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PR24: Havant Thicket Cost of Debt Allowance
Prepared for Portsmouth Water

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1. Introduction

This paper provides a review of Ofwat's PR24 approach to setting the allowed return for the Havant Thicket reservoir project.

2. Overall Approach

Ofwat's draft determination proposes a bespoke rate of return comprising:

- the industry-wide allowed return on equity; and
- a project-specific allowance for the cost of debt.

In our September 2023 paper for Portsmouth Water we noted that Ofwat faced a finely balanced choice as regards whether it should provide for a flat return for shareholders over the life of the asset or differentiate the cost of equity during the construction and operation phases of the scheme. It follows that we take no issue with Ofwat's draft decision to opt for the latter approach, albeit we note that it will be important that Ofwat acts in a manner that is consistent with its PR24 determination by sticking with the industry-wide return on equity at PR29 and at future price reviews.

We are also supportive of Ofwat's overall approach to the allowed cost of debt. As we highlighted in our previous paper, and as Ofwat notes in its draft determination, the Havant Thicket project is unusual in terms of its size (i.e. close to 2x the size of Portsmouth Water's starting RCV), the concentration of Portsmouth Water's spending and financing within a short period of time, and the chosen financing mix. These things together mean that it does not make sense to hold Portsmouth Water to the industry-wide cost of debt, as a benchmark that reflects the cost of a different basket of debt assembled over a noticeably longer period of time.

3. Calibration

While we are in overall agreement with what Ofwat has set out to do in its draft determination, we do have some observations about the specific way in which Ofwat has constructed its proposed bespoke allowance.

(NB: in the sections that follow, Ofwat's words appear in italics and our response follows in non-italics.)

3.1 Cost of embedded debt

"Embedded debt: While NERA's analysis calculates the allowed return for this debt as an RCV-weighted trailing average over 2020-25, we consider it reasonable as a starting point to consider whether the allowed return on debt we apply for Portsmouth Water's other wholesale controls appropriately remunerates the control. This involves applying a CSA uplift of 30bps for interest costs to the sector allowance of 2.46% to derive an allowance of 2.76% (real, CPIH). We consider that this base allowed return sufficiently remunerates the company for the cost of embedded debt."

Ofwat's allowance for the cost of the debt that Portsmouth Water will be taking into the 2025-30 regulatory period is set in line with the industry-wide allowance for embedded debt costs. This immediately strikes us as a very odd policy choice. The embedded debt that Portsmouth Water has for the Havant Thicket project was set up in 2023 and reflects interest rate conditions as at 2023. The industry allowance, by contrast, is intended to match the interest payable on borrowings dating back more than 20 years and, hence, contains a memory of interest rates over a period of more than two decades.

It would be an extraordinary coincidence if Portsmouth Water's cost of debt exactly matches industry-average embedded debt costs. Absent any evidence that such a coincidence has occurred, we think that Ofwat needs to provide for a bespoke allowance for embedded costs that recognises that the type of debt that Portsmouth Water has raised and the timing of issuance are specific to the Havant Thicket project.

This would bring Ofwat's approach to embedded debt into line with Ofwat's approach to new debt.

Our understanding is that the only fixed interest rate that Portsmouth Water has so far entered into is on a 14-year CPI-linked bond. Consistent with Ofwat's approach generally in PR24, we suggest that the regulatory allowance for this debt should be fixed in line with a benchmark for prevailing market rates at the point of issuance rather than actual cost. We provide further thoughts on this calculation in section 3.4 after we review Ofwat's approach to benchmarking the cost of new debt.

3.2 Cost of new debt

"Choice of index: While our sector allowance is based on the iBoxx A/BBB £ non-financials 10+ index and this is also featured in NERA's estimate, for Havant Thicket we instead propose to use the iBoxx BBB £ non-financials 3-5 index. We consider that this is better aligned with the shorter (5-6yrs) tenor of the £250m of floating rate facilities supplying the majority of the new debt for the project. A 'BBB'-rated index will also align better with the likely rating ceiling of Baa2 on borrowing in the construction period."

We agree that Portsmouth Water's current reliance on floating-rate debt warrants a move to a shorter tenor iBoxx index. We also agree with Ofwat's selection of a BBB only index.

