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17 October 2016

Cost of Debt Consultation
Ofwat
21 Bloomsbury Street
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[BY EMAIL ONLY]

Dear Sir

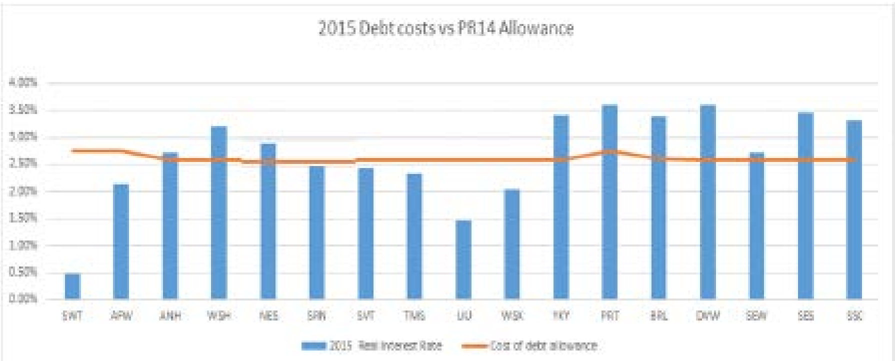
Water 2020: consultation on the approach to the cost of debt for PR19

We welcome your consultation for addressing this critical component of the methodology for PR19 at an early stage and in sufficient detail to enable a meaningful debate on your planned approach. Whilst this response will address the questions specifically posed by your consultation, we consider that these are not the key issues from our perspective. We therefore address what we see as the key issues in this letter and responses to your consultation questions are attached at Appendix 1.

Allowances for Cost of Embedded Debt

Your consultation confirms that the PR19 methodology will continue to reflect the well established principles of setting a weighted average cost of capital based on a notional level of gearing for the sector and assuming a common split of debt between existing (embedded) and new borrowings. The allowance for the cost of embedded debt would be based on a mix of industry sector evidence and historical market benchmarks, whilst new debt would be based on forecasts from market curves.

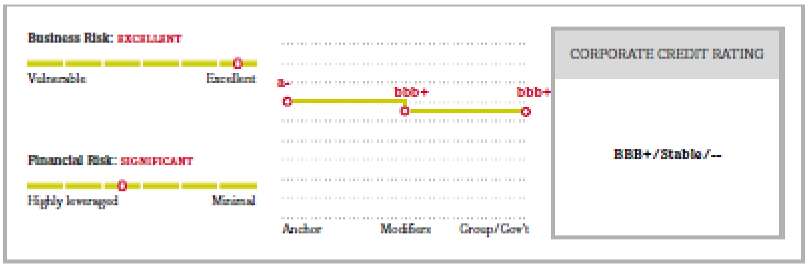
There is nothing intrinsically wrong with this approach – indeed it has been applied effectively through application of appropriate recognition of factors outside companies' control – over many Price Reviews. However, the failure to recognise factors outside companies' control at the last Price Review (PR14) has left smaller companies – principally the water only companies – with funding allowances below the actual rates payable on embedded borrowings that were efficiently incurred at the time that they were taken out. The effect has been highlighted by Ofwat's own comparisons of debt costs in 2015/16 against the PR14 allowances, as shown below.



Whilst debt costs averaged across the industry are not very different from the PR14 allowance, it is evident that only one water only company reported debt costs below the PR14 allowance, with the other six all reporting costs higher than those allowed. This clear recent evidence of systematically higher debt costs for the water only companies reinforces the evidence provided during the last Price Review, which was largely ignored by Ofwat on the basis of new tests introduced into the methodology after Business Plans were submitted.

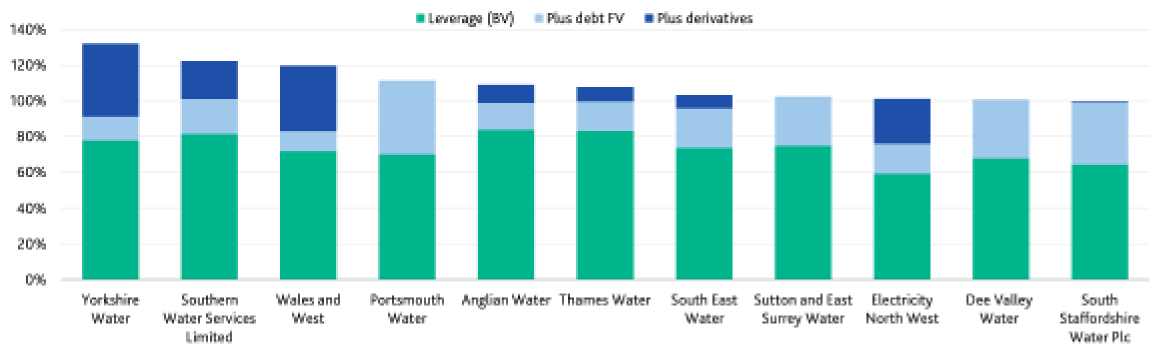
The systematic nature of the higher observed cost of debt for most water only companies is consistent with the view adopted by the credit rating agencies that the smaller companies need stronger financial ratios than the larger companies in the sector to achieve the same degree of financial resilience indicated by an investment grade credit rating. In our own case, for example, Standard and Poor's latest rating report (from January 2016) clearly indicates that the a- "anchor" rate (based on the Company's business and financial risk) is downgraded to bbb+ on the basis of a "modifier" related to the "relatively high exposure to operational risks, due to its size and cash flow coverage ratios".

