Cost of debt consultation
Water 2020
Ofwat
21 Bloomsbury Street
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17 October 2016

Dear Sir/Madam,

Consultation on the approach to the cost of debt for PR19

We are pleased to respond to Ofwat's consultation on the cost of debt. This is a key issue for the sector due to the importance of allowed returns in determining customer bills and in attracting investment to the sector. Although Tideway will not be affected immediately, we will be subject to the approach taken for the industry post-2030, and therefore are keen to engage in the debate.

We note Ofwat's proposals to introduce indexation for the cost of new debt on a notional structure. We understand the historical context over recent price controls which has seen companies benefit within the regulatory period from lower debt costs compared to those assumed in price setting and recent challenges to the legitimacy of Ofwat's approach. However it must be recognised that introducing the proposed new approach may mean that customers would pay more in certain circumstances.

Tideway has an indexation mechanism which shares risk (both upside and downside) between shareholders and customers. Ofwat's proposal for new debt only should be designed to ensure that companies continue to be incentivised to finance themselves efficiently and that there are no or at least limited unintended consequences.

The proposal to true-up inflation in relation to the cost of debt represents a fundamental change in the approach to regulation, which has to date had a real (rather than nominal) basis. Whilst we recognise that there may be a perception that rises in inflation (RPI) above those forecast at the time of price controls have led to unearned value for investors in regulated water companies, the corresponding rise in the nominal cost of capital fully offsets this, and we do not believe that this indicates a failure in the underlying structure of regulation. Moreover we believe that there are a number of practical issues with the proposal to adjust for the difference between actual and forecast inflation which would more than outweigh any potential benefits. In this case, we believe that the proposal does not best reflect the interests of customers.

We recognise the role of this consultation in Ofwat's wider policy agenda and we note the potential interactions between different policy areas. Of particular relevance is the interaction with the switch from RPI to CPI. Such interactions create additional complexity in assessing the implications of changes in regulatory policy, and may make it more difficult to avoid unintended consequences. There may also be a risk that the breadth of change means the industry is less

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able to realise the potential value of the reforms. Ofwat may wish to consider the potential benefits of introducing reforms sequentially rather than in parallel.

We note that Ofwat is not consulting on its approach to the cost of equity at this stage although has asked for stakeholder views as it develops its approach. We welcome Ofwat's openness to discussing these issues and willingness to look at new approaches that support an appropriate balance between risk and reward. There are some areas in the consultation that will need to be considered carefully in terms of how they co-exist with existing mechanisms (such as performance commitments) and more generally would work in practice (e.g. calibration, relative assessments, reflect customer requirements).

As reflected in Ofwat's assessment framework, it is important for regulation to be transparent, and we welcome Ofwat's early consultation with the industry on this matter. While we understand the intent of Ofwat's proposals, it is difficult to assess them fully based on the high-level principles set out in the consultation document. It will be important for Ofwat to provide companies with further detail as it develops its proposals in order for their implications to be assessed fully and to facilitate discussion between Ofwat, companies and other interested parties.

We look forward to engaging with you as the policies and detailed proposals are further developed.

Yours sincerely

Mark Corben

Chief Financial Officer

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?

Tideway agrees with Ofwat's proposal to continue to set the cost of debt allowance on the basis of a notional capital structure. We are supportive of the principle, supported by the notional approach, that companies should determine their own financing structures, which allows the most efficient financing to be put in place to the ultimate benefit of customers.

There are circumstances where using a notional cost of debt may not be appropriate for companies that are materially different due to circumstances outside of their control. This may be the case for small companies with irregular investment patterns and companies delivering large projects. In both these circumstances, it is necessary for the company to raise a significant amount of its borrowing at a certain time which may not be consistent with the assumptions underpinning a notional cost of debt for the sector.

One disadvantage of the notional approach is that it does not recognise any potential lag between issuance of debt and the drawing down of such debt, which may form part of a company's efficient financing structure. It may be beneficial for Ofwat to consider building an assumption on this lag into its notional approach.

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

Tideway agrees with Ofwat's proposal not to introduce a specific benefit-sharing arrangement for companies with securitised capital structures. We agree that financing is a matter for companies to determine and that customers should pay no more than the efficient financing cost. Ofwat's proposals are in line with these principles.

We note that in approaching this issue, Ofwat has identified securitised capital structures for separate consideration. With increasing sophistication of financing structures, it may be more appropriate to measure financing on a sliding scale rather than as a binary state as well as considering the structure and security of the finance. Companies have a range of tools to optimise financing, including the types of terms and conditions set out by Ofwat in its consultation document. As regulatory policy develops further, it may be more helpful for Ofwat to consider financing in this way rather than making a distinction between securitised and non-securitised structures.

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

We note Ofwat's proposals to introduce indexation for the cost of new debt on a notional structure. We understand the historical context over recent price controls which has seen companies benefit within the regulatory period from lower debt costs compared to those assumed in price setting and recent challenges to the legitimacy of Ofwat's approach. We also recognise that introducing the approach may mean that customers would pay more in certain circumstances.

On balance, Tideway is supportive of the introduction of indexation for the allowance for the cost of new debt. Tideway's regulatory framework to 2030 contains a cost of debt indexation mechanism based on new debt, and an industry-wide mechanism would potentially apply to Tideway post-2030.

While in principle we support the introduction of such a mechanism, it will be important for Ofwat to develop its detailed approach carefully to ensure it meets objectives and avoids unintended consequences. An important principle for the design of the mechanism is that it should be representative of new debt costs, including the selection of an appropriate index. It will be important for Ofwat to consider such impacts as it develops its detailed approach.