Portsmouth Water has informed us that it is considering switching some of its floating rate debt to fixed-rate debt at some point in the next five years, either using swap arrangements or by replacing existing floating-rate debt with fixed-rate loans/bonds upon maturity. Portsmouth Water has also said that replacement debt may be of a longer tenor than the current loans. This appears to be a perfectly reasonable, perfectly normal position for a company to take as a project nears the end of its construction phase. However, in this specific case, there is a risk that Portsmouth Water will feel constrained by Ofwat's use of a 3-5 year benchmark index all the way through to 2029/30 and consider that it is unable to make an otherwise sensible adjustment to its financing prior to the completion of PR29.

It probably makes sense for Ofwat and Portsmouth Water and Ofwat to sit down together and discuss what the optimal financing strategy looks like, thinking particularly from the point of view of the customers that will ultimately be picking up the costs. Ideally, this will result in a shared view of the type of debt that Portsmouth Water should be using over the next five years, which Ofwat can then transpose into its choice of benchmark index/indices. Alternatively, if there is no time left in PR24 for such discussion, or there is no consensus view, Ofwat can consider leaving the choice of reference index open and instead specify a rule that the PR24 iBoxx reference index will match the tenor of actual debt at any given point in time rather lock down on a known, specific reference index upfront.[1]

“Form of reconciliation: While NERA's modelling approach uses the extending trailing average from our cost of new debt indexation model to generate an allowed return from outturn data, we consider that the return should be based on the average yield of the iBoxx BBB 3-5 index for the charging year in question. This reflects that floating rate debt interest charges reflect the prevailing interest rate and have no 'memory' of previous years.”

Ofwat’s proposal to refresh and recalculate the value of the benchmark index in full every year is a logical approach in a world in which Portsmouth Water borrows only floating-rate debt. However, if there is reason to think that Portsmouth Water should be considering moving to a different financing mix before March 2030, the full annual refresh acts as an additional distortion to the choices that Portsmouth Water faces as regards its longer term financing strategy.

As under the previous heading, we think this points in the direction of further dialogue between company and regulator, with a view to either locking down on a different approach at an agreed point in the 2025-30 period or providing for flexibility for there to be an automatic switch to a more fixed allowance if/when Portsmouth Water commits to fixed rates.

“Company-specific adjustment: We set out in chapter 5 that we were allowing Portsmouth Water an uplift to its allowed cost of debt over 2025-30. We apply the same 30bps uplift to Havant Thicket's cost of new debt, to give a pre-reconciliation allowance of 3.55%.”

We agree that Ofwat’s award of an uplift over iBoxx rates should carry across to the Havant Thicket project.

3.3 Weights for embedded and new debt

“Share of new debt: … We adopt the NERA approach of treating closing 2020-25 closing notional debt (£97.5m) as embedded over the 2025-30 period, and inferring new debt as the difference between overall notional debt and this embedded balance.”

As noted above, Ofwat departs from NERA’s suggested approach by recognising explicitly that all borrowing other than the CPI bond is in the form of floating-rate loans. It logically follows that the only properly embedded debt that Portsmouth Water will take into the 2025-30 period – i.e. the only debt that is locked in at pre-2025 interest rates – is the accrued principal on the CPI bond.

“We do not consider refinancing new debt given the project's status as a new build asset in its construction period.”

We are not sure we follow what Ofwat means with this sentence. If it means that debt will drop out of the weighting calculation at the point when a loan matures, then we would say that Ofwat will be misrepresenting the mix of borrowing that Portsmouth Water will carry through to March 2030.

The weight for new debt should reflect drawn down floating rate loans as at 1 April 2025, any additional indebtedness that Portsmouth Water takes on during the 2025-30 period, and any required refinancing of either of these tranches of debt.

[1] We note that the NI Utility Regulator’s cost of debt indexation mechanisms for electricity and gas networks embodies exactly this kind of rules-based approach,

3.4 Summary – base cost of debt

Table 1 brings the above recommendations together into a single summary table.

