17 October 2016

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Dear Ofwat

**Portsmouth Waters response to the Ofwat Consultation on Cost of Debt**

We welcome the opportunity to respond to this consultation on the approach to setting the cost of debt for PR19, published on 6 September 2016. We also recognise the sensitivity of this particular issue given the observations by National Audit Office and Public Accounts Committee and, therefore, the need to set a more accurate cost of debt (including the introduction of a "true up" mechanism where any divergence between actual outturn and estimated costs arises). In addition we note that Portsmouth has not benefited from any "upside" in relation to actual cost of debt on a notional structure, given the already existing gap between the allowed cost of the debt and the efficiently raised actual cost of debt.

As you know Portsmouth Water has a single tranche of index linked fixed rate debt, maturing in 2032, which was efficiently raised in 2002 (Appendix A – report by NERA dated 17 October 2016). You are aware from our previous discussions, earlier this year, that the company's key financing ratios (particularly interest cover ratios) are adversely impacted by any variance between the embedded and allowed cost of debt and, as such, these proposals have the potential to further adversely impact the company's financability. In particular we suffer from the fact that our efficiently raised historic debt cost is no longer represented by the trailing average proposed for embedded debt, as the rate has reduced since 2002. We therefore highlight other potential indexation options used elsewhere in the UK regulatory environment (including those used by Ofwat).

This downward pressure on finaceability is further recognised by the recent analysis prepared and presented by Moody's at their industry conference on 12 October 2016. This highlighted the potential impact of extended period of low interest rates on the whole industry (which inherently will continue to widen the gap between our actual and allowed debt costs given the Ofwat methodology). The analysis also shows that 5 of the WoCS (including Portsmouth) are amongst those companies most severely exposed. This is a function of the lack of flexibility of WoCS to raise a diverse debt book.

Further downward pressure on the allowed cost of debt will further exacerbate the adverse impact of the proposed transition from RPI to CPI on Portsmouth Water. We were disappointed, on discussing this point with Ofwat, to hear that this effect has not been considered as part of this consultation.

Our response is also supported by a report which the Company has commissioned from NERA which is included with this letter. This presents our views and the relevant supporting data primarily relating to the approach to setting the embedded cost of debt. This is referenced within this response and appended in full for your additional consideration. We would be happy to consider including this within the Marketplace of Ideas should Ofwat feel that this would be helpful.

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We have responded to the specific questions that Ofwat has raised in the consultation document as follows;

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?

Addressing the second part of this question first; the consultation assumes that there will be no change in the basis of how the notional *embedded* cost of debt from the methodology (used at PR14) is set. We have addressed this point in this section rather than in question 3 where it could also be considered.

The current approach fails to fully compensate Portsmouth Water for the cost of its *efficiently financed* embedded debt. This is primarily because the current trailing average does not take account of the timing of debt issuance by Portsmouth (which was raised in a single tranche in 2002). Over time this approach continues to erode aspects of Portsmouth's financability and, as we have previously set out, is further exacerbated by the transition from RPI to CPI. We have provided support (Section 3 & appendix A NERA report) that Portsmouth's debt was raised efficiently, out-performing the market at the time.

We feel that it is important to note the challenges faced by smaller companies, like Portsmouth, in relation to access to debt markets and timing of debt issuance. We believe that a number of different indexation approaches (for embedded debt) could be effectively used in order to better reflect the company's actual cost of efficiently raised historic debt. This would narrow the differential between actual and allowed cost of debt (albeit in a notional capital structure). This is further explored below. We would also continue to support the approach that this could be addressed through a company specific adjustment. It is disappointing that the approach to such adjustments, is not recognised as part of this consultation as it is in important element of the overall subject of cost of debt, particularly for the smaller WoCs.

We have two observations and comments in relation to assumptions made in the consultation document in connection with setting the cost of embedded debt which reflects our historical issuance profile. These could be addressed through various mechanisms to set an index for embedded debt (under option 2) or through revisions to the existing approach. The key themes are as follows;

1. Evidence of sector out performance of benchmark cost of debt
2. Alternate regulatory approaches: how the index could be designed

<u>1. Evidence of sector out performance of benchmark cost of debt</u>
Ofwat makes a number of references throughout the document to persistent sector out-performance of the cost of debt. The current methodology for the embedded cost of debt already reflects this through a 15bp reduction.

However, analysis performed in the attached NERA report (sections 3.1-3.3) presents strong evidence that rating differences explain a large proportion of this variance and this is further reduced once adjusted for timing of debt issuance. As such the evidence for sector out performance is weakened. Furthermore evidence for the Halo Effect comes under pressure from like-for-like analysis and this is also recognised in the CMA finding in connection with RIIO-ED1 (NERA report section 3.4).

On the basis of this evidence we would challenge the conclusions made in relation to sector out-performance.

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2. Alternate regulatory approaches: how the index could be designed

We would argue that there are good alternatives to the current approach to setting the allowances for both the embedded and new cost of debt. Under "option 2" Ofwat has not prescribed the type of indexation mechanism but the CEPA report acknowledges that bespoke mechanisms may be required in specific circumstances.