Sutton and East Surrey Water PLC



This non-diversifiable additional cost of debt has been recognised in Price Reviews up to PR14 and needs to be reinstated at PR19 to avoid companies that have incurred long-term debt in the past – at rates that were efficient at the time the debt was taken out – being inadequately financed based on market rates depressed by the all-time low interest rates currently being observed.

This potential position was highlighted in last week's Moody's report on the impact of the proposed approach to debt indexation in a low interest environment on companies with a substantial proportion of long-dated debt.



Source: Company data, Moody's estimates

Whilst a number of the larger companies are included within the chart drawn up by Moody's, the fact that five of the water only companies are within the companies most exposed in this scenario is in itself telling.

Way Forward on Embedded Debt

Whilst your consultation makes it clear that companies will have an opportunity to make a case for allowances for company-specific circumstances, our experience at PR14 convinces us that Ofwat's criteria for assessing such cases needs to be spelled out at an early stage. Evidence exists of the efficiency of current long-term debt at the time it was taken out and this was presented at PR14. The evidence of the efficiency of our long-term debt primarily pointed to the fact that the rate achieved on our bond issue in 2001 out-performed the market at the time despite our relative size making the process of achieving out-performance more challenging. The period now being proposed for construction of a trailing average for new debt fails to recognise that smaller companies have taken out limited tranches of long-term debt that now fall outside the period captured by the proposed trailing average and will therefore be penalised under proposed allowances for both embedded and new debt.

We know that at least one other water only company with a similar profile of long-term debt has also presented similar evidence on this point. We would be happy to submit further expert evidence on our own position if you consider this will help further understanding.

Our concerns are that at PR19 – despite the evidence of the efficiency of our long-term debt and the compelling evidence presented of customer support for a company-specific allowance – unanticipated tests will be introduced at a late stage in the process and be used to disallow the Company's other evidence. We therefore ask that clear criteria for assessing company-specific cases be published in response to the submissions made on this consultation and included in the PR19 methodology to be published next summer.

We would be pleased to expand or debate any of the points we have made in this response. In the first instance please contact Joanna Campbell, Economic Regulation Manager (JoannaC@waterplc.com, 01737 785 692).

Yours faithfully

John Chadwick
Finance and Regulation Director

Sutton and East Surrey Water

Response to Specific Consultation Questions

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?

The principle that decisions about actual capital structures are best left to individual companies to manage and should not be pre-determined or over-influenced by regulatory allowances is well–established and widely accepted. Providing incentives for companies to out-perform financing allowances – as for other cost allowances – has served customers well and helped keep bills lower than they would otherwise have been.

However, the approach to cost of debt allowances (even on the basis of a notional capital structure) has also normally taken into account factors which are beyond the control of companies to influence. In particular, the additional costs of financing for smaller companies – reflecting the less frequent issuance of debt and the higher interest rate required – is recognised in the CEPA report published alongside your consultation and has been recognised in the allowed cost of capital prior to PR14. This must also be reflected in the methodology for PR19 and subsequently. This would still leave the incentive to out-perform financing allowances during the period and provide benefits to customers in future periods.

In Figure 3 on page 13 of your consultation you show that a number of factors lead to a company's actual debt costs being different from the allowance. One is having a better credit rating than that which is assumed. Evidence of recent credit rating assessments demonstrates that smaller water companies are restricted in the credit ratings they can achieve. Smaller water companies are perceived by the rating agencies to have a higher degree of operational risk due to their size and asset concentration compared to the larger water companies. The actual assessment for Sutton and East Surrey Water by Standard and Poor's in January 2016 is shown in the diagram included in our covering letter.

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

Modifications to industry-wide allowances ought to take into account factors that are genuinely beyond management control. The main such factor is company size, which is clearly non-diversifiable and ought therefore to be recognised.

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

We have a number of concerns with this proposal.

First, it appears to be aimed primarily at reducing the scope for earning higher returns on equity through out-performance of allowances for the cost of debt and has been targeted because of NAO and PAC criticism of Ofwat's approach at previous Price Reviews. As such, it represents a step towards rate of return regulation, which changes the regulatory regime fundamentally and undermines the scope for companies to out-perform allowances – to the ultimate benefit of customers.

