SEVERN TRENT

W2020: Consultation on the approach to the cost of debt

Severn Trent response

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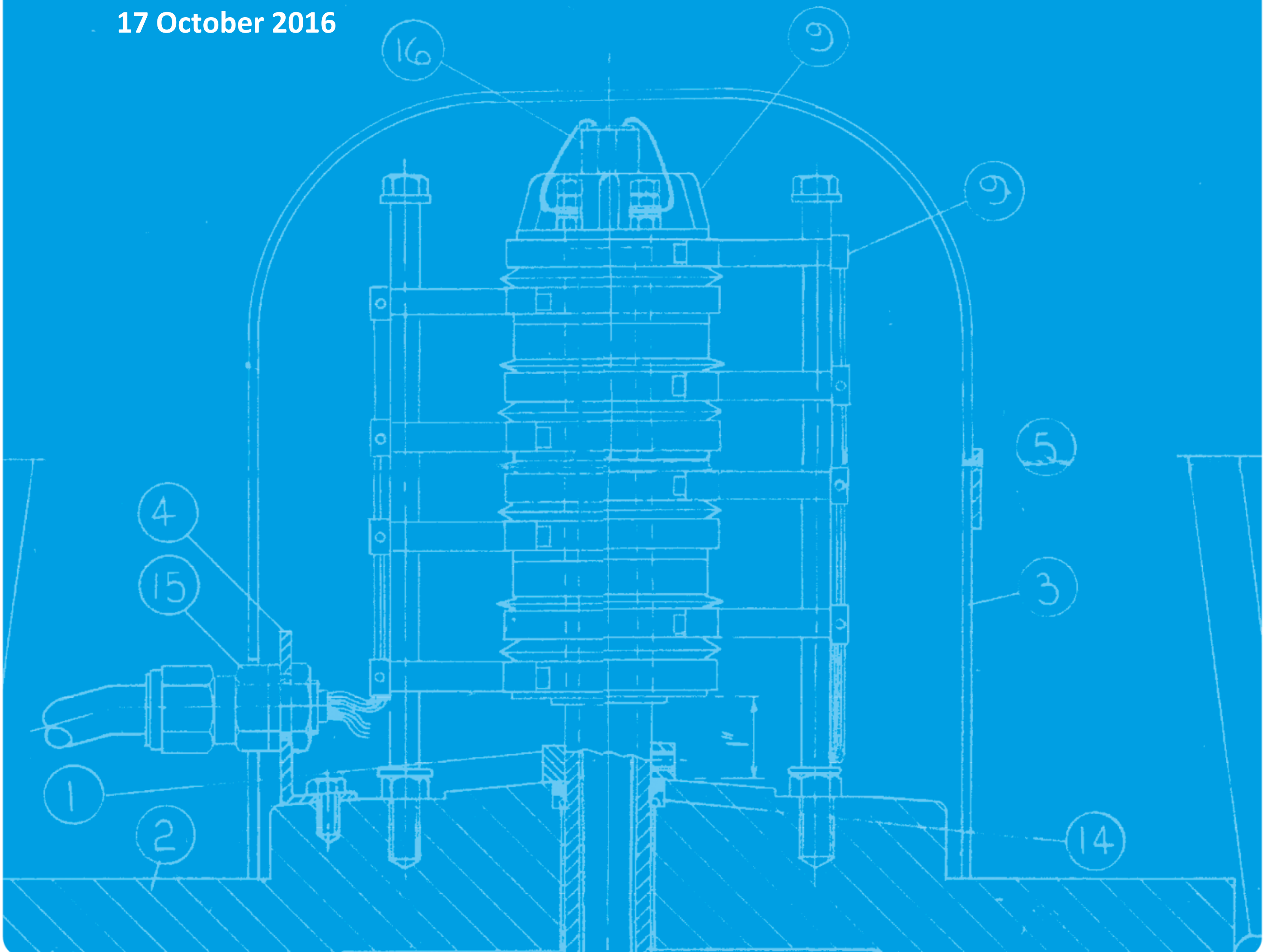

W2020: Consultation on the approach to the cost of debt – Severn Trent response

Overview of our response

The consultation on the cost of debt is very timely and we are supportive of the careful consideration of the issues well in advance of PR19. It is essential that the financial structures of the companies and underlying regulatory framework enables finance for future investment to be raised, when required, at a reasonable cost.