A further potential disadvantage of indexation, which should be carefully considered as Ofwat develops its approach, is the potential impact on prudent companies pre-funding debt. Using a notional approach to indexing the cost of debt generates additional risk to companies that debt costs will materially change between issuing and drawing down the debt, generating an indexation adjustment that is not representative of actual costs borne by the company, as highlighted in our response to question 1. It will be important for Ofwat to consider and address this mismatch as it develops its policy in this area, for example through the detailed design for the mechanism or the cost of capital allowance.

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

Tideway is broadly supportive of an end of period adjustment as a reasonable way to smooth impacts on customer bills and company returns by netting positive and negative annual adjustments over the period.

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 recognise the perception that rises in inflation (RPI) above those forecast at the time of price controls have led to unearned value for investors in regulated water companies. However we do not believe that there is a related issue with the structure of the underlying regulation. Moreover we believe that there are a number of issues with any proposal to make an adjustment for the difference between actual and forecast inflation in relation to the cost of new debt which would more than outweigh any potential benefits.

The regulation of the UK water sector, and most UK economically regulated industries, is based on a real basis, with revenues, RCV and cost of capital all calculated on a real basis at price controls. Should RPI outturn inflation be higher than expected, customers pay higher nominal prices, but there is no change in real prices. Equally, although companies receive higher revenues and RCV indexation, this is offset by an equivalent increase in the nominal (and importantly, actual) cost of capital.

We believe that this structure, which is fundamental to the economic regulatory framework, is highly desirable, protecting both customers and investors in real terms from outturn inflation.

Moreover the naturally RPI-linked nature of water company debt and equity is highly attractive to certain investors looking to lock in real returns. This in turn translates to a significant reduction in the cost of capital, in particular the cost of equity. Customers directly benefit from this.

In practice, most companies choose to raise a proportion of nominal debt. This is due to the greater depth of investor demand for nominal debt (including the potential to raise non-sterling debt), which can translate into lower pricing. However by doing so companies open an exposure to outturn RPI. In the event RPI is higher than that expected by debt investors at the point of investment (and therefore priced into the nominal cost of debt), shareholders will receive increased returns, and the converse also applies.

However this relationship between market expectations and outturn inflation is a natural consequence of financial markets and corporate finance. It does not point to any failure in economic regulation. Nor does it have any consequences for customers. It would seem an undesirable development to transfer the risk to customers for any potential inefficiencies in financial markets.

We would welcome greater clarity regarding Ofwat's proposals, including some worked examples, to better understand the concern and how this is best addressed. One concern appears to be not the mismatch between debt investors' inflation expectations and outturns, but between Ofwat's assumptions for inflation at price controls and the outturn. However as discussed above, this is of limited relevance for a price control conducted in real terms.

Ofwat does rely on observations of market expectations for inflation (via for example the difference in yield between nominal and real financial assets or the swap market) to help arrive at its assumptions for the real cost of debt and equity. However what is relevant is the market assumption at the point the observation is made, not the outturn level of inflation.

Any proposal to adjust ex-post for outturn inflation will have the adverse consequence of give customers an exposure to real prices that they do not currently have. It would also provide a risk to real returns for companies.

The natural hedging strategy for companies to this proposal would be to raise nominal debt. However there is a natural inconsistency between a real price control, where companies are funded a real return, and a requirement to raise nominal financing to manage risk. The result will be a cash flow shortfall for companies. Companies absorb this already as a "cost" of using nominal financing. However regulation that pushed companies towards higher proportions of nominal debt would greatly increase this cash flow shortfall. This would have significant implications for financeability which would push up the cost of capital and therefore customer bills.

There are also practical issues with the specific approach proposed, where inflation adjustments will differ between new and embedded debt. Companies will be required to increase the level of nominal financing to offset the risk of ex-post adjustments for outturn inflation. However once this "new" debt becomes embedded, it will be treated as real debt with no adjustment for inflation which suggests a better match with IL debt. This is turn will introduce a risk for companies, driving up the cost of capital.

We also note the interaction between this proposal and Ofwat's policy to move from RPI to CPI as a measure of inflation, both of which affect company financing strategies. There is a risk that a simultaneous change in these policy areas may have unintended consequences or reduce companies' ability to respond optimally to reforms in a way that best unlocks value for customers.

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?

No response

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 support Ofwat's consideration of novel and innovative approaches as a potential way to drive value for customers and companies. We recognise the potential for a menu based approach to the cost of equity to contribute to an appropriate risk and reward package and to play a role in incentivising company ambitions.

However, there are also a number of potential disadvantages to the approach which means its implementation would need to be considered carefully. The approach has not yet been used in practice and therefore is untested. Furthermore, the circumstances in which it is proposed to be used have material differences with those facing the UK water sector, including the absence of totex sharing and outcome delivery incentives in the Australian regime.

It will be important for Ofwat to consider how the approach fits with the existing regulatory regime including incentive mechanisms, in order to avoid double counting or perverse incentives. For Tideway, particular consideration would need to be given to the company's unique circumstances.

In practical terms, Ofwat may find it difficult to calibrate the menu correctly in order to fairly remunerate investment in the sector. Notwithstanding any guidance developed by Ofwat, it may be difficult for companies to assess their own business plans relative to other companies' plans. There is also a risk of perverse incentives generated by the menu if it drives companies to build a greater degree of ambition and risk into business plans than is optimal for customers.