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

Overview

We welcome the consultation on the approach to the cost of debt. In preparing this response, we have consulted with economic consultants, a bank and our shareholders, CKI, who have experience of debt indexation in other sectors and countries.

We support the continued use of a notional capital structure and we propose that this could be explicitly set at the industry average level of gearing. We also agree that there is no need for a specific benefit sharing arrangement for companies with securitised capital structures.

In principle, we support the proposal for the indexation of the cost of new debt and we believe that there will need to be a further consultation on the construction of such an index. We can see advantages of an in-period adjustment, but we feel this is an area where customer views should be considered.

We have some concerns over the proposed adjustment to the inflation estimate. We do have some concern that the adjustment could reverse the current balance of risk for different types of debt.

We agree that it should be up to companies to consider their risk sharing mechanisms rather than Ofwat imposing them.

Finally, we express some concerns over the idea of varying the cost of equity for menu choices. The focus for enhanced returns on equity should be through appropriately targeted and applied incentives for high performing and efficient companies.

A separate consultation on the structure of the debt index

We believe that, should the proposals for indexation for the allowance for the cost of new debt be agreed, there will need to be a separate and detailed consultation over the precise choice of index composition.

Our shareholders, CKI, have experience of the construction of debt indexes in other sectors and countries and we would be happy to share this and other evidence with Ofwat at an opportune time. We have made a few brief observations on this below:

Historical data period: if the historical data period is not in line with the current debt financing structure of the industry and the useful life of the assets, then this may stimulate companies to move to more short-dated financing strategies, which while they may allow some outperformance in the short term, could increase the risk in the long term.

Transaction cost allowance: The overall cost of debt should be considered by the regulator for the regulatory allowance, not just the coupon/yield paid to bond investors or lenders, but also of fees, hedging costs, among others (e.g. Ofgem does not allow for any transaction costs whereas the New Zealand regulator does). Furthermore, given Treasury departments need to maintain a prudent financing strategy, revolving credit facilities (RCFs) and letters of credit need to be in place constantly and bear relevant commitment fees. With a more complex index to track,

such costs become relevant and should be considered. In sum, not only the "face value" cost of debt, but the total cost of raising and maintaining a prudent financing strategy should be considered (NB this applies whether using a fixed cost of debt or a debt index).

Inflation component: As the regulatory WACC is in real terms and the observed indices are in nominal terms, there is a need to deflate the indices and "re-inflate" them again. It is important that this methodology does not cause impact on the final allowance. Ofgem deflates the nominal indices at a breakeven inflation (derived from nominal vs inflation-linked Gilts) and "re-inflates" by realised inflation, which has historically caused discrepancies.

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 with this approach. Ofwat have long held a consistent position of not showing preference for particular capital structures and leaving such decisions to companies. We agree with the reasoning outlined – allowing companies to make their own choice about financing whilst ensuring customers pay no more than the efficient financing cost.

The retention of the incentive to outperform on the cost of debt is very important. It treats the cost of debt in the same way as the incentive to outperform the totex allowance and is consistent with the RPI-X principles underpinning the regulatory system. The benefits to customers of such an approach are well documented and supported by all stakeholders.

Our one recommendation in this area is that Ofwat could confirm that the **notional capital structure will be set at or around the industry average level of gearing**. This would ensure companies had confidence over the transparency and predictability of the notional capital structure.

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 support this approach. We agree that companies with highly geared securitised structures have the same responsibilities to their customers as the other regulated companies. We also agree that Ofwat's notional financial structure approach and financial monitoring framework, alongside the licence requirements for an investment grade credit rating are sufficient to protect customers.

Finally, by default we support Ofwat's continued approach to set tax allowances on the basis of a companies actual level of gearing, so customers benefit from the lower tax costs from highly geared companies.

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

We support this approach in principle, but we believe a significant amount of discussion will have to be carried out to ensure that incentives to minimise the cost of new debt are maintained. The choice of the benchmark for indexation will require particular attention.

We agree that using an index linked cost of debt allowance for all debt would place undue emphasis on the choice of benchmark. It could result in inefficient financing as companies seek to match the benchmark rather than using their expertise and judgement to select lower cost debt that would result in reduced customer bills.

It would also risk generating significant variances (windfalls and penalties) when companies' embedded financing arrangements conflicted with the benchmark calculation. Such variations could result in loss of customer confidence or financial distress.

