Wessex Water
Claverton Down Bath BA2 7WW Telephone 01225 526000
www.wessexwater.co.uk

David Black
Senior Director
Ofwat
City Centre Tower
7 Hill Street
Birmingham B5 4UA

Direct line: 01225 526351
Email:
phil.wickens@wessexwater.co.uk

13 October 2016

Dear David

Consultation on the Approach to the Cost of Debt

Thank you for the opportunity to respond on your proposals and for the opportunity to contribute to the useful event that you held on this subject.

The Wessex Water Board does not support your proposals for indexation of debt cost at PR19.

While it is possible to make a logical case for indexation, and we understand how you have got to the current position, it represents a further shift towards rate-of-return regulation which is not in the long-term interests of customers. The sector requires strong and active equity participation if we are to meet the challenges faced; this proposal does not promote that outcome.

Even if rate-of-return regulation was a desirable outcome the complexity of multiple risk sharing mechanisms in the sector means we are in danger of creating an inefficient version of it.

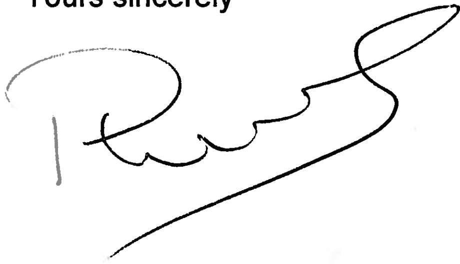
Your potential proposals around differential costs of equity for more ambitious plans in our view warrant further discussion. The industry needs greater incentives to innovate within the areas that remain regulated monopolies, but to date the rewards for doing so have remained unclear. Under this approach company Boards would need in advance some level of certainty of the high level criteria by which plan ambition is to be judged. We also think it would be helpful if the assessment of plan ambition is separated from the fast-tracking process. We would be happy to work with you to develop a proposal in this area over the coming months.

contd/...

a YTL company

I hope you find this helpful. We have responded to your individual questions on the attached appendix.

Yours sincerely



Phil Wickens
Director of Regulation and Reform

Appendix

Wessex Water: Response to the Approach to the Cost of Debt Consultation

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 – basing any assessment of a specific company on their actual cost of debt could reward poor past performance & penalise companies that have financed themselves in the most efficient way.

Related to this however it is not appropriate for company Boards to be required to assure that their submitted plans are financeable on a notionally geared basis. This requirement at PR14 was distracting and not in line with the principle of Board ownership of plans.

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, see response above.

Q3: Do you agree to the introduction of indexation for the allowances of the cost of new debt?
No – we consider that companies are the best placed to manage the risks associated with financing costs.

A fixed cost of debt approach has significant advantages. Companies are incentivised to minimise their financing costs, which is then passed onto customers when calculating the industry cost of embedded debt at future price reviews. It also provides greater customer protection against rising costs in the debt market.

The introduction of additional true-up mechanisms increase the complexity of the regulatory regime leaving investors less clear what risks they are bearing which may increase the overall cost of investment in the sector. As the number of risk sharing mechanisms increase the interactions between them cause unnecessary complexity, and the additive effects of them result in a shift in regulatory approach to a rate of return model.

If this is the overall policy outcome desired; which we disagree with as it removes the pressure to innovate and increase efficiency and is therefore not in customers' long-term interests; this could be achieved in a much more simple and transparent way.

Q4: Do you agree that indexation of the new debt allowance should have an end of period adjustment?
We do not agree with adjustments being made to indexation of debt allowances as outlined above; however an end of period adjustment would be preferable, as it will result in lower volatility of customer bills compared to annual adjustments.

It may however be sensible to allow companies the discretion to reflect changes in the index early without financial penalty and with an end of period true-up to ensure customers are protected.

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?

The details of your proposal for indexation are not clear. We are unsure if your proposals are to adjust for actual inflation or for long term measures of inflation implied by bond yields, nor whether the measure of inflation will be CPI(H) or RPI or a combination of both.

Companies suffer additional financing costs through an AMP period in nominal terms - with the nominal rates reflecting updates to the market's view of long term inflation. If you are to "true-up" the real cost of debt allowance, you should take the revised long-term view of inflation into account when assessing the outturn real cost of debt and comparing it with the determination allowance. Using outturn inflation (spot rates) would also create unnecessary and inappropriate volatility.

The lack of clarity of the treatment of indexation is symptomatic of the additional regulatory complexity, and reduction in transparency that introducing this type of indexation will entail. It therefore reinforces our view that you should not index the costs of new debt at PR19.

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 that we should not mandate an industry wide mechanism?

Yes, we agree that Ofwat should not mandate an industry wide mechanism.

Q7: What are the potential advantages and disadvantages of a menu based approach to the cost of equity, compared to the approach adopted by Ofwat at PR14?

We think that the potential approach that you have laid out has merit and is worthy of further consideration and agree with the principles that different plans require different equity returns - although we think the menu approach is unnecessarily complex.

It is unlikely that company Boards will wish to be seen as submitting plans that are "standard or basic", and the incentives are therefore skewed - it suggests also that company Boards would have knowledge of other company proposals in advance which would not be appropriate. Instead companies who wish to claim additional equity return should be expected to provide evidence on the ambition contained within their plan.

We consider that this approach would be an opportunity to give due allowance to companies whose plan proposes or predicts innovative solutions, or where companies are creating market based approaches and disrupting the traditional delivery methods - all of which implies greater equity risk.

Our view is that if we are to progress this approach company Boards would need to understand at least at a high level the criteria by which companies would be judged to achieve different categories. Relatedly the Board would need to be clear what yardstick ambition is to be assessed against - current company performance, industry historic performance, or future industry commitments. Overall, Company Boards will need to have sufficient certainty of Ofwat's intentions if they are to support a plan that takes additional risk.

It would be helpful if this assessment is disentangled from the enhanced/fast tracking process at PR19. A company could produce a high quality, efficient but ultimately unambitious plan that should be rewarded with the reputational and procedural benefits that fast tracking gives but should not necessarily receive additional equity returns. On the other

hand one might expect that Ofwat may want to scrutinise an “ambitious” plan further before it confirms an additional equity return, checking that the plan is financeable and that the balance of risks proposed are in line with its financing duty.