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By email only

17 October 2016

Dear Sir or Madam,

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

We welcome the opportunity to provide feedback on the cost of debt consultation and have reviewed the proposed guidance and considered the questions that you have posed.

We agree with the majority of the key themes of your proposal in relation to the cost of debt in principle, except for the adjustment to reflect outturn inflation.

We consider that risk should sit with those best placed to manage it and forecasting movements in interest rates is not something that water companies are best placed to manage; therefore we agree with your proposal that the forecast risk on new debt should no longer sit with us.

The choice of the index for this mechanism will be critical, as it will be important that the opportunity for companies to outperform the index remains, so that new debt outperformance can be passed back to the customers within future embedded debt rates.

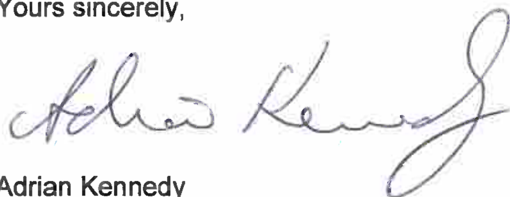
Whilst we agree with the consultation in principle, we also recognise that it provides only minimal detail on how these principles will actually be put into practice and our agreement above is subject to further clarification and detail on the following core areas:

- cost of new debt calculation methodology and index to be tracked,
- adjustment mechanism for cost of new debt,
- cost of equity proposal, to include further clarity on the proposed methodology, banding levels and interaction with other existing reward mechanisms,

We would welcome further information and constructive dialogue on these matters ahead of the proposed PR19 methodology consultation in July 2017.

We trust you find this feedback useful and look forward to working with you further.

Yours sincerely,



Adrian Kennedy

Director of Regulation

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Appendix 1 – YW response to 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?

- We agree that the cost of debt allowance should be set on the basis of a notional capital structure and notional cost of debt, as companies should bear the risk for the specific funding structures that they have chosen.
- Our agreement is subject to the retention of arrangements for company specific adjustments to debt allowances.

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 with this approach, as customers already directly benefit from reduced tax allowances as a result of the higher gearing within securitised structures. Securitised structures also incur more cost and we do not feel it would be appropriate for the customer to share any of this cost.

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

- We agree with the principle of introducing indexation for the allowance for the cost of new debt, subject to further clarity on the methodology and indices to be utilised.
- We consider that risk should sit with those best placed to manage it and forecasting movements in interest rates is not something that water companies are best placed to manage. By removing this risk premium from the company, the customer should benefit from a lower cost of debt.
- We would welcome further information setting out the proposed methodology ahead of the proposed PR19 methodology consultation in July 2017.

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

- We agree with the principle that indexation of the new debt allowance should have an end of period adjustment, to ensure stability of customer's bills throughout the period.
- Our agreement is subject to further clarity on the methodology for applying the adjustment.
- If an end of period adjustment is to be utilised, consideration should be given to including an element of forecast within the rate set at the FD to minimise the adjustment required.
- We would prefer to have the choice as to whether to make the adjustment through RCV or revenue.

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 don't agree with the principle of an adjustment to the inflation estimate to reflect out-turn inflation for new debt.
- In contrast to the forecast risk associated with forecasting interest rates, we consider that companies are best placed to manage inflation forecast risk, as this can be achieved through their treasury policy.

- When the new debt converts to embedded debt in the following price review, there will no longer be an inflation adjustment, resulting in the risk switching back from the customer to the company, which will introduce added complexity to treasury policy.

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?

- We agree that companies should be left to develop their own company specific risk mechanisms, so that we have the flexibility to agree with our customer forum the optimal solutions for our customers to benefit.

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 agree with the principle of seeking to reward companies for building more ambition and risk into their Business Plans, to improve the outcome for customers; however we are unsure at this early stage whether applying a menu based approach to the cost of equity would be the best way to achieve this, as this is more akin to a return on equity, rather than a cost of equity.
- The current proposal mixes the reward for submitting an high quality Business Plan, with a reward for the risk taken on by the company. Our view is that these are two distinct areas and the rewards would ideally be separated.
- The ESC regime lacks the other incentive mechanisms currently used by Ofwat, which we consider to be effective. This proposed mechanism would add significant complexity and uncertainty; therefore any additional reward may be best placed within the existing incentive mechanisms and risk based review.
- A specific consultation, providing further clarity on the proposed methodology and banding levels, ahead of the proposed PR19 methodology consultation in July 2017 would be beneficial.
- If a menu based approach is to be adopted, further clarity on the levels of return and the different grades should be provided as early as possible to provide sufficient time for companies to assess the options available and discuss them with their customers.
- We would expect to be involved in any decision making process that could result in the cost of equity being calculated in a different way from the current regulatory precedent of using the CAPM model.

Potential advantages of a menu based approach

- Incentivises companies to set more challenging Business Plans, improving outcomes for customers
- Stimulates innovation
- Rewards ambitious companies
- Allows greater flexibility and judgement in setting the cost of equity, versus the current CAPM model utilised, particularly in the current low interest rate environment

Potential disadvantages of a menu based approach

- Increases complexity and uncertainty within the regulatory process
- May conversely increase conservatism due to uncertainty around the self-assessment process
- Potentially incentivises companies to take on too much risk
- May distort the company's risk profile from that of its customers
- Attaching too much return to increasing risk could attract the wrong investors to the market
- Potential overlap with other incentives, it would need to be ensured that all the incentives were clearly linked
- Rewards planning, rather than actual delivery. On this basis we're unsure that the cost of equity is the best mechanism for applying this reward
- Insufficient incremental return between the banding levels, may discourage companies from setting more ambitious plans
- Menu approach should not penalise companies that remain as "standard"