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To: Water2020 <Water2020@ofwat.gsi.gov.uk>
Subject: Cost of Debt consultation - Welsh Water response

Cost of Debt Consultation
October 2016

To Whom It May Concern

Please find below Welsh Water's responses to the questions set out in Ofwat's recent consultation on the approach to the cost of debt for PR19.

We will continue to work to finance our debt as efficiently as possible, because this is central to keeping down long-term level of bills to our customers. Therefore, we would urge Ofwat to take the needs of investors for clarity and certainty into account as it prepares the framework for the regulation of the industry at PR19.

Yours sincerely,

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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?

Yes, we agree. It is a fundamental basis of incentive based regulation.

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

Yes, we agree.

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

We are not opposed to the introduction of an indexation approach for the cost of new debt, as long as the index is set appropriately.

However, we believe that the principles underlying the approach adopted previously, with the cost of new debt based on a forecast for the forthcoming period, is based on sound principles, and a strong case has not been made for changing it at this time.

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

There is an argument for an in-period adjustment to the cost of new debt, as this would give comfort to investors, and would be taken into account by credit rating agencies, in the case that Ofwat sets the allowance 'too low' in the first instance. This would apply also for the inflation adjustment for new debt. At the same time, however, we do have a concern about the complexity of managing multiple adjustments to revenue allowances, when viewed alongside other potential adjustments under discussion, such as in-period ODI adjustments. Such adjustments are hard for customers and the media to understand easily.

On balance we would prefer an end-of-period adjustment.

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?

If there is to be an adjustment for out-turn cost of debt, it makes sense for this to take account of out-turn inflation also. However, this measure could make it more risky for companies to take out fixed (rather than floating or index linked debt).

Q6: Do you agree that we should leave companies to develop their own company specific risk sharing mechanisms on a voluntary basis for the 2019 price review and we should not mandate a company specific risk sharing mechanism?

Yes, we agree. Because of our non-shareholder model, Welsh Water is in a unique situation in the industry in that all financial outperformance is shared with customers (it is not "shared" with anyone). If Ofwat does have any expectations of us with regard to a specific risk-sharing mechanism for the cost of debt, these should be made clear to us in advance.

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 principle of a allowing a risk-based return on capital is well understood. We do not see that the level of 'ambition' of a company's plan is the same thing as risk in the case of the water industry. In any case, it seems unlikely that the underlying level of risk is likely to vary greatly across the industry, and if it did, it could be argued that it is more appropriate to vary the whole WACC to account for this, not just the cost of equity.

As a means of rewarding high quality plans, we do not think that the menu-based approach to the cost of equity would work well. Our primary concern would be around the criteria that would define the level of 'ambition'. This is highly subjective and we would prefer to maintain the current focus on aligning business plans with customer preferences.

The Risk-Based Review approach adopted at PR14, in which incentives for companies to develop high quality plans were driven by reputational, procedural and financial benefits, worked reasonably well.