The approach to setting allowed returns is central to determining company revenues and ultimately shaping customer bills. We therefore welcome Ofwat's discussion on how risk should be allocated and how best it can incentivise the procurement of the lowest cost of finance. This analysis is critical because if companies are not incentivised to procure the lowest cost of finance, then it will lead to higher bills in the long term.

In considering the proposal and options put forward by Ofwat we are particularly mindful about what would incentivise the right behaviour in the long run with respect to both raising finance and setting capital structures. We think it would be inappropriate if an approach was adopted that incentivised companies to mimic a specific index (including raising debt based on a certain profile). Instead we believe a key objective is that companies should face strong incentivises to outperform financing assumptions so that they procure the lowest cost of debt, thereby delivering long term benefits to customers.

We therefore agree with Ofwat's position that companies should bear the risk for financing and capital structure. This creates the right incentives for companies to adopt efficient structures and importantly ensures that customers do not pay for inefficient structures.

We do have some concerns with the principle of indexing debt because it could encourage companies to issue debt to replicate the index. This could reduce the differential that Ofwat identified between company's debt costs and the A/BBB index. That said we think Ofwat's approach to only index new debt and apply the existing approach to embedded debt helps to mitigate this risk.

In relation to the proposals on equity, we welcome the concept of rewarding companies who take on higher levels of risk (or ambition). Such an approach would need to be underpinned by a robust and objective assessment. We would be happy to undertake further work on this to understand how this could be delivered – for example through a simple uplift to the cost of equity if a plan meets a defined set of criteria.

Finally, we think careful thought needs to be given to how any changes could be implemented in a straightforward manner. The regulatory model will become increasingly complex at PR19 through additional price controls with different forms, transition to CPI indexation (and associated true-ups) and new rules relating to developer charges (which fall under the single till at present). The cost of debt changes and associated true-ups will inevitably increase the risk of errors and unintended consequences. We would therefore welcome collaboration on how the policy changes can be simply implemented.

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?

Creating incentives for companies to procure the lowest cost of finance is critical to keeping bills affordable. We therefore support Ofwat's focus on the nominal cost of debt. We understand why Ofwat wish to focus on the notional structure – however as we have previously raised with Ofwat this could incentivise companies to increase gearing which is not without risks - which is why at a minimum those risks should not sit with customers and why we have supported greater incentives for equity.[1]

Using the notional capital structure instead of the actual structure delivers a number of benefits. Notably companies have a strong incentive to identify and adopt the most efficient capital structures. At the same time customers are not exposed to the risk that companies adopt inefficient structures. A shift away from the notional structure would mean the costs and benefits associated with capital structures would be passed through to customers. In that scenario it seems unlikely that companies would have an incentive to minimise financing costs and this could lead to higher bills in the future.

Setting a notional cost of debt also delivers benefits to customers because it creates a strong incentive for companies to identify the cheapest cost of debt. If Ofwat set the cost of debt by reference to actual debt costs companies would simply pass through the benefits (and costs) of financing decisions to customers. This means there would be limited incentive for companies to seek out the lowest cost of debt and customers would pay for this in the long run. Given that the sector faces a number of challenges, from population growth to climate change, incentivising companies to obtain the lowest cost of debt is critical to enabling affordable bills and a sustainable service in the future.

We also consider that by retaining the historic approach to embedded debt, there is an effective mechanism to ensure that customers benefit in the long run from the performance incentives associated with notional structures and notional debt. In the past Ofwat has set the embedded cost of debt allowance to recognise actual financing decisions. Customers have benefited from this. Over a 20 year debt issuance (which is the average industry duration of debt), this is approximately 78% of the value of interest costs (which are benchmarked in customers favour). Therefore, as long as embedded debt is benchmarked appropriately, customers will get a fair share of outperformance.