Secondly, it creates a new uncertainty about what the allowed cost of new debt will ultimately be, and adds further complexity to a regime that is already difficult for any but the most well-informed investor to understand. At a time when Price Controls are set to become more complex anyway – with the introduction of new controls for water resources and sludge – new layers of complexity and uncertainty should be avoided whenever possible.

Thirdly, it will provide an incentive for companies to minimise risk by seeking to match new debt issuances to the profile of allowances. This will tend to favour short-term debt (based on a five year regulatory cycle) that is at odds with the long-term nature of the underlying assets being invested in and will increase the volatility (and ultimately, long term cost) of debt and hence customers bills.

Finally, indexation with a subsequent 'true-up' will incentivise companies to adopt more homogenous financing arrangements and reduce the incentive for innovative arrangements. It is such innovative arrangements – including securitisations – that have delivered much of the financing benefits customers have enjoyed over multiple Price Control periods. Reducing the scope for such benefits in the future seems contrary to customers' interests.

We consider that the detrimental impacts listed above outweigh the benefits of debt indexation, particularly for a company like ourselves with efficient long-term debt that our customers have benefited from but does make us significantly less able to respond to short-term movements in an index. The focus should be on the long-term efficiency of the debt taken out rather than driving short-term decision making by companies.

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

One of the clear priorities for customers is stable and predictable bills, and much effort was expended by both companies and Ofwat at PR14 in smoothing bills profiles over the next five years. A number of mechanisms already operate which have an impact on actual bill levels within the current Price Control period – including legacy adjustments from PR09, revenue correction mechanisms for PR14 and, for some companies, in-period ODIs. The indications are that the number and impact of in-period ODIs will increase at PR19. Adding a further mandatory in-period adjustment for variations in annual cost of debt indices would potentially add to in-period bill volatility – and ought therefore to be avoided.

If an adjustment to the allowed cost of new debt is therefore to be made – and we do not support such an approach for the reasons already outlined – then an end of period adjustment would be the lesser of two evils.

The alternative would, of course, be to leave it to companies to decide whether to apply a year-on-year adjustment – or defer the adjustment to the end of period – depending upon the effect of other adjustments on bill changes in any one year. This would at least ensure that companies had the flexibility – and responsibility – for managing the impact of regulatory incentives on customers' bills.

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 do not support the introduction of a new mechanism that increases complexity and uncertainty of allowances for investors. Anything that magnifies the potential impact of these factors – including making an adjustment for inflation as well as for changes in the underlying index for new debt – ought to be avoided.

The same consideration needs to be applied to specifying how the adjustment for changes in the underlying index will be calculated. In particular, if you are to pursue indexation, the timing of when the actual market index will be taken and what the adjustment for the sector's historic performance relative to the market index need to be specified as part of the PR19 methodology.

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 this should be a decision for companies in consultation with their customers, informed by a clear statement on the way in which a company specific risk sharing proposal will be taken into account in the Risk Based Review and the benefits available from achieving Enhanced status. We note that the current trend of low interest rates and the time left until our existing debt matures means that the scope for out-performance during the next price control period is very limited.

The alternative approach of requiring a mandated risk sharing mechanism would need to specify the detailed mechanics of the mandated mechanism – including the basis of measurement (notional or actual capital structures) and whether the sharing would be based on the absolute debt cost or the rate. This will tend to undermine Board ownership of Business Plans and encourage a drift back towards a compliance approach to submissions that is contrary to many of the beneficial developments of PR14.

The worst of all possible worlds would be to introduce a mandated risk sharing mechanism at a late stage in the process – as was done with common ODIs at the Draft Determination stage in PR14. The lessons learned from this experience, and in particular in undermining CCG confidence in their ability to influence companies' plans in a meaningful way, must not be forgotten when designing risk sharing mechanisms at PR19.

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?

The Essential Services Commission (ESC) approach is an interesting concept. We are concerned that it is already too late in the process to adequately debate, consult and finalise such an approach. In practice, the time and resource available will be better spent in enhancing and refining the incentive properties of the Risk Based Review mechanism introduced at PR14.

We have the following observations on the approach:

- The outcome that the ESC approach is trying to achieve is no different from what the ODI, menu regulation and resulting totex incentive mechanism and enhanced status approach is trying to achieve. Any level of adoption of the ESC approach should replace existing mechanisms and not simply add to them as any further complexity risks dulling the incentive properties.
- The assessment processes has a number of risks attached for all parties. To provide a true incentive companies will need to be clear of the rules they are being assessed against or all companies will tend towards taking the 'safe' option. Equally, Ofwat may need to ensure that the approach it takes is not at risk of being judged subjective as that could lead to challenges.