Cost of Debt

18th October 2016

This paper sets out South East Water's views in response to the Water 2020: Consultation on the approach to the cost to debt for PR19.

1 INTRODUCTION

This document provides South East Water's response to the Water 2020: consultation on the approach to the cost of debt for PR19.

2 GENERAL COMMENTS ON THE CONSULTATION

We welcome this consultation paper on the approach to the cost of debt at PR19 and the fact that Ofwat has decided to engage on this important aspect of the price review at a relatively early stage in the PR19 process.

As a general comment we would encourage Ofwat to consider this decision within a framework of regulatory objectives and principles. When deciding on a methodology for determining the allowed cost of capital for water companies, it is important to maintain consistency with overall principles of good regulatory practice. We believe that an appropriate framework of objectives would be the following:

- Provides good incentive properties for companies to make efficient financing decisions and aim to out-perform their allowance which ultimately benefits customers;
- Results in an appropriate allocation of risks – where risks are allocated to the party best able to manage the risk;
- For risks that are outside of the control of the company, the approach strikes the right balance between risk and reward and does not unduly advantage or disadvantage customers and companies due to factors outside of their control; and
- Transparent and clear to understand, minimising uncertainty.

Overall, the proposed methodology on the cost of debt indexation performs well in some the above principles (such as good incentives) but faces challenges in others. In particular, we feel that the wholly notional debt allowance on embedded debt results in sharing of interest rate risk that is unbalanced. It excessively rewards those who benefitted from refinancing with shorter dated debt when market rates were low and excessively penalises companies who happened to have raised debt during periods of high market interest rates (even when raised efficiently). We consider that there are options to address this issue without compromising the other objectives.

This issue, if not addressed, could lead to a very one-sided benefit to companies without the ability for customers to share those benefits. It could also lead to financial instability for some companies which could have a knock on effect for the sector's borrowing costs which would be detrimental to customers. Moody's have highlighted this issue in their recent rating action on Yorkshire and Southern Water.

The issue of the cost of equity menu raises some interesting questions which merit further consideration. However, we do not consider that the form of menu proposed by the ESC in Australia is appropriate in the England & Wales context.

3 ANSWERS TO SPECIFIC CONSULTATION QUESTIONS

Below are responses to the 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?

We agree in principle that the cost of debt allowance should be set on the basis of a notional capital structure and notional cost of debt as this incentivises companies to be innovative in developing the most efficient capital structure, which delivers a lower overall cost of debt for the industry which in turn benefits customers. However, we do not consider a purely notional cost of debt allowance on the embedded debt to be appropriate for the water sector in practice.

The financial crisis resulted in an unforeseeable long term drop in debt financing costs such that companies with shorter dated debt quickly refinanced their debt at the new lower rates and companies with longer dated maturities continue to pay interest costs on a large proportion of their debt at high interest rates. Therefore the purely notional cost of debt methodology penalised companies that made a rational historic decision to secure longer dated debt before the financial crisis in order to provide a stable financing platform for the company – a strategy which delivers stability and therefore benefits customers in the long term. The purely notional cost of debt methodology rewards companies that made a decision to secure shorter dated debt before the financial crisis and therefore there is a one-sided benefit to those companies without the ability for customers to share in those benefits. Customers of those companies pay more for their water than they would if actual embedded cost of debt was taken into account.

The totex sharing mechanism uses the principle of rewarding customers and companies for outperformance. A sharing mechanism could be considered for the cost of embedded debt. Such an approach would preserve the incentives on the company to develop an efficient financing structure while providing a more equitable sharing of the 'pain' and 'gain' associated with movements in market interest rates between customers and shareholders. This would mean that companies continue to be incentivised to seek ways to outperform the cost of debt.

This pain/gain share approach to the rate of embedded debt could still be combined with a notional capital structure, to maintain an approach that is reasonably simple and transparent. The advantage of this proposal is that it would recognise that differences in embedded debt costs between companies reflect differences in the timing of issuance and maturity dates rather than the efficiency or inefficiency of the debt issuance.
The proposed system of industry embedded debt incentivises smaller companies to mirror the larger companies rather than trying to find the most efficient source/timing/maturity for

funding. When companies try to mirror a benchmark, innovation is stifled and customers suffer.

