United Utilities response to Ofwat consultation:

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

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Introduction

United Utilities welcomes the opportunity to respond to Ofwat's consultation on the approach to the cost of debt for PR19.

Whilst we agree with many aspects of Ofwat's preferred approach set out within the consultation, we also wish to raise attention to the following key issues:

1. **We believe that it would be preferable for Ofwat to adopt a less complex, more simple approach.** In particular we believe Ofwat should reconsider whether the inflation adjustment element of its proposals is desirable. The large number of mechanisms now proposed for the cost of debt – including debt indexation, inflation adjustments, benefit sharing - will tend to make the price control process overly complex and move too far towards a form of "rate of return" regulation;
2. **Any inflation adjustment should use a long term breakeven inflation.** We believe that, rather than adopting the proposed outturn inflation adjustment on the cost of new debt, Ofwat should use a long term "breakeven" inflation approach, retaining the principle that debt costs are remunerated through a real cost of debt plus outturn inflation as opposed to moving to remuneration through a nominal cost of debt. This would be in line with the recommendations from CEPA's report, as commissioned by Ofwat and the CAA. Any inflation measure that is used to convert a nominal yield into a real yield should be of a maturity that matches the nominal yield observed and should be observed at the same time. If this were not done then the impact of this would be to transfer the risk of inflation variances on new debt to customers, when we believe that such a risk is more appropriately managed by companies. Further, as investors value the inflation links within the regulatory regime, de-linking a non-trivial element of the RCV to outturn inflation (by virtue of the proposed inflation adjustment) could result in the water sector being deemed a less attractive investment proposition;
3. **There appear to be unintended consequences for RCV from the outturn inflation adjustment and these should be avoided.** There is a risk that, in making ex post adjustments to the inflation used to arrive at a real terms WACC, the proposed outturn adjustment to indexation could unintentionally impact the calculation of the RCV. Given Ofwat's planned transition to CPI, and its clear commitment to demonstrating that the RCV has been kept whole, we believe it is important to investigate and mitigate this issue in order that Ofwat's commitment to the RCV is not seen to be undermined as a result of this unintended consequence.
4. **Companies should have flexibility to manage indexation adjustments within period.** We would be supportive of an approach which allowed annual in period adjustments and would be pleased to work with Ofwat to try and facilitate such an approach through a licence change.
5. **The benefits of implementing risk sharing mechanisms need to be clear and predictable ahead of submission.** If companies are to voluntarily propose risk sharing mechanisms then the benefits and potential penalties for the company from proposing a mechanism should be clear and predictable, e.g. through the published requirements of Ofwat's risk based review assessment. Additionally, in order for companies to continue to be incentivised to voluntarily share benefits with customers on an ex post basis (as UUW did in AMP6) then past company behaviour should be taken into account when assessing companies' forward looking proposals.
6. **Company "self-assessment" incentives should not be adopted for PR19.** We do not believe that the "company assessment" element of the submission – as used in the approach proposed by the Essential Services Commission – would be suitable for Ofwat's PR19 process, given that it places a

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high value at risk from the company's ability to predict Ofwat's judgement of its business plan with sufficient accuracy. Furthermore, we do not support the use of the cost of equity for this purpose rather than an alternative form of financial incentive (e.g. % of revenues.) This is because it would tend to disadvantage listed companies compared to unlisted companies.

7. **Increasing the focus of incentives on the judged "quality" of business plans necessitates that assessments are more transparent and predictable than was the case at PR14.** If Ofwat is to place more value at risk from the business plan assessment process then the risk based review process would need to be substantially revised and considerably more predictable than at PR14. The increased value at stake would mean that Ofwat would need to take significant steps to ensure that companies were all being assessed on a level playing field. We also believe that any such assessment should be separately appealable to the CMA, recognising the increased significance of the assessment and the need to ensure there is confidence in the approach.

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United Utilities response to Ofwat consultation:

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

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 support the principle 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. We believe this approach best incentivises companies to achieve the most efficient cost of debt.

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 agree that there should not be a specific benefit sharing arrangement for companies with securitised capital structures. This is because whilst a benefit sharing approach may appear to offer some modest upside for customers in the short term, use of such a mechanism would present a longer term risk that customers could be placed in a position of bearing the costs associated with such structures if the associated risks materialise.

