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Dear Dermot

THE ALLOWED COST OF EQUITY IN THE WATER SECTOR

When we spoke on 9 September, you mentioned the cost of equity being allowed by Ofwat for the water networks, suggesting that there might yet be a reduction in the Ofwat number. You asked me how I thought that may be relevant to the ED1 review. Since our discussion, I have looked at this issue more closely with my team. This has reinforced my view that the Ofwat precedent for the water sector does nothing to suggest that the appropriate cost of equity for RIIO-ED1 is lower than 6.0%. If anything it seems to support a modest increase.

The cost of equity Ofwat estimated for the water sector is 5.65%, at 62.5% gearing. At 65% gearing, this cost of equity translates to 6.0% (based on the same asset beta, risk free rate and equity risk premium). It is also apparent from Ofwat's return on regulatory equity analysis that most companies have secured an uplift on the baseline figure, taking the outcomes to a range of 5.7% to 6.2%, with all but four companies at or above 5.8%. When levered to 65% gearing, the proposed return on equity for the majority of water companies is 6.2% or above.

Ofwat has also estimated a headline cost of capital for water networks only (as opposed to networks and retail businesses jointly) of 3.7%. Ofwat did not state its view of the cost of equity underlying this WACC, but holding other parameters constant it might be consistent with a cost of equity of 5.4%. Again if this were re-geared and the uplift to equity returns secured by most companies were factored in, Ofwat's network-only WACC is not inconsistent with a 6.0% cost of equity for the DNOs. In any case, the analysis Ofwat uses to support the allocation of a proportion of the overall returns to the retail business is arbitrary, especially since there is no real retail competition, and since bad debts have a specific allowance (and remained low even during the recession). We therefore do not think there is any evidence that Ofwat's determination is suggestive of a cost of equity that is lower than 6%, even after factoring in Ofwat's network-only cost of equity allowance.

Moreover, as I said when we met, electricity distribution networks face higher risk than water networks in many areas - such as higher exposure to cost and output delivery, changing uses of the network which are likely to bring higher costs and greater technical challenges, a longer price control horizon, and higher expected interest rates over the relevant period. I would also add to my list, but acknowledge that you might not add it to yours, that the slow-track DNOs are exposed to a further equity risk in an output-based comparative regime where the fast-track company has been so generously treated as to be able to establish higher levels of performance that influence future targets. The only risk factor pointing in the opposite direction appears to be the regulatory approach to the cost of debt, which serves to reduce financing risk. But this difference is minimal when an extending trailing average is compared with Ofwat's fixed allowance with a reset at five years. And that technical methodological difference is more than offset by the plain fact that the Ofwat cost of debt value is 2.75%, compared to a more likely outturn of 2.45% under the Ofgem method.

Unlike Ofwat, Ofgem has explicitly recognised that its proposed cost of debt will under-fund the industry. You know that I regard Ofgem's suggestion that this shortfall is funded by headroom in the cost of equity to be untenable on two counts: firstly, the justification that Ofgem offered in its *Draft determination* (that there is a 'halo effect' for DNO debt issuance relative to the proposed index) has fallen apart under scrutiny. We have shared this with your team since we spoke and we think they may have reached the same conclusion. Secondly, no such headroom exists and a proper like-for-like analysis of the Ofwat determination gives no precedent to support a cost of equity allowance below 6.0%, or a cost of debt allowance below the actual cost of debt Ofgem has estimated for the sector. As a result, it is not sustainable for Ofgem to take a public position whereby it congratulates itself for observing the principles of regulatory certainty by choosing a cost of equity that is within its stated range, only to tell the investor community that it thinks it is in order to 'rob Peter to pay Paul' on the debt side by using headroom that it claims exists to fund a shortfall on debt that undoubtedly exists.

We conclude, therefore, that the Ofwat decision, if it provides any precedent at all, supports Ofgem making full allowance for the electricity distribution sector's average expected cost of debt over the RIIO-ED1 period. Ofgem has not been more generous than Ofwat on equity returns, despite the risks being higher. But there can be no doubt that Ofwat has proposed a significantly higher cost of debt allowance. Ofgem should therefore start the trailing average at 13 years, rather than 10, in order to avoid underfunding the cost of debt it expects the industry to incur.

I hope you find these comments helpful. I am sure that both you and David have views on this matter and I look forward to discussing them with you in due course.

Sincerely

Phil Jones

Phil Jones
Chief Executive