Water 2020 - Risk and Return Workshop - Financeability

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1) High level approach to considering financeability
2) Where do we test financeability? - Appointee vs individual control level
3) Proposed financial ratio calculations
4) PAYG and RCV run off levers
5) What would we expect companies to provide to Ofwat
6) Solutions to financeability issues

The purpose of this workshop is to capture views on the development of our policy in respect of financeability.

Stakeholders should refer to our methodology document (one published) for our final policy.

Ofwat's statutory duties which are set out in Section 2 of WIA 91 as amended include a primary duty to exercise and perform our functions in a manner we consider is best able to :

"secure that undertakers are able (in particular, through securing reasonable returns on their capital) to finance the proper carrying out of their statutory functions."

We also have primary duties in respect of the **consumer** and **resilience** objectives and in relation to undertakers properly carrying out their functions and a secondary duty to **promote economy and efficiency** by water companies in their work.

We propose to retain our high level approach to assessing financeability. That is to:

1) Consider a notionally structured company with an efficient level of expenditure
2) Consider financeability before legacy adjustments relating to the previous AMP as these relate to out or underperformance against the price determinations of the previous period.
3) Consider a suite of financial ratios and will look at the average of those ratios over each of the 5 years
4) Ask companies to provide Board assurance that they are financeable on both an actual and a notional basis
5) Set the notional gearing at the start of the period and our modelling will allow gearing to fluctuate over the AMP rather than holding gearing constant.
6) Carry out sensitivity testing to assess the strength of the financial ratios under different scenarios

Companies remain responsible for their choice of actual capital structure and to ensure they meet the requirement to maintain an investment grade credit rating. Risks associated with choice of actual capital structure remain with investors, not customers.

Should we test financeability at the appointee level or at the individual control levels?

At PR14 we tested financeability at the appointee level and also carried out a high level check of the headroom within the retail business.

Appointee level	Individual control levels
Meets Ofwat's financeability duty	If each of the individual controls is financeable then overall the appointee should be financeable.
More efficient and straight forward to carry out the assessment	Assessing the financeability of each control individually will increase the amount of work that needs to be undertaken by both Ofwat and companies.
Minimises the volume of information that needs to be provided by companies	Increased amount of information that would need to be provided by companies. The allocation of debt between individual controls is to some extent artificial as most companies will continue to raise debt at the appointee level
Even if we assess financeability at the appointee level, then where we identify a financeability issue we would still need to consider the position of each individual control to identify where to use financial levers to address that issue	The new controls could potentially have different levels of notional gearing and different returns (WACC). As a result there will be different pressures on financeability for each control. We would not expect each control to be able to achieve the same levels for all financial metrics.
Under the terms of the licence a company would need to appeal the entire determination	A company cannot appeal individual controls

Discussion:

a) Do you agree with our high level approach to assessing financeability?

b) Should we be considering financeability at appointee or control level?

We expect to continue to use a suite of financial ratios to test financeability.

Debt ratios are shown below; we expect we will also look at equity ratios such as dividend cover

The ratios will not follow the calculations used by any particular rating agency, but will draw from all of them.

We will look at the average of each metric over the review period and also the general trend over the period, consistent with the approach taken by the credit rating agencies.

Ratio	Calculation
Gearing	$\frac{\text{Net Debt}}{\text{RCV}}$
Interest Cover	$\frac{\text{FFO(pre interest)}}{\text{Cash interest}}$
Adjusted cash interest cover (ACICR)	**Ofwat** $\frac{\text{FFO(pre interest)} + \text{capital charges}}{\text{Interest (excluding accretion of IL debt)}}$ **Alternative** $\frac{\text{FFO(pre interest)} + \text{capital charges} - \text{excess fast money}}{\text{Interest (excluding accretion of IL debt)}}$
FFO/Net Debt	**Ofwat** $\frac{\text{FFO (post interest)}}{\text{Net Debt}}$ **Alternative** $\frac{\text{FFO (post interest)} - \text{accretion of index linked debt}}{\text{Net Debt}}$
RCF/Net Debt	$\frac{\text{FFO} - \text{dividends}}{\text{Net Debt}}$