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

We agree that indexation should be introduced in relation to the allowance for the cost of new debt only. We recognise the difficulties associated with forecasts in relation to new debt and therefore can appreciate the benefits of introducing indexation in relation to new debt. Given that the main risk is to forecasting the cost of new debt, we would expect that the mechanism should be "reset" at each price control, with indexation only applying to new debt from that date forward.

However, in order to fully assess the proposal we would need further details to understand both a) how the mechanism is expected to work and b) whether the index (plus any adjustments) is likely to be genuinely reflective of water company financing costs.

For instance, it is not currently clear whether the indexation mechanism proposed by Ofwat results in an adjustment to the nominal allowed cost of debt set at the price review only (i.e. maintaining a fixed inflation assumption to calculate the real allowed cost of new debt) or whether the mechanism also includes an adjustment to the inflation measure (i.e. a trailing average of break-even inflation is stripped out from a trailing average nominal yield index to calculate the real allowed cost of new debt, similar to an Ofgem style debt indexation mechanism but for new debt only).

We have inferred from the consultation document that Ofwat's proposed approach is the former (i.e. stripping out a fixed inflation assumption from an indexed nominal cost of debt), albeit subject to the proposals under question 5. We do not support this element of Ofwat's preferred approach in retaining a fixed inflation assumption in conjunction with a debt indexation mechanism, because an inflation measure that is used to convert a nominal yield into a real yield should be of a maturity that matches the nominal yield observed and should be observed at the same time.

As detailed further under our response to question 5, we also do not support an outturn inflation adjustment to a nominal cost of debt. We believe that, irrespective of whether an indexation mechanism is used, it is important to retain the principle that debt costs are remunerated through a real cost of debt plus outturn inflation as opposed to moving to remuneration through a nominal cost of debt (which would

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be the case if outturn inflation were used in the proposed inflation adjustment). As investors value the inflation links within the regulatory regime, de-linking a non-trivial element of the RCV to outturn inflation (by virtue of the proposed inflation adjustment) could result in the water sector being deemed a less attractive investment proposition. It would also appear to amount to a significant change in the way that the RCV operates in relation to inflation adjustments, which is only implicit in Ofwat's proposals and which has not been specifically identified for consultation. Given the importance of the RCV to investors - and the depth of Ofwat's commitment to it - we therefore believe this issue warrants further investigation and mitigation because it is not our understanding that Ofwat expected that such a result would emerge; rather, we expect that this arises as an unintended consequence of other proposals.

Instead we would support indexation of the cost of new debt only, as long as the inflation measure used to calculate the allowed real cost of new debt has a duration and averaging period that matches those used for the benchmark index (i.e. a x year trailing average of (say) 10 year breakeven inflation), which we understand would be in line with the recommendations set out in the CEPA report[1]. Please also cross refer to our comments in response to question 5.

Further we believe that the exact details of any eventual indexation mechanism and the underlying indices and inflation measures used should be subject to further consultation with sufficient time for reflection and response to ensure that any eventual indexation mechanism is genuinely reflective of water company financing costs.

In addition, we have noted Ofwat's comments in the consultation document as to whether water companies have been able to achieve a cost of debt that is persistently and significantly lower than corporate debt benchmarks (with the 10 year trailing average of the iBoxx 10yr+ NFC A/BBB benchmark specifically used as an example). Whilst we have not sought to verify the accuracy of any of the numbers presented - and therefore do not currently have a view as to whether this is the case or not - we do note that one of the implications of the June 2016 EU referendum vote is that following Brexit water companies are likely to lose access to EIB funding. This is likely have an adverse impact on the future cost of debt of the water industry and accordingly on the relationship to benchmark indices. In a recent report published by Moody's[2], Moody's appear to estimate that UK water sector EIB funding was around c70-c120bps lower than alternative funding and represented c.13% of existing debt.

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

We believe that it is beneficial to customers that companies who are able to embrace a licence change should have some flexibility to choose when to take indexation adjustments. This would give companies the scope to smooth bill impacts to customers across periods and avoid volatility in customer bills. Such approaches would be in line with customer preferences as stated in a number of research studies that have been published in the sector[3].

