is a very judgmental area (who defines what these buckets actually mean). Companies are penalised if they have a view that differs from the Ofwat view. A board of directors is unlikely to approve a "basic" business case, so there will be a tendency for all of them to become inflated.

The Australian example is not relevant to the UK as the Australian organisations are public institutions. Ofwat should not be focusing on this area, as water companies are already incentivised / penalised by the ODI and SIM mechanisms. Ofwat should also look at the return on regulatory equity (RoRE) and not the cost of equity as a fairer way to introduce any flexing mechanisms.

There was no consideration given to the ramifications if a company does not achieve its targets, but has received an enhanced cost of equity. This may also encourage building riskier business plans if ambitious become synonymous with risk.

In conclusion, the range of consultation proposals has clearly been expressed by Ofwat, and DVW has fully engaged in the consultation. DVW looks forward to the future debate and directions taken on these topics in readiness for PR19.

Yours sincerely,

Ian Plenderleith
Chief Executive