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

Yes we agree with this approach. We consider that Ofwat should ensure that the proposed arrangement works both for traditional capital structure as well as securitised structure, as a significant proportion of the water sector already has securitised structure and customers have been benefiting from it.

The securitised structure adds diversity of financing structure to the water sector. The added diversity gives greater robustness to the financing sources for the water sector which benefits customers.

Securitised companies have restrictive covenants that are designed to protect the interests of debt providers by ensuring the long term financial strength of the company but these covenants in turn protect customers who also benefit from the financial stability a securitised structure delivers. For example at the earliest stage of financial stress, the companies are prevented from paying any dividends to their shareholders which means all profits are retained in the business until the company is once again in a position of financial strength. These companies are also required by their debt providers to pay for stand-by bank facilities to ensure that there are funds available to pay for any unexpected shock to the business.

The analysis in the consultation referred to the benefits of securitised arrangements in terms of efficient financing costs, management incentives and tax benefits. It is important therefore that Ofwat's approach to the cost of debt going forward recognises that these structures are a legitimate component of the financing of the sector. This should not mean special treatment for securitised structures and we agree with the proposed approach to not introduce a special benefit sharing arrangement. At the same time we consider that the chosen approach should be fit for purpose for both securitised and more traditional financing routes.

We would also note that there are different drivers behind decisions around financing and these are not all easily captured within a securitised or corporate financing distinction. For example, for smaller companies access to certain debt markets (e.g. the index linked bond market) was only possible through a structured finance route involving debt covenants. Therefore, the financing decision was often prompted by the aim of securing index linked debt on reasonable terms rather than deciding for a securitised model in itself.

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

Yes we agree with the introduction of indexation for the allowance for the cost of new debt.

Implications for smaller companies

We note that this will introduce a higher level of volatility for smaller companies, such as South East Water, in terms of the ability to match the performance of the index, compared to larger companies. South East Water may have four outstanding corporate bonds at any point in time compared to well over ten for the larger WaSCs. This greatly restricts its ability to match any debt index as debt is raised infrequently and so will only match the debt index at a specific point in time.

This financing risk, if not treated in the allowance on the cost of debt, will stay with the shareholders and results in a higher cost of equity. We consider that Ofwat should ensure that this risk created by the indexation methodology is taken into account and compensated for appropriately in one form or another.

Profiling of debt issuance

Any methodology should take into account that new debt will not all be raised on the first day of the new regulatory period. A notional company will raise debt evenly over the period such that any variation between the ex-ante and ex-post cost of debt will have a greater impact on interest for debt raised at the beginning of the period than debt raised at the end of the period.

Consideration of the index

An allowance should be made for additional costs not included in the index such as transaction costs including upfront fees, revolving credit facilities and new issue premium.

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

Yes we agree that an indexation of the new debt allowance should have an end of period adjustment.

It is important the precise methodology for the end of period adjustment is set out with the PR19 methodology so customers and companies fully understand the implications during the price determination process.

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?

We agree with adjusting the inflation estimates to reflect out-turn inflation for new debt, but only if the adjustment made truly serves the purpose of mitigating the risk of inflation forecast error.

We also agree with the view of Ofwat that it would not be appropriate to make an adjustment for out-turn inflation on embedded debt at PR19 as debt already raised has been raised on the basis that a fixed real cost of debt was being funded and debt structures for companies have been created on that basis and can only be changed over a long period of time.

However, we consider it important for Ofwat to be mindful of any potential unintended consequences caused by its proposed inflation adjustment mechanism. For example if the proposed adjustment is based on the difference between out-turn inflation and ex ante inflation assumptions, this may have ramifications on companies' choice over:

- Index-linked debt versus fixed nominal debt – the above example of true up mechanism would render index-linked debt redundant for the current regulatory period; and
- The tenor of new debt – the longer the tenor of the new debt, the longer it would stay as embedded debt in subsequent regulatory periods where it loses the true-up protection against inflation risk, which would suggest that debt with longer tenor would require more index-linked protection.