We would be supportive of an approach which allowed annual in period adjustments and would be pleased to work with Ofwat to try and facilitate such an approach through a licence change. This is on the

[1] "Alternative approaches to setting the cost of debt for PR19 and H7". August 2016. Cambridge Economic Policy Associates Ltd.
[2] "2017 outlook – UK water sector: Stable outlook but macroeconomic and regulatory pressures rising". October 2016 Moody's Investors Service Ltd.
[3] A summary is included in section 3.2.1 – "Evidence on consumers' preference for bill stability and predictability" in "Water 2020: Regulatory framework for wholesale markets and the 2019 price review – Appendix 1: Securing legitimacy of future price controls – further evidence and analysis" – Ofwat, May 2016.

basis that in period adjustments would be better aligned to when the associated costs or benefits are actually incurred by the water company and will therefore result in more stable financial ratios (impacting financeability and lowering risk).

In order for this approach to work, the yearly adjustments must be mechanistic, as envisaged. In this case - and in contrast to some other “true up” adjustments - no deferral would be needed in order for any calculation to be agreed.

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 this element of Ofwat’s proposals. In this consultation Ofwat has set out a number of mechanisms aimed at managing risk around the cost of debt. However, the sheer quantity of mechanisms proposed (debt indexation, inflation adjustments, benefit sharing) will tend to make the price control process unnecessarily complex, and move too far towards a form of “rate of return” regulation.

It is also not clear from the consultation document how Ofwat’s intended adjustment would work; we have interpreted the words “out-turn inflation” to mean a short term “spot” inflation measure such as the year average RPI or CPI/CPIH, as distinct from an updated forecast for a longer term inflation measure (matching the duration of the benchmark index), such as breakeven inflation derived from gilts or swaps. However, to the extent we understand it, we tend to disagree with Ofwat’s proposed approach of adjusting the inflation estimate to reflect outturn inflation because we believe that, irrespective of whether an indexation mechanism is used, it is important to retain the principle that debt costs are remunerated through a real cost of debt plus outturn inflation as opposed to moving to remuneration through a nominal cost of debt. Further any inflation measure that is used to convert a nominal yield into a real yield should be of a maturity that matches the nominal yield observed and should be observed at the same time. As investors value the inflation links within the regulatory regime, de-linking a non-trivial element of the RCV to outturn inflation (by virtue of the proposed inflation adjustment) could result in the water sector being deemed a less attractive investment proposition.

There is also a risk in making ex post adjustments to the inflation used to arrive at a real terms WACC, that the proposed outturn adjustment to indexation could unintentionally impact the integrity of the RCV as perceived by investors. At present, the price control allows for index linked revenues based on real returns on an index linked asset (the RCV). The proposed inflation adjustment would significantly change this approach as it effectively fixes nominal returns on the same index linked asset. Aside from this significantly deviating from the index linked basis of returns that many investors have committed to, it also creates uncertainty as to whether the underlying value of the RCV (based on expected returns) has been affected.

Given the importance of the RCV to investors and the strength of Ofwat’s commitment to it, we believe that these impacts were unintended and are not desirable; a significant change in the way that the RCV operates in relation to inflation adjustments has not been clearly flagged or consulted upon and would appear to be at odds with keeping the RCV whole. Therefore we believe this issue warrants further investigation and mitigation in order to avoid this unintended consequence from Ofwat’s proposals.

We agree with Ofwat’s comments in the consultation document that companies can efficiently manage the risk of inflation variances by the use of index linked debt and that transferring this risk to customers could adversely impact companies’ incentives to issue index linked debt. As such we fully support one element

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of Ofwat's preferred approach being that in relation to embedded debt inflation forecasts set at the price review should not be updated to reflect outturn inflation.

In relation to new debt only, our interpretation of the adjustment proposed by Ofwat would be that in order to achieve a real indexed cost of debt for new debt that a nominal yield for a long term financial instrument would be established (following the proposed debt indexation approach) and then short term outturn inflation (say financial year average) would be "stripped out". This would result in a real yield that essentially mimicked nominal debt as opposed to index linked debt. This contrasts with previous regulatory precedent where debt costs have historically been remunerated through a real cost of debt plus outturn inflation and also contrasts with our understanding of Ofgem's debt indexation approach and that recommended in the CEPA report where in order to achieve a real indexed cost of debt for new debt that a nominal yield for a long term financial instrument is established (based on the iBoxx index) and then forecast inflation derived from similar maturity financial instruments would be "stripped out". This results in a real yield that essentially mimics index linked debt.

