



PR24 Methodology  
consultation response

Appendix 2 – A response to  
Q7.5 (allowed return on debt)

7 September 2022



## Q7.5. Do you agree with our proposed approach to setting the allowed return on debt?

- 1.1 We agree with keeping the overall approach consistent with the CMA water redeterminations and PR19 Final Determination. There are, however, a select few areas which we encourage Ofwat to reconsider for the Final Methodology, noting also the CMA's position.
- 1.2 **Cost of embedded debt:** whilst we are supportive of using the industry's actual balance sheet as the primary means for setting the embedded cost of debt, we advise caution around the deflation of the implied nominal interest rate from the industry's balance sheet, assuming the APR will be the primary source of data. We also have concerns with the exclusion of 'Class B' debt and interest rate swaps. We consider both of these to be highly relevant and their inclusion as necessary if the logical integrity of the regulation in this area is to be maintained.
- 1.3 **Setting the allowed cost in real terms:** based on the FY21 and FY22 industry data shares, it is apparent that the average nominal interest rate has been less volatile than outturn CPIH, resulting in a real interest rate that is materially different between the two years. We infer this to be largely driven by a high proportion of fixed nominal debt in companies' actual capital structures. An implication is that a point estimate for the real allowed cost of embedded debt can potentially under- or over-estimate the industry's actual cost and therefore could create issues for financial resilience and financeability (if the allowance is set too low) or affordability (if the allowance is set too high). We ask Ofwat to set the allowed cost in a way which most appropriately reflects the underlying cost of embedded debt; this may need to consider a period of averaging of historical data and/or a normalised inflation forecast, as examples.
- 1.4 **Class B debt:** although we understand Ofwat's concerns around the inclusion of highly subordinated, risky 'junior' debt, we do not consider typical Class B debt, including that of Thames Water's, to fall under this category. Aside from ranking, Class B debt is similar to 'Class A' debt in the WBS structure insofar as it is senior secured debt and supports the credit quality of the 'Class A' debt component. A particularly relevant consideration is the level and quality of the security from which the lenders benefit: that Class B is typically securitised at the operating company (albeit ranking behind Class A lenders), and is subject to regulatory ringfence arrangements. This is a clear and important differentiator from more junior forms of debt, such as 'MidCo' or 'HoldCo' debt issued outside of the operating company, which are typically only secured against the residual cashflows from, or shares in, the 'OpCo'. Class B debt should be taken into account as part of the operating company debt mix. We note that Ofwat did not propose to exclude observations of a company's debt even if its senior or Class A tranche was above the notional level of gearing.
- 1.5 Credit ratings are also an important factor.– Class B debt is primarily targeted at lenders who buy investment grade assets, as it maximises the pool of available capital to improve pricing and reduce refinancing risk. Drawing upon ratings methodologies from S&P and Moody's, despite their differences, a common thread is that the rating of Class B is closely correlated to either the rating of Class A (S&P) or the Corporate Family Rating (Moody's).



- 1.6 We also consider the inclusion of Class B to be essential for the logical integrity of this area of the regulation. Take the following theoretical example: there are two identical companies which are both geared at 70% OpCo. Company 1 has 5% Class B gearing (i.e. 65% Class A gearing) whilst Company 2 has one tranche of senior secured debt. Assume the weighted average cost of debt for Company 1 (based on cheaper Class A and more expensive Class B) is equal to Company 2, i.e. structuring does not generate any cost of debt benefit. Ofwat's proposal would result in different observations of the embedded cost of debt for two economically identical companies at an appointee level. It draws into question which one is the 'correct' pricing for these two economically identical companies under the proposed methodology – arguably to include only Class A would under-price the embedded cost of debt, but if the overall OpCo debt is considered there is no difference or ambiguity. We also note that Ofwat has not proposed to exclude Class B (or similar) issuances when assessing the cost of new debt allowance.
- 1.7 **Interest rate swaps:** we have identified a number of issues from excluding these. We agree with Ofwat that interest rate swaps have a useful risk management role as part of companies' treasury strategy and would go further to state that they have an essential role in giving companies flexibility to achieve particular risk- or shareholder value-based objectives in today's money markets.
- 1.8 Because hedging impacts cashflows available for debt service as well as for equity, it should be these post-hedging economics that are most relevant for observing the industry balance sheet. To use another hypothetical example: two identical companies have actual capital structures which are equal to the notional capital structure, albeit Company 1 achieves this through index-linked bonds and loans whereas Company 2 achieves this through fixed rate debt hedged with index-linked swaps (i.e. it has no index-linked bonds or loans). In periods where inflation fluctuates significantly, Ofwat's proposed approach would capture the inflation impact on cost of embedded debt for Company 1 but not for Company 2. As with the above example, it draws into question which one is the 'correct' pricing as both companies are economically identical and should have the same creditworthiness and embedded debt cost. It would not be unreasonable to assume the notional company is either Company 1 or 2 or a mix of both. In a period of rapidly rising inflation, the proposed approach would likely set too low the cost of embedded debt at a price review (and vice-versa in a period of low inflation or deflation), and thereby impact financeability.
- 1.9 We also query Ofwat's notion that swaps are not debt. This may be conceptually true, as is the notion that swaps are to hedge risks and not to finance expenditure, but in practice entering into swaps can be an integral part of financing expenditure so that, for example, the post-issuance level of hedging remains within approved hedging exposure limits. To draw a strict distinction between hedging and debt financing risks potentially risks creating artificial incentives for companies to distort their treasury practices with respect to swap instruments, which might not be efficient or conducive to financial resilience.
- 1.10 Taking a strict view on swaps not being a part of overall cost of debt also creates ambiguity around swap accretion accumulated over time. Economically this is the same as accretion of the face value on an index-linked bond, which is the same as indebtedness itself. If interest rate swaps are to be excluded, would this not logically require the exclusion of in-year swap accretion charges and inclusion of its cumulative balance in companies' net debt? If so, (i) this would be highly complex and (ii) it undermines the