We recognise that it is very difficult for a regulator to predict the cost of new debt for a 5 year period. We understand the benefits of ensuring financing risks are borne by companies, but we do recognise the challenge to this approach made by the National Audit Office and the Public Accounts Committee. To retain customer confidence, we feel that indexation for new debt has some legitimacy, provided the workings of such an approach can be agreed as reasonable and practical.

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

To inform the debate on this point we think it is helpful to firstly quantify the scale of associated potential impact on customer bills. If we assume that gearing is 62.5% (PR14 notional) and new debt is around 25% of total debt for the period (as per PR14), then a 1% change in the cost of new debt (e.g. from say 4% to 5%) would increase the Cost of Capital (WACC) by 0.16%. For NWL, this would increase customer bills by 0.9%. For a Northumbrian water & sewerage customer, this would be an increase in the average bill of £3.40.

We understand Ofwat's preference for an end of period adjustment to avoid year-on-year bill volatility and we would be interested in the views of customer groups in this area.

We do see merit in in-period adjustments. An in-period adjustment would have the advantages of passing on to customers any gain from outperformance quickly, in line with the NAO proposals. It would also protect companies against temporary financial pressures in the case of unexpected actual debt cost increases or significant reductions in any underlying index. Finally, it would allow the impact of a gradual change in the cost of new debt to be spread for customer bills over several years, rather than an accumulated impact applying to bills in the first year of the next period.

Provided the approach is symmetrical for increases and decreases and NPV neutral, we would be comfortable with either approach.

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 are unclear on exactly how this mechanism might work and we suggest a worked example might help. At the recent Ofwat workshop, there appeared to be uncertainty over whether a spot rate or a longer term inflation rate would be used. The CEPA report recommends 20 year breakeven inflation for the water industry (page 139), although the inflation period should match the index debt tenor for consistency.

We have set out the proposal as we understand it, based on the CEPA recommendations and commented accordingly.

Although the mechanics are complex, if our understanding is correct the intent seems clear; ie Ofwat will ensure that customers pay exactly the benchmark nominal cost of debt. This point is very important and requires clarification and confirmation given the risk transfers that this will bring, which are discussed below.

In order to deliver exactly this amount of remuneration, we assume Ofwat will first provide for a fixed deduction for inflation in the conversion from the nominal index readings to a real allowed cost of debt, then let indexation of price limits and the RCV take its natural course, then finally true-up for any revenue or RCV indexation over and above the inflation rates factored into its original fixed deduction.

A worked example – New debt in 2020/21

Suppose that the 2020/21 allowed real cost of new debt is calculated using the following values:

2020/21 average index bond yield value = 4.0% (nominal)
Fixed PR19 inflation forecast for 2020-25 = 2.5%
The allowed real cost of new debt in this case would be 1.5%.

Now suppose that out-turn breakeven AMP7 inflation is as follows:

Year	2020/21	2021/22	2022/23	2023/24	2024/25
Inflation	2.5%	2.0%	2.0%	2.0%	1.5%

Under a conventional price control, the total remuneration that a company would receive for debt issued in 2020/21 (via a combination of in-year revenues and RCV indexation) would be:

Year	2020/21	2021/22	2022/23	2023/24	2024/25
Inflation	2.5%	2.0%	2.0%	2.0%	1.5%
Real return	1.5%	1.5%	1.5%	1.5%	1.5%
Nominal return	4.0%	3.5%	3.5%	3.5%	3.0%

Under Ofwat's new proposals for PR19, the total nominal remuneration would be a fixed 4.0% in every year, because Ofwat would adjust for the inflation variation from the 2.5% per annum.

In the example given, there would be a true up additional revenue allowance at the end of the period for the accumulated differences between the two.

As we understand it, this proposal reverses the current risk balance between types of debt issued. To date, index linked debt has been a popular financing choice as has matched the indexation of the debt to the regulatory indexation of the RCV. As we understand it, this matching will cease and it will instead be fixed rate nominal debt that exactly matches the mechanism. So,

1. If the company issues fixed nominal debt exactly in line with the index, then, for the full control period (including true up), it will receive this nominal allowance, irrespective of actual inflation.

2. If the company issues floating rate nominal debt, it will receive a flat nominal allowance irrespective of variations in the floating nominal rate over the period.

3. If the company issues index linked debt, with a fixed real rate, it will receive a fixed nominal return that does not vary according to outturn inflation. Thus, it will bear inflation risk.

This reversal of risk profile between types of new debt will need considerable explanation and discussion in our view. There is a risk that, in trying to 'solve' one issue that another one is created.

This is therefore a critical area that should be further covered in the subsequent consultation on implementation of any index.

