Ofwat

Aligning risk & return – draft determination webinar

23 July 2019

Agenda

- Introduction
- Cost of capital and retail margins
- Risk and uncertainty
- Financeability
- Putting the sector in balance
- Q&A

Cost of capital & retail margins

Evolution of our cost of capital estimate, 2017-2019 (nominal*)

	'Early view' (Dec 2017)	Change	Revised view for DDs (Jul 2019)	Explanation
Risk free rate	2.10%	-56bps	1.54%	Lower yields, lower rate rise expectations and basing estimate on index-linked gilts.
Total Market Return	8.60%	+3bps	8.63%	Minimal change. Updated estimate aligns with historical and forward-looking evidence.
Debt beta	0.10	+0.025	0.125	Higher figure as data shows debt premium has risen faster than equity premium.
Notional company equity beta	0.77	-0.07	0.71	Lower – mainly due to share price decreases increasing listed firm enterprise value gearing.
Cost of equity	**7.13%**	**-57bps**	**6.56%**	**Lower due to lower beta & risk-free rate.**
Cost of new debt	3.40%	-4bps	3.36%	Higher point estimate offset by lower predicted rate rise and 25bps outperformance wedge.
Cost of embedded debt	4.64%	-13bps	4.50%	Lower due to point estimate using 15yr iBoxx average and 25bps outperformance.
Embedded:new split	70:30	+10%	80:20	Higher, based on company submissions on debt issuance / paydown plans over 2020-25.
Overall cost of debt	**4.36%**	**+2bps**	**4.38%**	**Effect of higher embedded:new split largely offset by lower allowances.**
Vanilla WACC (Appointee)	**5.47%**	**-22bps**	**5.25%**	Fall due to lower cost of equity.
Retail margin adj.	0.10%	+1bp	0.11%	Revised assumption based on company data.
Wholesale WACC	5.37%	-23bps	5.14%	Calculated as appointee WACC minus retail margin adjustment

* Figures may not sum due to rounding

Featured change: Cost of embedded debt

Listed nominal water bond issues have at issuance systematically outperformed the iBoXX over 2000-2018, by an average across all years of 31 basis points:

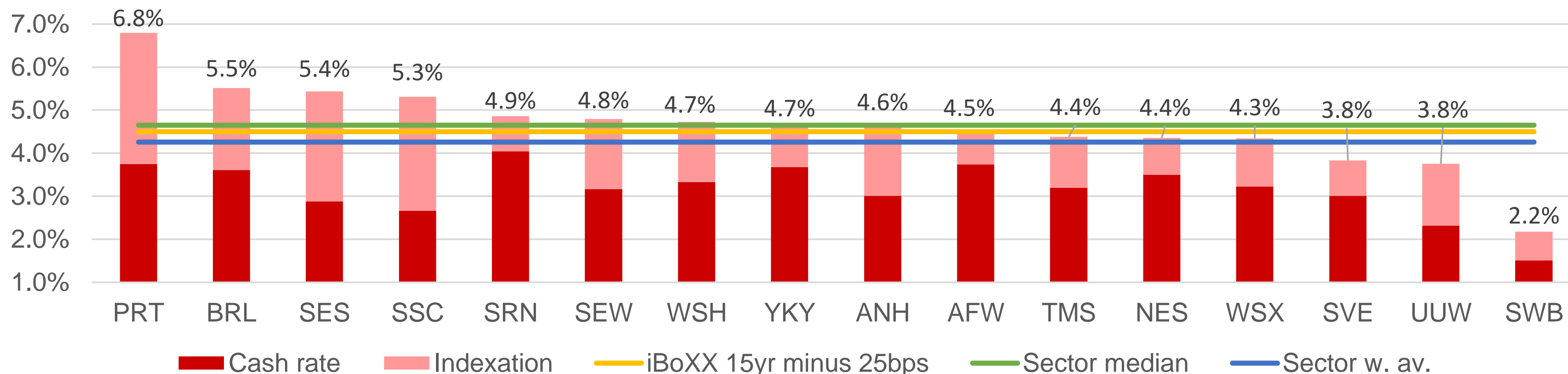
Average outperformance of nominal listed bonds of tenor >10yrs, relative to iBoxx A/BBB 10yrs index (bps)

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
6	34	46	32	35	44	29	60	n/a	61	-51

2011	2012	2013	2014	2015	2016	2017	2018	Average bps (2000-2018)
8	27	13	48	n/a	44	39	50	31

Our allowance of 4.50% nominal is based on a 15 year trailing average of our benchmark index, adjusted for 25bps outperformance:

Comparison of balance sheet embedded 'pure debt' vs. our point estimate and high/low range (nominal)



Equity beta estimates derived under different approaches to unlevering/re-levering

	Calculation	'Enterprise value' approach	'Book value' approach	'Indepen' approach
Raw equity beta	A	0.64	0.64	0.64
Gearing of listed comparator	B	54.7%	62.8%	54.7%
Unlevered beta	C = A x (1 – B)	0.29	0.24	0.29
Debt beta	D	0.125	0.125	0.125
Asset beta	E = C + D x B	0.36	0.32	0.36
Notional gearing	F	60%	60%	55%
Re-levered beta for notional company	G = (E – (D x F)) / (1 – F)	0.71	0.60	0.64

Our current approach is the 'Enterprise value approach'. There are criticisms of this approach which have been made by some of the 2018 UKRN Study authors and also the 2018 Indepen report for Ofgem. Some argue that this approach leads to a notional equity beta which is volatile and unduly affected by share price movements in the listed comparators.