We strongly believe that any inflation measure that is used to convert a nominal yield into a real yield should be of a maturity that matches the nominal yield observed and should be observed at the same time. If not this would transfer the risk of inflation variances on new debt to customers, which we believe is better managed by companies, and would impact water companies' incentives to issue index linked debt. Also by applying different approaches to the way inflation is stripped out to calculate the real cost of debt for embedded and new debt this would result in embedded debt being remunerated on a real cost of debt plus outturn inflation basis with new debt being remunerated on a nominal cost of debt basis. This effectively incentivises companies to raise new debt in nominal form (to match the risk profile of the allowed returns), yet at the subsequent price review this same debt would be treated as embedded debt and then remunerated on a real cost of debt plus outturn inflation basis, at which point it would have been more appropriate for the water company to have raised that debt in index linked form (to match the risk profile of the allowed returns).

We recognise that it may be difficult to construct an appropriate means of stripping out term matched inflation within a debt indexation mechanism that works well with CPI transition due to the absence of a liquid gilt or swap market from which such inflation estimates are usually derived. However, we do not think this is sufficient justification to adopt the proposed adjustment to reflect short term outturn inflation on new debt. We note that in its report[1] CEPA has recommended an approach whereby an adjustment is made to RPI breakeven inflation for the RPI/CPI wedge.

We would be supportive of an adjustment to the long term inflation estimate set at the price review on new debt only where an updated long term inflation measure (i.e. long term break even inflation) is used, similar to the methodology used by Ofgem in its debt indexation and that CEPA recommend in its report. However, we would not support an adjustment to the inflation estimate on new debt only that replaces a long term inflation forecast with a term mismatched short term inflation measure (which is how we have interpreted Ofwat's proposed approach).

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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?

Whilst we recognise the merits of a voluntary approach, the incentive properties of such an approach may be problematic. In particular, the benefits or potential penalties to the company from proposing a risk sharing mechanism should be clear and predictable, e.g. through the published requirements of Ofwat's risk based review assessment. Otherwise, it seems difficult to envisage companies being receptive (let alone ambitious) in proposing a risk sharing mechanism, particularly if there is a risk that a company would have been materially better off had it not done so.

If companies are to participate in proposing risk sharing mechanisms then it should not be the case that a company could conceivably be better off if it does not offer such a mechanism at all, and hence seeks to retain, in full, the benefits of any outperformance, to the (relative) detriment of a company that does offer such a mechanism. Whilst it is unclear what benefits companies will gain from proposing a specific risk sharing mechanism (e.g. it could be a necessary condition of "enhanced" status) it seems likely that the more companies are able to articulate those benefits to investors, the better placed they will be to develop substantial and meaningful arrangements as an acceptable and well supported component of PR19 plans. Therefore we believe there are considerable benefits that could be achieved if Ofwat were to clarify the value to companies of offering such a mechanism.

As well as seeking for companies to volunteer a risk sharing mechanism on a forward looking basis, Ofwat should also take account of historic company behaviour in assessing future business plans. In particular, whilst we have not previously proposed a formal *ex ante* company specific risk mechanism in relation to financing outperformance, we have shared outperformance benefits with customers based on an *ex post* assessment of the affordability of doing so. If these decisions are not taken into account then the incentive for any additional sharing of benefits – above and beyond those set out in business plans and the regulatory framework – is weak. As a result, companies may see less value in sharing such benefits on an *ex post* basis and they would therefore be less likely to materialise for customers.

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?

Whilst we fully support increased transparency over the relative rewards of different quality assessments of PR19 business plans, we do not believe that the "company assessment" element, as proposed by the Essential Services Commission (ESC), is suitable for Ofwat's PR19 process. Such an approach would place a high value at risk from the company's ability to predict Ofwat's judgement of its business plan with some accuracy. This element of the ESC mechanism also seems unnecessary given that companies are already able to use ODIs to incentivise greater "ambition" in their performance – a mechanism which is not, as far as we are aware, utilised by the ESC and which is much more closely aligned to tangible customer objectives and desired outcomes.