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 support leaving companies to develop their own risk sharing mechanisms for the 2019 price review. We agree that an area of historic unanticipated company benefit over recent price control periods has been associated with the reduction in the cost of new debt, so these proposals do reduce that underlying risk to customer's confidence.

We note there are already significant benefit sharing incentives in place for both totex efficiency (the 50:50 share) and for service delivery (outcome delivery incentives).

As Ofwat note, further risk sharing mechanisms may weaken company incentives to manage financing risks themselves.

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 role of incentives

Northumbrian Water supports the use of incentives that reward excellent performance in service delivery and in efficiency. We believe that companies that can demonstrate sustainable performance in these areas should be rewarded through increased returns on equity.

A menu based approach would not necessarily result in the most efficient and highest performing companies earning higher returns. It is not clear how the proposed criteria such as risk and ambition would be measured although these would appear to involve significant subjectivity. It is also not clear how these criteria would relate to customer benefit.

In our view it is more appropriate to apply rewards for excellent performance as an enhanced return on the required cost of equity. Manipulating the calculation of the cost of capital through the application of a variable cost of equity is a complex and potentially confusing approach which lacks transparency. It could result in companies in the lower categories being penalised rather than the higher scoring companies being rewarded. This could result in some companies not earning the cost of capital and it is not clear how this would be consistent with the financing of functions duty.

Increased returns should only be attainable in areas where customers have expressed their support, for example, in the strategic dashboard, or in broader customer engagement.

Northumbrian has supported the increase in the central totex efficiency incentive rate to 50% and we were the only company to select a materially ambitious menu choice that was lower than the FD baseline or the original Business Plan.

There are opportunities for further use of incentives in our view. Encouraging innovation, sustainability and resilience are three areas where incentives could be better targeted. This could include exploring opportunities for including competitive funding arrangements for exemplar projects which is an approach that has been applied in other regulated sectors.

Concerns over the approach

We have many concerns over the approach outlined in the consultation over the cost of equity. We understand that the ESC proposals have not yet been tested in practice, and are proposed in a regulatory regime that does not have conventional incentives for efficiency or outcome delivery.

1 Requirement for customer support or consultation

We believe an approach that has impacts on customer bills should have customer support before proceeding. The decision over the cost of equity allowance appears at this stage to be a regulatory one on behalf of customers. Customers must be directly involved in this decision as they will be the ones that will be paying for such an equity allowance through their bills.

2 The criteria for assessment of ambition

The criteria for self-assessment and regulatory assessment appears subjective at this stage, in particular the reference to the ambition of the plan. For example, the ESC refers to the transfer of risk from companies to customers. There will be areas where customers may prefer that the risk remains with them rather than being transferred to companies – the proposals to index the cost of new debt are a prime example of this.

The reference to outcomes and services and operations needs clarification – would this be for current demonstrated performance, or the proposals made for future performance? It is relatively easy for a poorly performing company to make ambitious proposals to improve from a low base, it is much harder for a frontier company to propose the same rate of improvements, despite delivering a higher level of performance overall.

Finally, customers who are paying for a high level of ambition in a business plan could quickly lose confidence in the approach if such ambitions are not delivered.

3 It rewards proposals not delivery

In our view, it is much more appropriate to reward actual outperformance ex poste rather than trying to reward an ambitious ex ante prediction. The regulatory regime works best and has the confidence of customers when it can demonstrate rewards and penalties for actual, visible performance, rather than for business plan proposals that propose subjective levels of future ambition.

4 It moves the company focus from delivering to setting out proposals

For an incentive to work effectively, it should be well understood by companies and their investors. The current regime incentivises the delivery of customer outcomes for an efficient level of costs. It is these two powerful and well understood incentives that drive the varying levels of the return on equity, depending on company performance. To complicate this by adding a layer of complexity for the quality of a plan undermines investor confidence in the clarity of the regime and risks focussing the companies on 'doing a good business plan' rather than delivering for their customers.

5 It confuses the calculation of the cost of capital with the opportunity for outperformance

In economic terms, there is a difference between an incentive payment for performance that will increase the return on equity and adjusting the cost of equity used in the cost of capital calculation.

Changing the cost of capital in the way outlined potentially confuses the cost of capital and the opportunity to outperform the cost of capital through outperformance. In our view, this would undermine investor confidence in the regulatory regime, creating uncertainty that an efficient company would be able to finance its functions. We are not convinced that the cost of equity is the appropriate mechanism for making rewards, there are more appropriate mechanisms.