In the calculations above Net Debt is calculated as all borrowings less cash. It does not include any pension deficit liabilities, as these are only partly funded by customers and any amounts in excess of what has been allowed is the responsibility of companies. Capital charges = RCV run off in the calculation of ACICR

We would expect companies to provide assurance on financeability based on the financial ratios that we set out in our methodology. This should include the Ofwat ratios and could include the alternative ratios

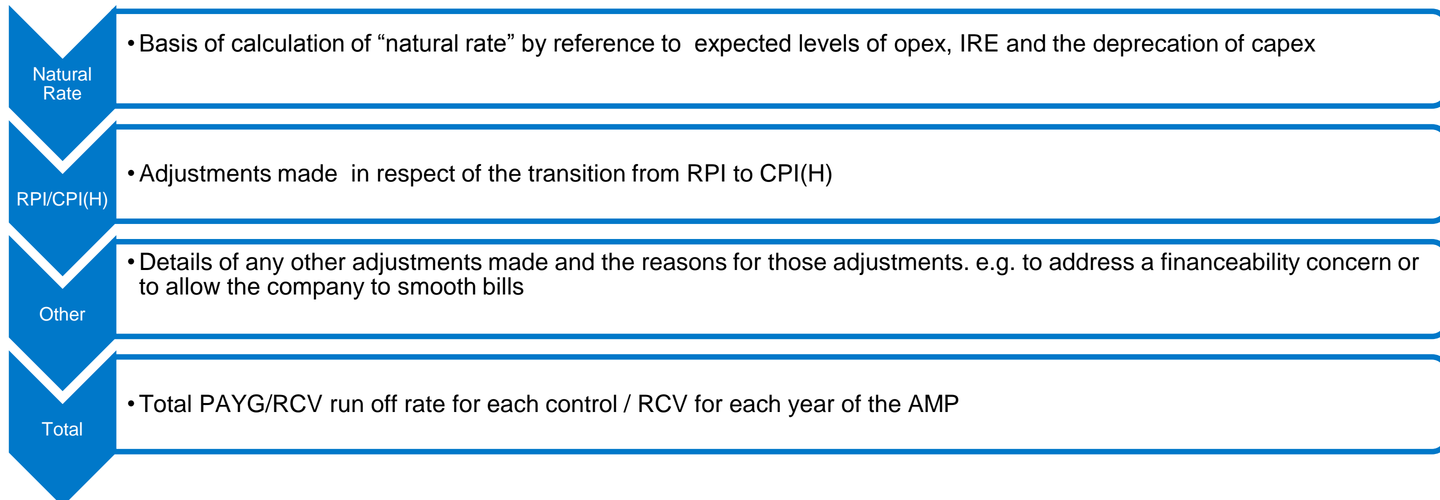
In line with the approach used at PR14 we intend to ask company Boards to provide assurance that they have satisfied themselves that the appointed business is financeable on a notional basis. Companies will also need to show that they will be able to comply with the requirement to maintain investment grade credit rating based on their actual structure.

Companies will be required to submit a set of financial metrics as defined by Ofwat

	Appointee	Individual wholesale controls	Retail controls (HH for all cos and NHH for Wales)
Notional basis	✓	✓(TBC)	Headroom check only
Actual basis	✓		

Companies will also be required to provide to provide evidence/explanations to support the PAYG and RCV run off rates that they have proposed for each control for each year.

For a WaSC there could be up to 4 PAYG rates and 10 RCV run off rates for each year.



For each control companies will need to determine appropriate PAYG and RCV run off rates.

The choice of PAYG and RCV run off rates enables companies to alter the level of revenue that they collect in each year and how much they defer till subsequent years.

The appropriate rates will be different for each company – linked to investment programmes

At PR14 we allowed companies to suggest appropriate rates and we looked at the impact of these rates on the financeability of each company.

Companies also adjusted their PAYG rates to resolve financeability issues or to smooth bills. At PR19 companies may use these levers to smooth the transition from RPI to CPI/CPI(H)

For PR19 how should we consider what the **appropriate levels of PAYG and RCV run off should be?**

- Balance between affordability and financeability
- Impact on current customers vs future customers
- Impact on RCV growth

Difficult to assess PAYG and RCV run off in isolation.