The ESC regulates Government owned or sponsored regulated entities, not private companies or publicly listed companies who are competing for global capital. The use of the cost of equity as the value being adjusted would significantly affect market sentiment to the detriment of listed companies, providing a relative advantage to highly leveraged companies which are overwhelmingly financed by debt. Therefore it

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would seem more equitable to use an alternative financial value (such as % of revenues) rather than the cost of equity assumed in the WACC.

We also note that it is unclear how symmetric or asymmetric any such process proposed by Ofwat would be. For example, it is unclear where the baseline cost of equity would fall within the matrix. If it falls towards the top left (i.e. at the point where both company and Ofwat agree that the company's business plan is "leading" or "ambitious") then the approach would be asymmetric, and would tend (systematically) to reduce expected returns to companies. This risk would tend to put upward pressure on the WACC, which would need to be recognised. This point was raised in the Gray review, which noted that under CAPM the Cost of Equity would need to adjust to reflect the inherent risks associated with an asymmetric incentive/penalty regime.

We are concerned that the approach set out risks a situation arising where a lot of value is put at risk from the company's second guessing the nuances within Ofwat's risk based review process. Should Ofwat seek to place greater value at risk from the risk based review, it should recognise two key shortcomings from the PR14 process that would need to be resolved for such an approach to be legitimate:

- Lack of clarity and predictability in the risk based review process; and
- Level playing field in the business plan assessment process

We discuss each of these further below.

Lack of clarity and predictability in the risk based review process

Ofwat stated that it did not wish to fully publish its risk based review criterion for company PR14 plans, and at the time we agreed that it may have stifled innovation in the preparation of business plans. Whilst we supported that principle, if there is to be greater value at risk from the business plan assessment process at PR19 then the assessment process must be far better defined and predictable. This would include publication of all assessment tools – not merely totex models – well in advance of business plan submission and predictable, objective, consistent and transparent application of the risk based review process. This is particularly true if that process also requires an element of self-assessment by companies. It would not be legitimate to, in effect, levy substantial financial penalties onto companies as a result of an unclear or unpredictable process which left gaps in companies' understanding of the approach.

It was clear in a number of instances at PR14 that assessment criteria changed following receipt of company business plans, and also that some assessments were subsequently proven to be flawed. One example of this is the RCV adjustment for the Capex Incentive Scheme (CIS) mechanism where Ofwat later recognised faults in its model, despite "failing" companies - including UUW - as part of the risk based review that brought that fault to Ofwat's attention to these issues at the time of submitting its business plan.

Level playing field in the business plan assessment process

The various assessment categories, and their inherent financial impacts, should be equally available to all companies, not only to those that are favoured by an arguably simplistic approach to the assessment process.

At PR14 Ofwat took a deliberately schematic approach to many of the key assessment processes, particularly cost assessment with totex models for wholesale costs and domestic retail costs assessment (based on Average Cost to Serve), which largely assumed that company costs varied with scale. The risk

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based review then targeted additional assessment requirements on companies which deviated from those relatively crude cost models. This naturally meant that company specific circumstances which were not controlled for in the cost assessment models led to some companies having apparently favourable assessments (which led to more positive assessment outcomes in the risk based review) and some companies with unfavourable assessments (leading to more negative assessments in the risk based review). It cannot be acceptable that companies are unable to access the higher levels of business plan assessment simply due to shortcomings (no matter how well justified) in Ofwat's suite of cost assessment tools.

Challenge and appeal of business plan assessments

In the event that Ofwat decided to proceed with its outlined approach, it should also be the case that once Ofwat has published its assessment of company plans that the assessment should be subject to challenge by companies. This will ensure that assessments, and the resulting financial impacts, are being reasonably applied and not resulting from either misunderstandings in interpretation of company plans, or due to ambiguous or previously unpublished risk based review assessment criteria. This is especially the case if the value at risk due to the assessment is large.

Ultimately, the outcome of the risk based review should be capable of being separately referable to CMA if the company has reason to dispute Ofwat's view of the company's plan relative to its own assessments. These steps would recognise the increased significance of the assessment and the need to ensure there is confidence in the approach

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