Ofwat webinar: Aligning risk & return

14 February 2019 11.30 - 12.30pm
Q and A

Areas covered:

- Aligning risk & return

Webinar slides are available on our website.

Question and answer session

Q. Does Ofwat expect companies to re-present their whole RORE analysis in their resubmitted business plans or only for the issues that were identified?
A. We expect companies to resubmit their business plan tables and the financial model; App26 will be a key element of this. We do not necessarily expect companies to rerun their entire RORE analysis but where actions were identified, we expect companies to take account of these in their response.

Q. Do you have any thoughts on how the new frontier shift on no RPE above CPIH could affect the totex RoRE assessment, as that is a general change without an action?
A. This is a matter for companies to consider when determining their P10 and P90 assumptions for the totex RoRE range. But the RoRE analysis assumes that an efficient, notionally financed company with no out/under performance would earn the regulated cost of equity.

Q. Will you be covering questions that were pre-submitted to Ofwat?
A. A number of the pre-submitted questions were company-specific; the webinar will not cover these questions. Where appropriate we will arrange meetings to discuss these.

Q. The FFO calculation used within the financial ratios in the financial model does not take into account new connection income that is treated as revenue under IFRS, is this approach intentional?
A. This is a question that Ofwat will come back to companies on.

Q. Could you talk through the Appendix 3 views on adjusting RCV run off for CPIH transition?
A. The PR19 methodology set out our expectations for the transition from RPI to CPIH. We highlighted that in 2020 the split would initially be 50/50 between RPI and CPIH; with all new investment allocated to CPIH. The policy was derived following extensive consultation and balanced the views of investors and companies.

The methodology also set out an expectation that companies should engage their customers on the speed of transition to CPIH. However, the speed of transition to CPIH was just one aspect of what we looked at and, as part of this, the methodology allows companies to propose alternative approaches making use of financial levers and ensuring the transition is supported with customer preferences. In our IAP assessment, we looked for evidence of this in business plans.

We do not have a firm view on the profile of bills to support the transition to CPIH but, where companies are proposing alternative bill profiles, this should be supported by evidence of customer engagement and support.

Q. Can you talk through the dividend cap of 4.5%; this is different to the previous guidance that 5% was reasonable.
A. We do not apply dividend caps as we do not regulate dividends. However, we do need to have a view on dividends for the purpose of financeability. The reference to previous guidance around a 5% dividend yield is from our 'putting the sector in balance' position statement which suggested 5% as an upper limit for reasonable nominal base dividend yield. This figure related to the company's actual financial structure, and we said that where companies propose a higher base dividend yield, this should be robustly justified

For the notional dividend yield, we consider the yield plus growth assumption should be no higher than the real cost of equity; this is consistent with the approach adopted at previous price reviews.

Q. Can you provide further guidance regarding what you consider compelling evidence to support target credit ratings used by companies in finaceability assessments?
A. We expect companies and Boards to present a clear rationale for their decision to target specific credit ratings, on a notional and actual basis. This could be different for different companies. It is a matter for companies to decide and present supporting evidence. Where there is less headroom in the financial rating that a company is targeting, the evidential bar is higher given the potential lower levels of financial resilience.

We note that Moody's has changed its guidance on the targeted adjusted interest cover ratio threshold. We comment on this in the publications that accompanied the IAP decisions[1] and companies should take account of our comments in their resubmissions.

Q. Both Fitch and Moodys now target 1.5x AICR for baa1 rating, which is 10bps higher.
A. We are aware that Fitch has also revised its target.

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[1] See section 4.3 of [Technical appendix 3: Aligning risk and return]