Consultation on the approach to the cost of debt for PR19

Southern Water's Response

October 2016

Southern Water's response to Ofwat's consultation on the approach to new debt for PR19

Overview

Thank you for the opportunity to respond to your consultation on the approach to new debt at PR19. We believe the paper presents a balanced and proportionate consideration of the issues. We broadly support the conclusions, with the following additional observations.

- We would suggest a refinement to the proposed approach to adjusting the cost of debt, building on the approach used for the Thames Tideway. This would reset the allowed cost of new debt should the delta move beyond a pre-defined limit.
- Alongside the introduction of a mechanism for new debt, it is important that Ofwat gives greater attention to the assessment of embedded debt. The significant differences between companies' embedded debt costs reflect prudent treasury management and the timing of debt issuance as much as financing efficiency. We suggest a corridor mechanism for taking this account in a proportionate way.
- We do not support the introduction of a cost of equity menu at PR19. We believe the current incentive regime, including ODIs and the risk-based review, generally work effectively. We would encourage instead the development of a set of objective and transparent criteria for the risk-based review.

We set out responses to the specific consultation questions below.

Responses to consultation questions

Q.1. 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 capital structure used to set the cost of debt should continue to be based on a notional company.

We believe that following the introduction of a cost of debt index in relation to new debt, greater attention will need to be paid to the sector's embedded debt.

Whilst the notional company financial modelling assumes a homogeneous embedded cost of debt this is not the case at an individual company level for many reasons that do not relate to differences in gearing or financing efficiency. Not least of these is the exercise of prudent treasury management and the time at which the debt was raised. To ignore these legitimate differences would risk unfairly penalising efficient companies. It is critical that any new mechanism does not undermine the sound risk management of water companies' treasuries.

To deal with these issues, we would propose a corridor approach whereby companies outside the corridor would be able to submit evidence to support their embedded debt costs, on the understanding they would receive 50% of the difference from customers.

In the absence of a mechanism of this type we believe there is a danger that companies will be retrospectively penalised for historic prudent treasury management. We believe this may encourage companies to take treasury management risk such as refraining from hedging against future market interest rate volatility and relying too much upon short tenor debt. This will weaken the financial resilience of companies and expose customers to greater refinancing and event risk over time.

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. Capital structure is a risk that should sit with companies and shareholders who are best placed to manage it, not customers.

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

We agree that it is sensible to introduce an adjustment mechanism for the cost of new debt. We would support the introduction of a mechanism that resets the allowed cost of new debt in the WACC versus a market index, should the delta move beyond a pre-defined limit (similar to that used for Thames Tideway).

The market index will need to include a provision for the costs of issuing new debt, and we also propose the addition of a separate 'cost of maintaining liquidity allowance' given that the proposed unbundling of the WACC removes the opportunity for companies to balance risk and reward within a single allowance.

It is unlikely that the assumed 25% of new debt will be raised evenly across an AMP. We therefore believe some consideration needs to be given as to how efficiently raised debt will be grandfathered into future allowances. We believe companies need to be focused on risk management and not outperforming an index.

It is worth noting that companies will continue to fund the wedge between the real cost of debt and nominal interest from their revenues. This will be a more significant amount at a lower cost of capital.

In addition, companies receive the year on year movement in RPI on revenues and RCV, whereas the cost of debt index will be deflated using a much longer measure of breakeven inflation. This basis risk might give rise to financeability issues in the short term.

Whilst we appreciate and indeed support the proposed reduction in risk of the cost of new debt we are not certain it would have any impact on the cost of equity. Whilst it might lower the variance of returns, we believe that it will ultimately reduce the scope for outperformance which equity would otherwise retain. We appreciate that this is symmetrical but we do not think this is reflected in equity valuations.

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

Yes, we support an end of period adjustment in order to reduce customer bill volatility and so that the impacts of any true-up on customer bills and financeability can be considered in the round. If the adjustment takes place at the end of the period it is important that the mechanics are clear so that companies can monitor the risk on an ongoing basis.

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?

To benchmark the cost of new debt it will be necessary to deflate a nominal index. We believe that this should be done using a long term measure of breakeven inflation (i.e. the market implied inflation measure that would make the returns of a nominal and index linked gilt the same over the same maturity). This is important to ensure consistency between the market rate used and the inflation adjustment.

We agree the same adjustment should not be made to embedded debt.

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?

Yes. We do not think it would be appropriate for Ofwat to undertake an additional risk-sharing mechanism. Rather, it should be for companies to determine, in the context of their business plans as a whole, whether an additional sharing mechanism is appropriate.

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 do not support the introduction of a new cost of equity menu. The Essential Services Commission introduced this mechanism into a sector that did not have other incentives and was suffering from poor quality business plans.

We believe the existing ODI and enhanced regimes provide adequate rewards and penalties. We would encourage the development of the enhanced regime to ensure that the criteria for success are as objective and transparent as possible.