- The interaction between PAYG and RCV run off means that a company can achieve the same allowed revenue with a high PAYG rate and a low RCV run off or with a low PAYG rate and a high RCV run off.

There are a number of key questions that we need to address when considering the “**natural**” rate - the rate before adjustments relating to financeability, bill smoothing or CPI/(H) transition The PAYG and RCV run off rates can be used to move revenue between periods in an NPV neutral basis.

1) What is the appropriate level for the PAYG lever?

   PAYG = Opex and IRE

   PAYG = Opex plus IRE (expensed in P&L Account)

2) How should we benchmark the appropriate level for the RCV run off?

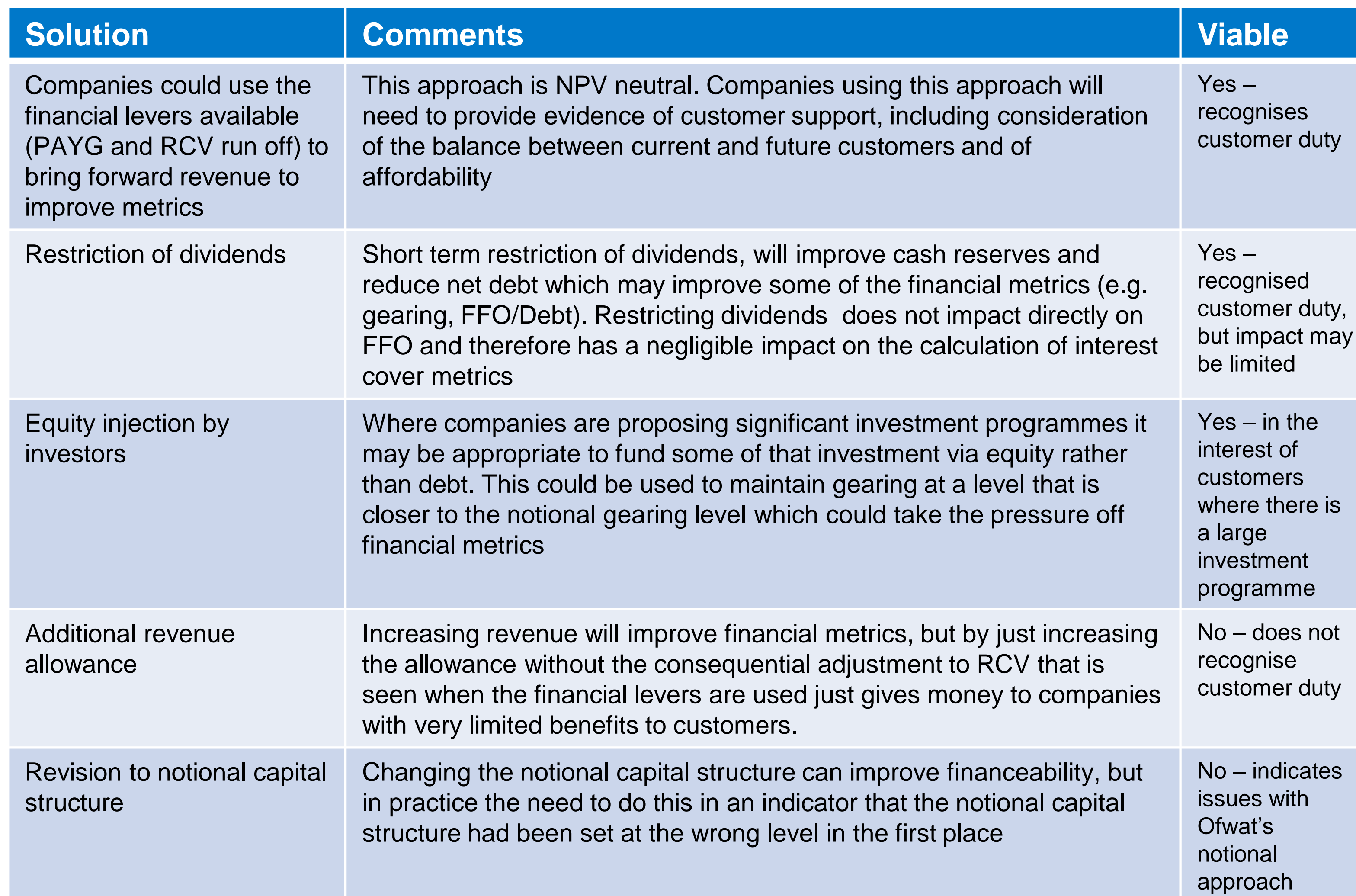
   Is it valid to link it movements in fixed assets?