The allowance that we are proposing for embedded debt is based on the logic that Ofwat applies when selecting the reference index for the rest of Portsmouth Water's borrowing. We first select a BBB index with a tenor that matches the tenor of Portsmouth Water's bond. We then take a reading of the index at the point when the bond was issued.[2]

Table 1: Proposed cost of debt allowance

	Weight	**Allowed cost**
Embedded debt	As per the average forecast value of the outstanding principal on Portsmouth Water's CPI bond (A)	iBoxx £ non-financials BBB 10-15 year index in the month of issue plus 30 basis points (fixed)
New debt	As per the average forecast value of the debt-financed portion of the Havant Thicket RCV minus amount (A)	iBoxx £ non-financials BBB 3-5 year index plus 30 basis points (refreshes every year) then either: a specified longer tenor index starting from a mutually agreed date plus 30 basis points (fixed) or an automatic switch to an index with a tenor that matches the new tenor on Havant Thicket debt at the point when Portsmouth Water opts to fix rates plus 30 basis points (fixed)

3.5 Issuance and liquidity costs

"Issuance costs: We contemplated using benchmarking to derive our assumption for this allowance but considered that there was a risk that such sector benchmarks might not reflect project-specific issuance costs. In addition, we would expect a higher annualised issuance cost due to the shorter tenor of instruments (particularly RCFs) used on the project."

We agree that Ofwat's allowance for issuance costs should be based on the way in which Portsmouth Water has actually borrowed.

"Liquidity costs: … We were not convinced that NERA's use of the 'Liquidity Building Block' approach was appropriate to remunerate liquidity costs faced by Havant Thicket. As a project with significant excess capacity in its arranged RCFs, we considered it more logical that the relevant allowed return for liquidity purposes should be an RCF commitment fee rather than the sector WACC, as used by NERA."

[2] We propose a single-month snapshot rather than an annual average on the grounds that there was an increase in interest rates of more than 2 percentage points between April 2022 and March 2023. Portsmouth Water cannot reasonably have been expected to match the 2022/23 annual average when issuing a single bond at a single point in time.

We similarly agree that Ofwat's allowance for liquidity costs should reflect the cost of the actual facilities that Portsmouth Water has entered into.

"We did not include the commitment fees of holdco RCFs in line with our final methodology policy of excluding the cost of holdco debt from our cost of debt benchmarking. Holdco financing is outside the regulatory ringfence and so bears a component of equity risk which is compensated for in the allowed return on equity."

We do not agree with Ofwat's stance on holdco facilities.

Ofwat states that parent company support is remunerated via allowed equity returns. However, this is only true if the £m of the parent company's support amount is properly captured on the capital base side of the WACC x capital base calculation. Ofwat's measure of capital base is the RCV. It follows that the allowed return on equity only remunerates equity financing for capital costs that are added to the RCV. Any financing that lenders or shareholders provide beyond the direct financing of RCV-eligible capital costs, by design, is going to be ignored unless Ofwat overlays a separate allowance in a separate line item within its calculations.

This is exactly the logic that Ofwat uses to justify a stand-alone liquidity allowance in its industry cost of capital calculations – i.e. Ofwat does not seek to argue that the cost of maintaining RCFs is compensated for in the allowed cost of embedded/new debt. There is no reason to treat facilities held at holdco level any differently provided that Ofwat makes allowance only for the capital that is needed specifically for the Havant Thicket project.

3.6 Future price reviews

"Our expectation for future price reviews (which will cover the post-construction period) is that Havant Thicket should be integrated into our sector framework for setting allowed returns as early as reasonably practicable. We expect that Portsmouth Water will have due regard to this consideration in its future financing decisions concerning Havant Thicket."

We noted at the start of this paper that Ofwat's decision to provide a bespoke allowance for the Havant Thicket cost of debt was rooted in the unavoidable mismatch between the profile/vintage of the industry's debt book and Portsmouth Water's comparatively short, sharp burst of financing activity.

We consider that it is highly unlikely that this mismatch will disappear any time soon. When, for example, Ofwat comes to set PR29 price controls, the industry cost of debt will almost certainly need once again to contain a 'memory' of interest rates stretching back to the 2000s, including a large chunk of debt raised during historically favourable pre-2022 market conditions. Portsmouth Water's borrowing, by contrast, will inevitably be skewed much more towards recent issuance and post-2022 interest rates.

It is right that Ofwat should want to consider at each reset whether there continues to be sufficient disparity to justify a bespoke cost of debt allowance for Havant Thicket. However, we think that the default position a priori should be that a separate allowance will need to continue until such time as there is evidence of an irreversible convergence in the composition of Portsmouth Water's borrowings versus the industry average debt mix.