logical integrity of the regulation for the reasons set out in the above example and (iii) the benefit to customers is unclear.

1.11 **Cost and share of new debt:** we would like to seek clarity from Ofwat on the following:

- The analysis and data which underpins Figure A1.5 and Ofwat’s observation that a diversified issuance strategy in terms of tenor would result in outperformance against an allowance based on a 20-year tenor. We are particularly interested in whether this is a coincidental outcome based on the characteristics of the curve at that point in time which might reduce or invert at some point, or a systematic outcome;
- How it intends to control for different credit ratings – for example, would the sector ‘average’ be weighted by the relative size of each issuance;
- Would the forecast maturity of embedded debt be based on average years-to-maturity or total instruments falling due in-period;
- What would the rate of new RCV formation be based on for the notional company, both at the early view and for the draft and final determinations.

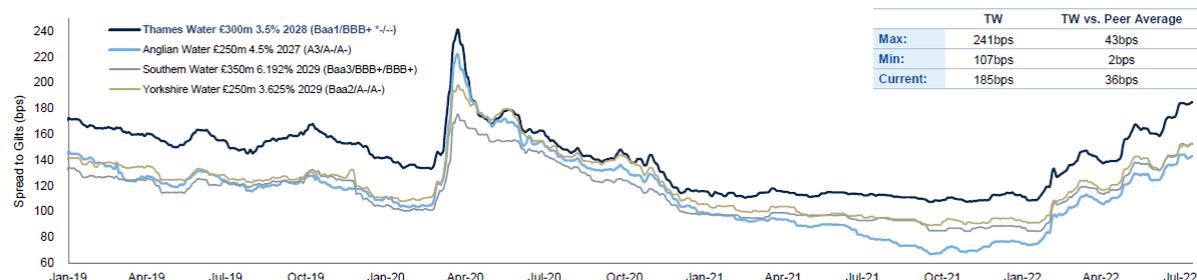
1.12 **Cost of debt:** we note that Ofwat have not directly challenged our case for a large company debt issuance premium as inefficient or unreasonably incurred, but simply observed that this is “rare”. Ofwat (and the CMA) have recognised that company size is a relevant factor assessing a company-specific adjustment to the allowed cost of debt. From the consultation, Ofwat appear to consider a diverse debt issuance strategy to be at least reasonable and even necessary to mitigate the impact of higher costs of debt.

1.13 In practice, diversifying the sources of debt capital is a part of prudent treasury management, particularly as the debt portfolio, and the associated annual volume of required debt issuances, increases. This becomes more important – and evident in practice – when the issuance demands are such that Sterling-based investor limits are approached. In economic terms. This is not to say that companies in this position cannot access Sterling capital further, but that often the price demanded by the marginal investor in the Sterling market starts to increase for a large issuer and may reach a point where the Sterling market no longer represents best value when compared to non-Sterling sources. Table 1 shows that for same or similarly rated debt, Thames Water’s Sterling debt is priced wider than our peers’.

