27 January 2021

BY EMAIL TO: waterdetermination2020@cma.gov.uk

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Our Ref HMGO/KL/270121
Your Ref

Dear Sir or Madam

Portsmouth Water response to CMA cost of capital discussion document

Introduction
Thank you for the invitation to comment on your recent paper on the cost of capital. We recognise the importance of setting the appropriate costs of capital – one that balances the respective risks and returns and continues to ensure that the industry remains attractive to investors over the long term.

We are aware that quantifying the cost of capital is not a simple exercise. There are many different approaches available to regulators. However, the fact that other regulators in the UK also need to determine a cost of capital does introduce benchmarks or reference points, even if the methodologies differ slightly.

The complexity of this assessment is demonstrated by the revised cost of capital your most recent discussion document proposes. We note it is 0.3% lower than that underpinning your provisional findings for the 4 appellant companies published in September 2020.

Company background for context
Portsmouth Water is water only company serving 300,000 households and 15,000 commercial properties in Hampshire and West Sussex.

Whilst we recognise that the approach to the cost of capital must be appropriate for the whole industry we would also like to raise the point that as one of the smallest water only companies' the methodology decisions can often disproportionality impact the business. In relation to the cost of capital we did receive an uplift to the industry cost of capital (the company specific premium) recognising the premium to debt interest that smaller companies must pay.

However, we recognise that, as a small company, other cost of capital methodology decisions can also disproportionately impact us.

At PR19 we were the only company to exceed Ofwat's assessment for Totex. We also received the highest SIM payment for the AMP6 period, reflecting our consistently high customer service performance. Many of our ODI targets were used as benchmarks for the industry in the Final Determination. Our average bill is the lowest in the industry at £100.

However, the most challenging aspect of the regulatory regime relates to our financial structure. In the early 2000s we, along with many other water companies, took out long term "Artesian" loans at what was then very attractive rate of interest (3.65% + RPI). This arrangement was both beneficial to the customers of Portsmouth Water and it also put downward pressure on average industry cost of debt.

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However, in the current low interest rate environment this arrangement is expensive and out of step with the market. As a small company we tend to access markets much less frequently as we do not have the "scale" to carry a mixed portfolio of debt. As such Artesian is currently our only long term debt facility and now represents a major burden for customers.

Whilst the Final Determination did recognise that we do not have the same degree of access to the market as a whole, it did not recognise the full cost of our embedded debt, despite our view that it was procured efficiently at that time.

Tenor of Debt used in the benchmark
The first key issue for us is, therefore, the time horizon used to determine the cost of debt. Ofwat used 15 years for their Final Determination, explicitly not including the early part of the new century when our debt arrangement was put in place. We note that the CMAs provisional findings revised that assumption to 20 years, and this resulted in a higher debt cost estimate.

Our view remains that that given this is a long-term industry with asset lives significantly greater than 20 years, a longer the time period should be used to assess the cost of embedded debt. This is particularly relevant for the small companies, which tend to need to access debt markets much less frequently and therefore cannot efficiently carry a portfolio of debt with a mixture of tenors.

The 20-year period is also aligned to the tenor of issued water company bonds, as set out in Figure 2 on page 11 of the CMA's document. We also agree that the use of shorter periods may provide inappropriate signals to companies - encouraging the use of shorter tenors of new debt potentially increased financing risk.

We note that your consultation is proposing to reverse its assumption in the provisional findings. This change, in combination with a new estimate of the cost of new debt and the revision to the ratio of new to embedded debt results in the cost of debt reducing materially from 2.4%% to 2.12%, a reduction of 0.33% from the provisional findings. If implemented this would have a large and disproportionate impact for Portsmouth Water.

Approach to "aiming up"
The second key issue is use of "aiming up" in the provisional findings with an uplift to the point estimate on equity.

We acknowledge that the Ofwat methodology consciously sought to change the balance by which returns were made and that the levels of service, or ODIs, should play a role in generating additional return over and above the "guaranteed" WACC. However, at the industry level, the Final Determination appears to be skewed *against* ODI outperformance and as such, the scope to earn ODI rewards to complement the WACC is very limited.

