

Cost of Debt Consultation  
Water 2020  
Ofwat  
21 Bloomsbury Street  
London  
WC1B 3HF

17 October 2016

Dear Sir/Madam,

### **SOUTH WEST WATER'S (SWW) COST OF DEBT CONSULTATION RESPONSE**

We are delighted to have the opportunity to respond to Ofwat's Cost of Debt Consultation.

We are pleased Ofwat is considering the approach to the cost of debt and other aspects of the next price review at this time to give the opportunity to companies to fully engage in these developments.

At the last price review South West Water recognised that financing performance, when driven by movements in the underlying market economics, should be shared with customers. Our unique WaterShare mechanism identifies the movement in financing (based on the established iBoxx rates) compared to the rates allowed within the price controls for new debt. This is then considered alongside other metrics (including specific cost impacts) with any net benefit returning to customers.

In light of this, we support proposals which seek to share net benefits with customers, but we do not believe that a mechanism for financing should be considered in isolation and would strongly seek an approach which reflects the overall performance of the company, mirroring our own WaterShare mechanism. We would welcome discussion and engagement with Ofwat in establishing this framework.

We note, however, that our current WaterShare approach means the net benefit to customers can be delivered 'in-period' rather than at the end of the period as proposed in this consultation. We therefore support an approach which allows companies to develop a pain/gain mechanism supported by their own customers and shareholders.

We support a framework which encourages companies to develop a strong, innovative and balanced business plan and rewards those who deliver this. However, a methodology that links this directly to an allowed cost of equity, is perhaps an iteration too far from one which 'rewards' good plans with specific incentives, (such as early determinations and financial benefits as at PR14).

We set out in an appendix to this letter, additional points on our analysis for the consultation together with our responses to the specific consultation questions. We look forward to discussing our response with you.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Louise Rowe', written in a cursive style.

Louise Rowe

Finance Director

## APPENDIX

**Q1: Do you agree that the cost of debt allowance should be set on the basis of a national 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 that it is for Ofwat to opine on the appropriate capital structure and support the use of a 'notional' structure enabling companies to set their own strategy in response to this.

We therefore, agree that the debt allowance should be based on a notional capital structure, with both an assumption of gearing and the level of embedded / new debt requirement set by Ofwat.

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

SWW does not operate within a securitised structure and following the acquisition and merger of Bournemouth Water the securitisation covenants surrounding the Artesian debt were removed.

It is important that companies are given the flexibility and responsibility to finance and structure their business as they feel fit reflecting the needs of investors and shareholders. The securitised structures already in place are likely to have both advantages and disadvantages compared to more traditional corporate structures, but in order to maintain comparability and avoid additional complexities within the regulatory framework we agree that a specific sharing arrangement is not required and all companies should follow the same mechanisms proposed.

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

SWW has previously highlighted that indexation within the regulatory framework is a risk mitigator for investors and should not be used to deliver under/over performance. We would therefore agree that indexation should be introduced for the cost of new debt to avoid performance being driven through changes in forecast indexation. However, consideration will be required on the basis of indexation used - particularly with the absence of a current CPI linked market for debt instruments.

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

We understand and fully support that the impact of indexation (whether under or over performance) should be reflected in customers bills. SWW has an existing framework which shares the movement of any changes in the market rates on new debt (whether higher or lower) and is calculated on an annual and cumulative basis. Any benefit or underperformance is then combined with other metrics and reviewed by our independent WaterShare panel who decide on how any net benefit is returned to customers.

In light of this, we support proposals which seek to share net benefits with customers, but we do not believe that a mechanism for financing should be considered in isolation and would strongly seek an approach which reflects the overall performance of the company.

Whilst the true-up mechanism proposed moves this benefit sharing to the end of the period we would support this consistent approach across the industry and understand that this approach avoids volatility in customer bills.

**Q5: Do you agree to an adjustment to the inflation estimate to reflect out-turn inflation and so mitigate inflation forecast error for the new debt only?**

Whilst the estimated forecast inflation rates impacts more significantly on new debt, with rates usually well established for embedded debt, any embedded debt which is directly linked to RPI would be impacted by changed inflation rates. In addition, with the change in indexation to CPI/H proposed in the Water 2020 consultation, a true-up for this specific element of embedded debt may also be appropriate.

**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?**

In the last price review South West Water recognised that financing performance, when driven by movements in the underlying market economics, should be shared with customers. Our unique WaterShare mechanism identifies the movement in financing (based on the established iBoxx rates) compared to the rates allowed within the price controls for new debt. This is then considered alongside other metrics (including specific cost impacts) with any net benefit returning to customers.

In light of this we support proposals which seek to share net benefits with customers, but we do not believe that a mechanism for financing should be considered in isolation and would strongly seek an approach which reflects the overall performance of the company mirroring our own WaterShare mechanism.

We note, however, that our current WaterShare approach means the net benefit to customers can be delivered 'in-period' rather than at the end of the period as proposed in this consultation. We therefore support an approach which allows companies to develop a pain/gain mechanism supported by their own customers and shareholders. We would welcome discussion and engagement with Ofwat in establishing this framework.

**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 and PR14??**

During PR14 Ofwat introduced the risk based approach and identified those companies with business plans which were considered 'enhanced'. There was significant incentive for companies to achieve this and deliver plans which balances the needs of customers, stakeholders and investors.

We support a framework which encourages companies to develop a strong, innovative and balanced business plan and rewards those who deliver this. However, a methodology that links this directly to an allowed cost of equity, is perhaps an iteration too far from one which 'rewards' good plans with specific incentives, (such as early determinations and financial benefits as at PR14).