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 that a benefit sharing approach would not be appropriate for companies with securitised structures.

It is not clear from the consultation what the objective of such a mechanism would be and therefore it is not clear that this would be a targeted or proportionate intervention. As noted in the consultation, a pain gain share for specific companies would blur the boundary of responsibility for the choice of financing structure and management of financing risks. This could lead to higher financing costs and ultimately higher bills in the long run.

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[1] National Grid and Severn Trent, Options to encourage equity financing in the water and energy sectors, p. 41.

If the issue Ofwat is seeking to address is one of highly leveraged companies' then we consider that alternative approaches might be more appropriate. We discuss this in response to question 7.

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

We consider that Ofwat's proposed approach will transfer the risk of forecasting error from companies to customers. However, it's important to emphasise that customers may incur higher bills as a consequence of this policy. For example, if the cost of debt increases faster than what was forecast then bills will rise.

As we noted earlier another key concern with indexation is that it could reduce the incentives for companies to procure the lowest cost of debt. This is because companies would have an incentive to match the issuance of debt to the index and thereby mitigate the risk that the index adversely moves. If such behaviour is adopted it could lead to higher embedded debt costs as companies may avoid raising debt when interest rates are low due to concern that they will fall further (and so the allowed amount will also fall).

We therefore think that Ofwat is right to reject full indexation as per option 2. Although option 3 still incorporates indexation, retaining the existing approach to embedded debt means that replicating an index is not without risk. Hence companies would retain an incentive to try and outperform the index (and some of those benefits would be shared with customers).

Overall we think that if the issue Ofwat is seeking to address is forecasting error then it is appropriate to only focus on indexing new debt.

As noted in our summary, any mechanism selected needs to be as simple as possible. This should:

- limit the risk of any unintended consequences;
- ensure the changes are easily understood by investors;
- reduce the chance of errors by companies or Ofwat in any calculations; and
- enable companies to work through any tax or other implications.

The adjustment should be mechanistic and presented in advance of the price control such that current and potential investors can clearly understand any impacts on their decisions.

For companies (and Ofwat) this change will add complexity to what is already a challenging modelling process, and will create the need for additional true-ups. This comes with its own risks as it increases the opportunity for errors and therefore the simpler the process the better.

We believe from Ofwat's consultation that any adjustments to the cost of new debt will be restricted to a true up between the forecast and actual market index. This adjustment will be applied to the cost of debt and therefore will adjust the allowance based on the notional company structure.

However, from the discussions at the workshop on 10 October it was clear that Ofwat still have to work through the exact mechanics and choice of index it might adopt. The sooner these questions are answered the easier it will be for interested parties to understand the true consequences.

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

We believe there is merit in having a single annual true-up process where possible, with companies able to decide how best to smooth the effects over time. This avoids large end of AMP changes to revenues or RCV balances, helps with ensuring smoother bill profiles (as it limits step change adjustments) and is fairer in relation to customers who will realise any benefits sooner.

Allowing in-period adjustments does not necessarily mean that 100% of the adjustment needs to occur in a single year. Companies could be allowed the flexibility to manage these adjustments, with a back stop position of an adjustment at the end of the AMP as currently proposed.

Given in period ODIs and revenue adjustments may already be creating additional bill volatility for customers, a further mechanism (if flexible enough) could allow companies to manage these various impacts in the interests of customers. If all adjustments were in one direction it may be appropriate to delay adjustment to later in the AMP or the following AMP.

If Ofwat were to move to longer price controls in future, this type of in period adjustment mechanism would continue to be applicable, helping to limit the impact of any such change on customers and ensuring benefits were equitably shared.

We note that whilst in a different context (adjustment of an error) British Gas, in its appeal to the CMA, argued strongly for in-period corrections wherever possible.[2] Given the introduction of competition and additional retailer input into the water industry going forward, this is an example of customer preference for in period true-ups. We also note that Ofgem already use an annual true up process in relation to indexation adjustments and therefore it would be informative if views were sought on how this is working in practice.