3) Should the RCV run off rate be the same for both the RPI linked RCV and the CPI(H) linked RCV within each control?

4) Companies will need to demonstrate they have engaged with customers and have customer support for the proposed bill profile, including that they have considered the issue of affordability for both current and future customers. But how should we assess appropriate use of PAYG/run-off levers?
   - Assessment of overall affordability of the resulting bills as a starting point
   - Predetermined basis of calculation (e.g. PAYG = opex + IRE expensed)
   - Detailed assessment where business plan PAYG/run-off material deviation from predetermined calculation

Group discussion: How should we determine what the appropriate rates for PAYG and RCV run off should be for each company?

Companies should submit business plans that are financeable and explain how they have ensured the plan is financeable. Where financial metrics indicate that a problem, there are a number of options that we could be used. Examples below.



Solution	Comments	Viable
Companies could use the financial levers available (PAYG and RCV run off) to bring forward revenue to improve metrics	This approach is NPV neutral. Companies using this approach will need to provide evidence of customer support, including consideration of the balance between current and future customers and of affordability	Yes – recognises customer duty
Restriction of dividends	Short term restriction of dividends, will improve cash reserves and reduce net debt which may improve some of the financial metrics (e.g. gearing, FFO/Debt). Restricting dividends does not impact directly on FFO and therefore has a negligible impact on the calculation of interest cover metrics	Yes – recognised customer duty, but impact may be limited
Equity injection by investors	Where companies are proposing significant investment programmes it may be appropriate to fund some of that investment via equity rather than debt. This could be used to maintain gearing at a level that is closer to the notional gearing level which could take the pressure off financial metrics	Yes – in the interest of customers where there is a large investment programme
Additional revenue allowance	Increasing revenue will improve financial metrics, but by just increasing the allowance without the consequential adjustment to RCV that is seen when the financial levers are used just gives money to companies with very limited benefits to customers.	No – does not recognise customer duty
Revision to notional capital structure	Changing the notional capital structure can improve financeability, but in practice the need to do this in an indicator that the notional capital structure had been set at the wrong level in the first place	No – indicates issues with Ofwat’s notional approach

Appendix

We are developing the financial model to allow separate **annual RCV run off rates for both the RPI and CPI(H) linked RCV's within each control.**

<table>
<tr><th></th><th>Water Resources</th><th>Network Plus Water</th><th>Bio resources</th><th>Network Plus Wastewater</th></tr>
<tr><td>RCV pre 2020 - RPI Linked</td><td>Rate</td><td>Rate</td><td>Rate</td><td>Rate</td></tr>
<tr><td>RCV pre 2020 – CPI(H) Linked</td><td>Rate</td><td rowspan="2">Single Rate</td><td>Rate</td><td rowspan="2">Single Rate</td></tr>
<tr><td>RCV post 2020 – CPI(H) Linked</td><td>Rate</td><td>Rate</td></tr>
</table>

It may be appropriate for companies to put forward separate RCV run off rates for pre and post 2020 RCVs. Companies will be required to explain their approach to RCV run off which we would assess as part of the initial assessment of business plans.

This means that we will need to collect 10 RCV run off rates for each year for a WaSC and 5 for a WoC.

It may be appropriate to maintain flexibility for companies to apply those rates on a **straight line or reducing balance basis**

Companies may need to consider submitting clear explanation of the proposed PAYG and RCV run off rates, for example.

a) How they have determined the "natural" rate

b) Any adjustments that they have made to deal with the transition from RPI to CPI(H)

c) Any adjustments that companies have made to address bill smoothing/profiling or other issues.