This inter-play between the two is not straightforward and may cause uncertainty and create arbitrary winners and losers owing to the type and the tenor of new debt companies choose to issue.

Q6. Do you agree that we should leave companies to develop their own 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 companies should be left to develop their own company specific risk mechanisms on a voluntary basis for the 2019 price review.

We agree that pain-gain sharing arrangements in relation to financing can be complex due to the differences between actual and notional capital structures. This means they may lack transparency. Increased complexity discourages investors from the water sector, thereby increasing the cost of financing which is not in the interests of customers.

There are specific instances where companies could benefit or suffer from the difference between funded cost of debt and the actual cost of debt for reasons that arise from unanticipated movements in the market and unanticipated regulatory responses to those movements. These differences can only be resolved through specific arrangements for the particular circumstances.

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?

By way of preamble, we would like to comment on the principle covered in the consultation document that the allocation of risk around out and underperformance against the cost of debt allowance may change the risk faced by equity holders. We want to stress that even with a well-designed cost of debt indexation methodology, it would be unlikely that all market risk and forecast error can be eliminated equally for all water companies such that a material reduction of cost of equity can be achieved across the sector. As explained in our response to Q3, smaller companies such as WOCs would benefit from a lower degree of risk reduction than larger companies, due to their lack of ability to perfectly match the index. For SEW, the equity holders would continue to take material risk on out and underperformance against the cost of debt allowance.

We note that the self-assessment process set out by the ESC is mainly aimed at improving the quality of the business plans. As the business plans in PR14 were generally regarded as high quality, adopting an approach similar to the ESC at PR19 would, in our view, be trying to fix a problem that does not exist. Furthermore, a menu with companies trying to anticipate the regulator’s scoring mechanism is complex and could lead to unintended consequences, for example with the company investing effort in trying to second-guess the regulatory assessment.

The entities regulated by the ESC are government owned and so have different considerations in setting the cost of equity. The application of a menu based approach by the ESC also reflects the different risk profiles of the Victorian (Australia) water companies given the diverse demand and operating cost characteristics. In addition, the ESC has no other mechanisms to influence outcomes whereas in the UK Water sector incentives such as totex menu choice, SIM and ODIs have already been developed to incentive good quality business plans, strong customer service and other operational outperformance. Any change in the calculation of the cost of equity should be considered carefully in relation to the suite of incentive schemes already in place.

However, we believe that the principle of allowing different levels of cost of equity according to quality of business plan is sound. Recognising some business plans are more innovative than others would benefit customers in the long-term. By not recognising the level of risk inherent in a business plan, there is an implicit incentive for companies to incorporate as little innovation in the business plan as possible, which is not always in the best interests of customers where innovation can deliver benefits to the company and the water sector.

There are two specific factors that may call for the allowance of different levels of return on equity:

- First, good quality and well written business plans versus poor ones; and
- Second, plans that adopt higher level of innovation in search for efficiency gains and better services versus those taking lower risks.

In the first case, there is merit in awarding companies with good quality plans by a higher allowed return to incentivise better business plans from the industry. The higher return on equity would be the mechanism for providing the well-rated companies with a financial reward for a good quality plan.

In the second case, it is appropriate to award a higher return on equity to compensate companies for the additional innovations built into the business plans.

We consider that it would be important for Ofwat to be absolutely clear on the distinctions between these two factors when designing the different levels of allowed returns and when setting the overall methodology for PR19. These two drivers for differential returns are capturing different aspects of the business plan and it is preferable that they can be treated separately.

Any methodology for an ex-ante setting of the uplift to the cost of equity needs to be robust so that it is clear that the method applied is not arbitrary. This relates both to identifying which companies are selected and also the size of the uplift the selected companies receive. A lack of transparency or unnecessary levels of complexity in the methodology would be a disincentive to investors in the sector and may more than off-set the benefits of recognising the level of innovation inherent in a business plan.

In order to determine the best way forward on this proposal we believe a workshop to understand the pros and cons of different structures should be set up prior to any formal proposals being set out for consultation.