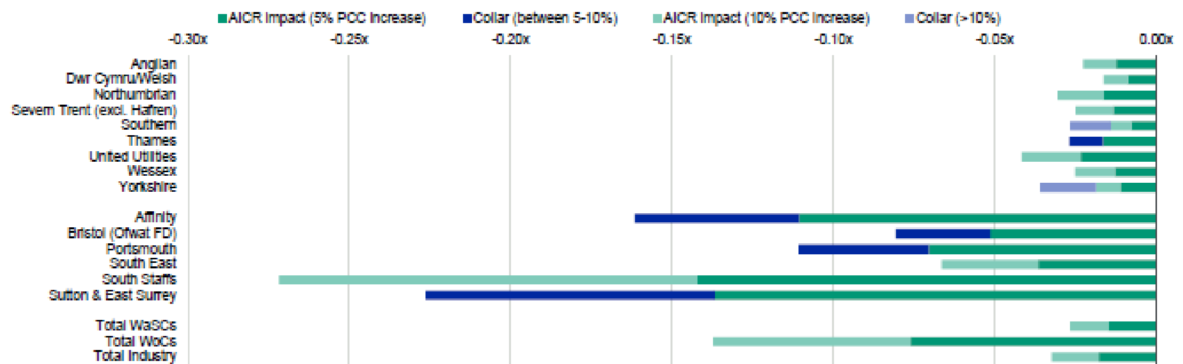
Whilst we welcome the concept of aiming up we believe there is a clear distinction between WoCs and WaSCs. We note from the 2019/20 Financial Resilience Report published by Ofwat in December 2020, the scope to outperform is greater for wastewater than water. This would suggest that different aiming up rates should apply to each group.

The risks of the two different groups of companies are different as illustrated by Moodys in their January 2021 paper, where they look at the impact of a PCC penalty on the key financial ratios of the business.

Exhibit 11

Penalties for increasing household water usage over 2020-21 could result in disproportionate reduction in water-only companies' AICR

Data based on Ofwat's FD



Most WaSCs do not have ultimate performance collars. Companies shown with collars are Southern Water (16.7% PCC increase), funded through its subsidiary Southern Water Services (Finance) Limited (Baa3 stable) Thames Water Utilities Ltd (8.8%; Baa2 stable), Wessex Water (12.7% at standard penalty rate, but unlimited at enhanced penalty rate), Yorkshire (16% at standard and 17.6% at enhanced penalty rate), Affinity Water Limited (8.1%; Baa1 negative), Bristol and Portsmouth (both at 8.6%), and Sutton & East Surrey Water plc (8.9%; Baa2 negative). Based on the CMA's provisional findings, Bristol Water's PCC penalty rate has reduced, which if confirmed at the final decision would mean that the maximum AICR reduction, including the collar, would be 0.04x rather than 0.08x.

Sources: Ofwat and Moody's Investors Service

We conclude that as shown above, the risk of materially weaker interest coverage sits disproportionally with the smaller WoCs, rather than the larger WaSCs. This would support a higher rate of aiming up for WOCs.

Investability & financeability

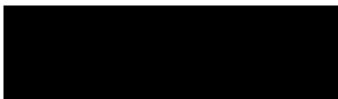
Given the long-term nature of the industry and the future need for significant investment to address population growth, climate change and environmental improvements; and given the uncertainties that this will bring, it is critical that the industry maintains its longer-term attractiveness to investors.

This will require the sector to be seen as an investable proposition, with a reasonable prospect of an appropriate balance of risk and returns with associated fair and reasonable returns to equity investors.

Finally, we do not support the use of “financial levers” to deliver a determination which is deemed financeable. This creates a divergence between the regulatory and Rating Agency positions whereby the Rating Agencies reverse any adjustments to pay as you go or the RCV run-off in making their assessment for ratings. In other words, this financeability lever is not effective in practice as it is not reflected in ratings assessments and erodes RCV over time.

Thank you again for the opportunity to comment and please do not hesitate to contact me if you have any further queries.

Yours faithfully



HELEN ORTON
Finance and Regulation Director