Anglian Water

PR19 CMA Redetermination

Annex 1 Submission following November and December main party hearings

Submitted 17 December 2020

Hearing Transcripts November / December 2020		
Transcript & reference	**Relevant text**	**Anglian Response**
Ofwat hearing 30 November 2020, page 21-23.	*But if we extend to 20 years, there are a number of companies that issue debt at shorter term as well. So, if you have a subset of companies that have a shorter maturity profile and, at some point in the future, the cost of debt may start to increase, there is a question about how that backs in for those companies…* *What we do not have in mind is a particular profile and life of debt, and that is up to company treasury functions and they will all take different approaches and strategies in regard to that.*	Should market rates increase there is a real risk that companies which issue shorter tenor or variable rate debt will be more exposed to market movements than companies which have raised long term finance under this scenario. Ofwat appears to suggest (as a result of its 'industry average' policy) that if interest rates increase, it might need to increase allowances beyond the level that would be implied by a 20Y trailing average, to protect companies which have issued shorter term debt. This recognises that Ofwat's policy of shortening its trailing average has transferred refinancing/interest rate risk to customers over time. Whilst actual company financing decisions are a matter for company management, regulatory policy has a bearing on those decisions. Due to the lack of a clear benchmark and stable regulatory policy, companies which have issued long term financing in line with the selected benchmark are exposed to losses, and there has been a risk transfer from companies to customers over time.
Ofwat hearing 30 November 2020, page 25 line 7.	*The way we did that is used the notional structure, and so we used the notional level of debt. What we should be trying to do is ensure that a company that raised debt at a notional finance level would have a reasonable prospect of recovering that over time.*	Ensuring that a company that raised debt in line with the notional finance structure has a reasonable prospect of recovering that debt over time is a reasonable approach. However, Ofwat's position is inconsistent and selective because it appears to recognise the importance of the notional structure in relation to gearing (60%), but not that this concept applies to tenor (20Y) and debt mix (33% index linked, 67% fixed) for the notional company. Consistency between the tenor assumed for the notional company (e.g. as reflected in the market benchmark selected) and the trailing average period ensures that a company issuing 20Y debt on a continuous basis can expect to recover costs equal to the yield at issuance across the maturity period of each instrument. This is not achieved by Ofwat's 15Y approach, which does not allow for recovery of costs across the maturity period of water company debt raised before 2005, when companies were raising long-term debt consistent with the prevailing regulatory guidance.
Ofwat hearing 30 November 2020, page 37.	*I think is something for both Ofwat and Ofgem to reflect on further, that, actually, despite the move to use*	Ofwat's statement implies that it is not in practice adopting a benchmark-led approach but setting allowances based on actual costs.

	of iBoxx trailing averages, we still, both of us in different ways, place quite a high dependence on the sector actual cost of debt.	This is problematic because (1) it undermines the *ex ante* predictability of the cost of debt remuneration mechanism because actual costs cannot be known *ex ante* and Ofwat does not apply a benchmark-led approach consistently over time; (2) it suggests that Ofwat did not implement its stated policy objective to adopt a benchmark-led approach; (3) this approach is likely to create perverse incentives such as firms trying to match other firm's financing activities; and (4) Ofwat's view of actual borrowing costs is misleading and understated due to the exclusion of swaps, and would be materially distorted if APRs were used as a reference points. KPMG has previously set out[1] the implications of an approach that calibrates the allowance based on the actual costs and that this would mean that regulatory policy would neither be setting the right incentives, nor appropriately allocating risk. Companies should be incentivised to incur efficient costs based on factors which are controllable by the company, i.e. securing an efficient cost of debt against market rates prevailing at the time of issuance. Instead, Ofwat's mechanism rewards or penalises companies for factors that companies do not control (future market movements, regulatory discretion, other companies' financing policies). Because companies receive a cost of debt allowance that changes between price controls depending on (1) changes in market conditions and (2) discretion in regulatory policy when setting the allowed cost of debt, they are still exposed to significant risks of a mismatch between their (efficient) costs and regulatory allowances in the future, even when they issue debt at the most efficient cost available to them in the market at a given point in time.
Ofwat hearing 30 November 2020, page 20.	*The level of the terms of the companies' average tenor of debts vary between about 13 - 17 years over recent time periods… As we say, when we look at the sector average life of debt, it is 13 years at the moment.*	The 13Y average life referred to by Ofwat reflects the *weighted average years to maturity* (i.e. time to maturity across the portfolio) which is a forward-looking measure at a point in time. By design it is not reflective of tenor at issue or when debt was raised across the sector. Consistency with the tenor at issue is required to enable companies to recover costs equal to the yield at issuance across the life of each instrument: • The average *tenor at issue* of debt across the sector is 20Y based on fixed rate bonds and 25Y[2] based on all public debt issuance including index linked debt, materially higher than the 13Y weighted average years to maturity cited by Ofwat. • The CC noted in 2010[3] that *one of the main factors affecting the cost of fixed-rate debt is the time it was taken out, and interest rates fluctuate over time.* This is also not captured by the weighted average years to maturity.