Irrespective of which decision Ofwat takes, it will be important that there is clarity about how the adjustments should be made (in advance) and that once the decision is made these rules are adopted.

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?

In isolation it appears sensible that if Ofwat introduces debt indexation, it should make adjustments to reflect differences between the forecast and actual inflation. However, in practice we are unclear whether such an adjustment is necessary. This reflects:

- the use of CPI indexation which Ofwat noted is considerably less volatile than RPI and so the magnitude of forecast error is likely to be significantly diminished; and
- another true-up introduces additional complexity and makes it harder to understand the impact of different mechanisms/incentives (i.e. because there would be more noise which in turn would make the signalling power of the other incentives weaker).

Our position is that unless there is compelling evidence of a failure then Ofwat should avoid intervention. Given that we have yet to see any evidence of CPI forecasting error we think Ofwat should avoid introducing this mechanism, at least in the short term.

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[2] Whilst the appeal was not upheld by the CMA it did acknowledge the principle of returning value to customers, but found in this particular case there were relevant reasons for the approach adopted by Ofgem.

Q6: Do you agree that we should leave companies to develop their own 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 not be mandated to introduce specific risk sharing mechanisms.

Our concern with the concept of introducing additional sharing mechanisms is that it represents a fundamental departure from price regulation to rate of return regulation. This was something we raised at PR14.

We consider that price control regulation, as applied by Ofwat, is one of the principle reasons for the success of the water sector since privatisation. This model has delivered significant efficiencies whilst enabling the sector to attract investment which has allowed service levels to rise. Under the form of regulation applied:

- companies face strong incentives to outperform on costs, service and finance, thereby shifting the efficiency frontier; and
- customers benefit from the outperformance through both (i) sharing mechanisms; and (ii) the reset of controls every 5 years, particularly in relation to finance (embedded debt).

Introducing an additional sharing mechanism, whether it's for finance, costs or service would inevitably reduce the power of the incentives for companies to deliver lower costs and higher service levels. This means companies are less likely to try and outperform the regulatory settlement. This would impact both our customers and customers more widely as its unlikely that we would see ambitious plans and frontier shifts.

Therefore, whilst we welcome the approach of not mandating a risk sharing mechanism, we are unclear on the benefits an additional sharing mechanisms and consider that it could negatively impact customers in the long run.

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 are supportive of Ofwat's desire to explore how different levels of risk in business plans should be remunerated. This is particularly relevant for lower geared companies that have a greater capacity to adopt ambitious business plans.

Over the short-medium term we expect that there will be the potential for greater divergence in the services and service levels offered by companies. In part this will reflect the different preferences of customers but also different levels of ambition and the ability of companies to take on risk (i.e. companies with lower gearing are more likely to be able to take on more risk).
To facilitate this divergence and the development of more ambitious business plans we think Ofwat should explore how it could remunerate greater risk (as its likely that ambitious plans will inevitably observe more volatility relative to other companies).

The approach put forward by the ESC has some merit because it creates a mechanism to remunerate different levels of risk. However, there are two issues which warrant further consideration:

- Whether this is the right mechanism to remunerate higher risk plans?

- Whether combining this with the RBR (as the ESC appears to do) could conflate risk/ambition with the quality of evidence in a business plan.

We think that if Ofwat is seeking to promote more ambitious plans it should also consider and consult on more straightforward solutions. For example, it could allow a higher equity return for companies if their plans meet certain conditions – such as higher value, stretching and innovative ODIs. Assuming companies will still be able to select their own package of ODIs, there would then be a clear choice between 'safe' ODI approaches with a lower return potential and more challenging packages with higher risk, but higher equity returns to acknowledge that risk.

Another challenge is whether it is appropriate to link base equity returns to the quality of a business plan. Ultimately investors base return should reflect the level of risk they are prepared to take. Therefore, it may be better to address some of the behaviours around the business plan process via a separate, simple reward for a 'good' plan, such as a fast track process to determination, in a similar way to the PR14 approach.