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17 October 2016

**Cost of debt consultation – response**

Dear Sir or Madam,

We are generally supportive of Ofwat's approach to indexation of the cost of debt. In particular, of the three high level options described, we agree that Option 3 is the most appropriate.

Q1: We agree that the cost of debt allowance should be set on the basis of notional capital structure.

Q2: We agree that securitised companies should not be treated any differently.

Q3: We agree to the introduction of indexation for the cost of new debt component of WACC.

Q4: We agree that indexation should use an end-period adjustment. We believe this is preferable both in terms of managing financeability and also minimising annual volatility of customer bills.

Q5: We do not believe an adjustment for outturn inflation is necessary. The linkage of revenue and RCV to inflation is desirable.

Q6: We agree that additional pain/gain sharing mechanisms should not be mandated. We note that any sharing would in any case need to be strictly symmetrical given that financing costs are largely driven by macroeconomic factors and only in part by an efficient treasury function.

Q7: With respect to variation in the cost of equity, we do not see the Victorian regime as desirable. We note that model lacks the other incentive mechanisms that Ofwat uses, such as totex, ODIs and SIM, which create variation in returns based on performance. We believe that the self-assessment component may also incentivise companies towards conservatism, since a company may put forward an ambitious plan and yet be awarded a lower cost of equity if the regulator does not concur, making the company doubly worse off.

In addition to the specific questions in the consultation, we believe the following points are also important:

- The indexation methodology should be specified in PR19 and the adjustment process should be purely mechanical, with no retrospective judgement to be applied by the regulator, e.g. it should be analagous to the old revenue correction mechanism. We believe this will help companies predict and manage their future revenues and also enhance legitimacy in the process.

- Companies should be able to choose whether to absorb the adjustment through RCV or revenue, taking into account the impact on financeability as well as present and future customer bills.

- An allowance for transaction costs should be included in the cost of debt. We suggest the allowance be outside the indexation mechanism as this will not be captured in market-observed bond yields.

- In relation to the embedded cost of debt, we believe a longer lookback period would be appropriate to match the long asset lives. For example the run-off rate for Yorkshire Water is over 30 years.

We look forward to continuing collaboration with Ofwat on Water 2020 to ensure that there is no impact on existing investment and the sector remains attractive to capital providers in the future, such that the net benefits to customers can be maximised.

Yours faithfully,

**Holly Koeppel**

Corsair Capital LLC

**Andrew Dench**

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Deutsche Alternative Asset Management (Global) Limited in its capacity as Manager for the RREEF Pan-European Infrastructure Fund, L.P.

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