[1] KPMG, A Reply to Ofwat's PFs Response, Paras 4.1.3 – 4.1.21 (PFREP001).

[2] See for example, Anglian's Response to Provisional Findings, p. 85.

[3] CC (2010): Bristol Water plc A reference under section 12(3)(a) of the Water Industry Act 1991 – Appendices.

		Ofwat cites *recent* debt issuance rather than all outstanding debt over the long term, this is inconsistent with its stated policy objective of recognising and remunerating long term finance.
Ofwat hearing 30 November 2020, page 20 line 14.	*So, effectively, our 15-year backward look plus the 5-year forward look, you are looking at cost of debt over a 20-year time period.*	Interest rates have declined materially over time. As a result the trailing average period is very sensitive to when debt is assumed to have been raised and how many years before the financial crisis this happened. Ofwat suggests that in practice it has implemented a policy that is consistent with the economic life of assets in the sector (20Y) as its trailing average covers a period of 20Y. However, this is incorrect, as the 15Y trailing average only takes into account market conditions up to 15Y before the start of AMP7 (i.e. 2005 to 2020). This means that market conditions before 2005 when (1) market rates were higher prior to the financial crisis; and (2) companies raised long term 20Y debt in line with the average asset life in the sector are not taken into account by Ofwat's proposed trailing average period.
Ofwat hearing 30 November 2020, page 34 line 3.	*The KPMG analysis, for example… focuses on a subset of data which amounts to £35 billion but actually, we have £60 billion of debt in the sector.*	KPMG's analysis of the timing of debt issuance across the sector is based on public debt, as water companies have predominantly issued investment grade bonds in line with the target rating and capital structure assumed for the notional company. In addition, this is the most complete and robust publicly available dataset for outstanding water company debt issuance. This approach is also consistent with Ofwat's approach to the calibration of the index throughout PR19 (for example in its Draft Determinations), which was based on the same dataset. Ofwat calibrated its trailing average period based on the same public debt issuance (Refinitiv data) across the sector and noted in its Draft Determination that "*in contrast to this, the 15-year trailing average has the merit of providing greater coverage of years when the water sector was actively issuing debt – around 80% of outstanding listed bonds in our sample were issued in the period 2004-2018*."[4] It is also important to note that the analysis of public debt (and the £35m) does not include the impact of inflation accretion on index-linked debt which, *all else equal,* understates the total value of the debt. Given that the majority of index-linked public debt was issued pre-2011 this exclusion likely understates the coverage that a 20Y trailing average period provides. Furthermore, Ofwat's comparison is misleading as it is based on the debt balances in the 2020 APRs which include instruments that are not relevant for the setting of the cost of debt allowance such as finance leases and revolving credit facilities.

[4] Ofwat (July 2019), PR19 draft determinations: cost of capital technical appendix

Ofwat hearing 30 November 2020, page 36 line 7.	*We do not get a figure of 4.95 per cent. You will have seen in our final determination the analysis that we did which supported the number that we allowed, which was more like 4.47 per cent, from memory.*	The cost of debt implied by Ofwat's balance sheet cross check (4.45% based on the median cost for WaSCs and large WoCs) excludes costs associated with swaps. Ofwat has not published data which estimates the cost of debt associated with swaps across the industry based on 2018 data. Europe Economics' analysis, for Ofwat, in 2017 estimated the impact of derivatives at c.50bps; including these costs in the balance sheet cross check implies an all in cost of debt of 4.95%. Anglian[5] and KPMG[6] have previously set out in detail the why it is not appropriate to exclude swaps. Examples include: • Swaps are inextricably linked to underlying issuances (to diversify funding sources and achieve efficient debt issuance). Excluding hedging derivatives presents an incomplete picture of the all-in cost of financing (where only the 'pure' debt element of the synthetic instrument is taken into account) and would ignore legitimate costs that companies have incurred in securing low costs and managing risks. • Customers have benefitted from companies' use of swaps given that at certain points in time swaps were the only means of obtaining index-linked exposure which supports financeability and lower bills. • Delineation between pure debt and swaps introduces a false distinction for risk allocation. There is no difference in practice in the nature of risk exposure between these two. It is not clear why, for example, index-linked debt (which hedges inflation risk) should be taken into account, but an inflation swap (which achieves the same outcome) should not.

[5] See Anglian Statement of Case, pages 268, 270.
[6] See KPMG Embedded Debt Report, section 6.7 (SOC441).