South Staffs Water
Green Lane, Walsall WS2 7PD
www.south-staffs-water.co.uk

Cost of debt consultation
Water 2020
Ofwat
21 Bloomsbury Street
London WC1B 3HF

By email: water2020@ofwat.gsi.gov.uk

17th October 2016

Dear Ofwat,

South Staffs Water welcomes the opportunity to respond to Ofwat's consultation on cost of debt for PR19.

Responses to the questions raised within this consultation are provided below:

Yours sincerely,

Philip Saynor,
Director of Finance and Regulation

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?
Similar to PR14, we suggest that Ofwat takes an evidenced based approach on setting a notional cost of debt. Particularly, we would request Ofwat to revisit the difference in cost of debt between WaSCs and WoCs, which is also suggested in the CEPA report.

At PR14, PwC analysed that small WoCs incur debt financing costs of around 25 bps above WaSCs and large WoCs. In addition, the CMA concluded that Bristol Water should have a small company premium uplift of 0.4% for the cost of embedded debt, evidenced by the differential between WaSC debt (issued at a discount to iBoxx) and WoC debt (issued at a small premium to iBoxx).
The CMA did not apply the customer benefits test used by Ofwat, which CMA believed placed too much weight on the impact of a merger. If such customer benefit test is conducted at PR19, we believe it should retain the assessment of SIM, customer services and ODI measures of WoCs.

For the cost of embedded debt, we suggest that Ofwat use a longer period than the 10 year used at PR14 (eg. CEPA suggests the use of 20 year trailing average data).

Furthermore, we would also appreciate clarity on the ratio of new and embedded debt that will be applied at PR19 to calculate the overall cost of debt. We believe less debt will be refinanced for WoCs at PR19, due to the long term embedded debt already issued for those companies, hence reducing the ratio of new debt compared to WaSCs.

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 believe if any specific sharing arrangement is to be proposed for securitised capital structures, an evidenced based cost benefit analysis should be conducted.

Q3: Do you agree to the introduction of indexation for the allowance for the cost of new debt?
We are not in support of option 2, indexation of all debt.

However, we believe an indexation to the allowance for cost of new debt is sensible, although we would not be able to evaluate the cost and benefits until the index is identified.

Q4: Do you agree that indexation of the new debt allowance should have an end of period adjustment?
Consistent with our view on other true-up mechanisms (ODI etc), we believe any adjustment should be an end of period adjustment to minimise bill fluctuations.

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 understand Ofwat's suggestion in principle but would again need to understand details on the methodology. For example, how would this interact with the CPI/RPI

switch proposed in the Water 2020 package, particularly around the presentation of real cost of capital in both RPI and CPI terms? How will the inflation true up be separated for debt linked to RCV inflated by RPI and CPI?

Also, although long term inflation assumption is used in deflating to real cost of debt at the beginning of the AMP, we presume the outturn inflation adjustment would be based on a spot rate. We believe consideration should be given for potential market volatility in choosing the outturn rate.

Furthermore, we believe that new index-linked debt should be excluded from this true-up as it already adjusts to outturn inflation.

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?

We believe that a form of pain/gain sharing mechanism is already being introduced with the indexation of cost of new debt.

For any additional sharing mechanism, we believe the decision should be left to the companies to engage with its stakeholders to determine whether an additional risk sharing mechanism is appropriate and if so in what form, although the concept may be hard to explain to customers.

We believe there is also a danger that an additional sharing mechanism could reduce incentives on companies to reduce debt costs and pass on risks to customers (as pointed out by Ofwat in the consultation).

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 believe in principle that a differential cost of equity could be beneficial, but we believe a good starting point may be revisiting the approach taken at PR14 (which gave companies with enhanced status higher costs of equity). More clarity on the measures of an "enhanced company" shared in advance of business planning, may incentivise companies in a proper direction for PR19, however the process will need to be transparent and objective.

We believe the mechanism used in Victoria, Australia will not directly apply to the water industry in England, where companies already face reward/penalty incentive mechanisms such as totex menu, ODIs etc. Interaction with these other incentive mechanisms should be assessed carefully, in order not to introduce undue risk and hence potentially increase the level of returns that is required.