As we have noted, the current approach to setting the embedded cost of debt does not allow for the efficient debt raised outside of the index's time frame or the need for small companies to raise single large tranches of debt. This could be addressed by the use of a bespoke indexation mechanism that better represent the embedded debt costs. There are a number of other examples of regulators implementing cost of debt indexation mechanisms that reflect the timing of debt issuances for companies with atypical debt profiles. These are;

- Ofwat for Thames Tideway Tunnel and
- Ofgem for Scottish Hydro Electric Transmissions Ltd
- UREGNI for Northern Ireland gas distribution networks

In these examples the index used recognises the debt profile of the Company. These are covered in more detail in Section 2 of the NERA report. We would posit that such an approach could be applied to Portsmouth and other companies, where there is appropriate evidence that the debt structure and cost is efficient and there is a financability need. This could be achieved by reflecting the index at the time a company actually raised its debt or through a company specific uplift.

We strongly believe that there is sound evidence and precedent for revisions to the current and proposed approach to setting the embedded cost of debt allowance for companies with atypical debt profiles, such as ourselves. The recognition of our efficiently incurred debt costs could be achieved through a move to "option 2" with the use of a mechanism that reflects the profile of our debt issuance, or through a company specific adjustment under your preferred option 3.

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In relation to the Notional Capital Structure we support the continued approach. Ofwat have consistently argued that it is not their role to promote or advocate specific capital structures. Any change from this policy position may change the incentive away from ensuring companies establish efficient capital structures.

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| 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 the proposal. We do not feel that there is strong evidence that a separate approach should be taken to companies with securitised structures, especially given Ofwat's position not to advocate or promote a specific capital structure. We also feel that such arrangements would bring additional complexity to the regulatory regime.

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

We have raised a number of observations in relation to assumptions on "sector out performance" and alternative indexation approaches under question 1, above, which have not been repeated here.

Given the challenges involved in estimating the cost of new debt and the previous observations from NAO and PAC we support the concept of a mechanism that allows more accurate setting of the cost of new debt including true up mechanisms.

From a company specific perspective Portsmouth will not refinance its existing debt until c2030 when the current structure matures. As such the ongoing low interest rates, which will continue to drive down the allowed cost of debt, will result in further downward pressure on Portsmouth's credit rating and ultimately financeability. We have made various points above in relation to this issue.

We have considered re-financing earlier than 2032 but our discussions with financial intermediaries have confirmed the cost of release from our current arrangement is prohibitive and likely to result in an untenable leverage of > 100% of RCV.

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

If one assumes that some form of true up mechanism is required, in administrative terms it is simpler, practically, to apply and end of period adjustment. This also allows some measure of stability of customer bills throughout the AMP.

However, we recognise as other 'in AMP' adjustments (eg WFRIM) are now in operation, it may not add significant administrative burden if an 'in period' annual adjustment was permitted.

We note that from a company perspective, because we have a fixed embedded cost of actual debt the true up mechanism will result in additional forecasting risk for the Company, as we may plan and execute on one basis without full confidence in the ex post 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?

Before addressing this specific question raised in the consultation there remains a broader issue of understanding;

- What approach to inflation is expected to be used for both new and embedded debt? (RPI, CPI, weighted average etc). The comments included on pg 30 of the consultation are very high level.
- How the true up mechanism will work? There is potential for significant complexity here considering the transitional arrangement proposed for RPI/CPI transition and one would expect some degree of symmetry between the two mechanisms

In such a complex and material area it is important that Companies and their Boards have better visibility of the specific proposal here; together with any interaction with the proposed change of indexation of revenue and RCV. From our discussion with Ofwat we understand that this latter point has not yet been modelled.

We would support an approach to true up inflation on all debt (embedded and new). We would be interested to understand Ofwat's view that such an adjustment "may have more significant implications" which could perhaps be illustrated by some example scenarios.

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?

At this stage we would support the proposal that companies should develop their own company specific risk mechanisms.

We note that for Portsmouth it will be highly unlikely that there is any out performance upside available (based upon the current proposals). In this situation, where there can only be customer downside exposure, we do not believe that it would be possible or appropriate to implement a gain/pain share. It would not appear consistent with the principle to "promote fairness and reflect the best interests of customers" if the company could only expect a downside scenario, with the risk allocated to the customer.

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 note that the menu based methodology, which is currently used in Australia, is an interesting approach. In the first instance we feel it is important to understand what possible issue this approach would be used to address in the UK regulatory environment? As the regulatory environment in Australia is very different to the UK with different incentive mechanisms (eg largely state owned, no TOTEX model, no ODI style rewards and penalties) it may not, intrinsically, be well designed to fit within the very different UK environment.

Putting the above observation to one side, we see the primary challenge being in relation to how one can "objectively and consistently" define the different classifications within this mechanism. There could be a risk that arbitrary assessment is used with a lack of clarity for companies and the regulator unless a clear and transparent definition could be applied.

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We recognise the significant of this particular issue for Portsmouth Water and would like the opportunity to discuss this response with you, including our advisors.  If you would like to discuss any of our points in the meantime please do not hesitate to contact me.

Kind regards

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**Enclosure**
Appendix NERA “Response to Ofwat’s Cost of Debt Consultation for PR19”