Figure 1: UK Water Secondary Trading Analysis – GBP

UK Water Secondary Trading Analysis – GBP

Class A Peers — Historical Spread Comparison

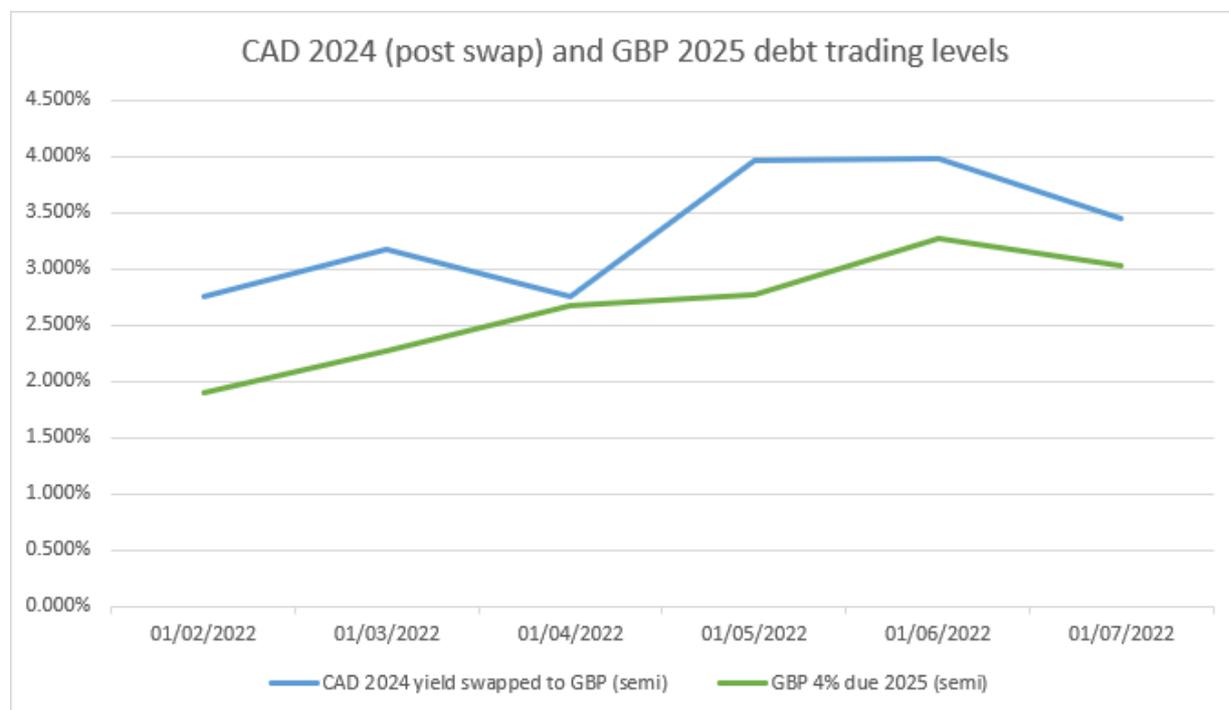


Source: Thames Water



1.14 Furthermore, in recent years’ experience, the marginal price of our debt raised in non-Sterling markets is generally higher than the marginal price in Sterling, although this spread does change from time to time. Figure below provides an example of recent trading data for our Canadian dollar-denominated bond (post-cross currency swap but exclusive of swap charges) versus a comparable Sterling-denominated bond.

Figure 2: CAD vs GBP Bond Secondary Trading Analysis – GBP Equivalent



Source: Thames Water

1.15 We consider the following to be drivers of higher pricing:

- Non-Sterling investors being less familiar with TW and UK water credit, being more risk averse and pricing this higher
- Other costs, such as credit margin costs on cross currency swaps, and additional legal fees

1.16 Whilst the situation above might not impact most companies, and arguably should not be priced into the notional company allowance for all companies, it is conceptually similar to the higher marginal costs incurred by small companies. We therefore consider it to be relevant for a company-specific assessment and welcome further engagement on this issue.

1.17 **CPIH transition costs:** whilst Ofwat’s comments are noted, the reality is companies will likely still have a significant portion of their debt as RPI-linked by the beginning of AMP8. As such, it would be not unreasonable to assume the notional company to be in a similar position – and have close to 33% RPI-linked debt – unless the CPI- or CPIH-linked debt or derivatives market can significantly increase in activity over the remaining years of AMP7.

1.18 We would expect as a matter of policy for the notional company to transition to CPIH-linked hedging. This clearly cannot happen overnight and would be limited by market



capacity and cost factors for this to be executed even in the short term. We note that there are differing opinions as to whether basis risk is material; in this context, the Oxera report (i) may need to be refreshed for the last six years of data to make it more relevant and robust for Final Determination purposes and (ii) suggests the enterprise value might be more stable, which leaves open the possibility that the equity value becomes more volatile, and it is the cost of equity that is in question.

- 1.19 One approach, therefore, is to assume that the notional company transitions its RPI-linked debt portfolio to a CPI- or CPIH-linked portfolio using market-based instruments, over a realistic timeframe and at a market-level cost. With an appropriate level of financial markets engagement, this will help to provide leadership to the industry that there is a plausible and efficient route for the transition. If companies choose not to follow these arrangements (and there may be entirely legitimate reasons), this would be at their risk.