Alternatives include:

- 'Book value' approach – use book value gearing to unlever, and re-lever using notional gearing as normal
- 'Indepen' approach – use enterprise value gearing to unlever but adjust notional gearing when re-levering by estimate of notional company market-to asset premium (Indepen favour 1.1).

We welcome views on this issue.

Key issue: Parameter volatility

Illustrative impact of data changes to our updated cost of capital estimate, February – June 2019 (nominal)

	28 February 2019	28 June 2019	Change in DD WACC (bps)
Risk-free rate (15 year index-linked gilt yields)	1.54%	0.99%	-6
Unlevered beta (2 year daily data)	0.29	0.26	-21
Cost of new debt (iBoxx A/BBB index)	3.36%	2.61%	-9
Total:			**-37**

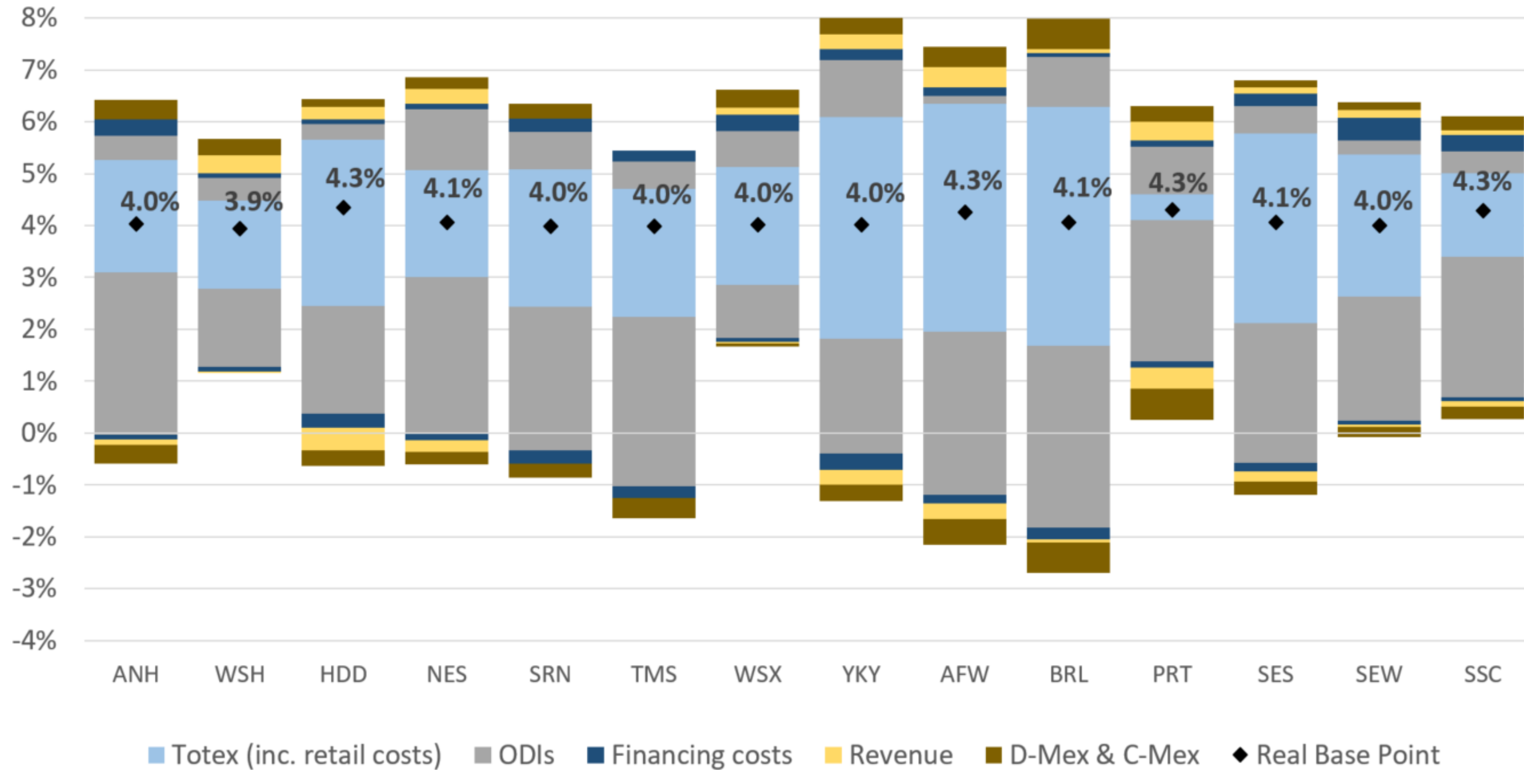
We will update our cost of capital estimate for final determinations in December 2019, drawing on more recent market data.

We assess that our draft determinations are financeable for the notional company structures. However, we set out that we seek further Board assurance from companies that they will remain financeable on a notional and actual basis in response to our draft determinations.

We expect companies to provide further Board assurance to confirm that they can maintain long-term financial resilience, taking account of the interventions we have made to their plans and the reasonably foreseeable range of plausible outcomes of their final determination including evidence of further downward pressure on the cost of capital in very recent market data.

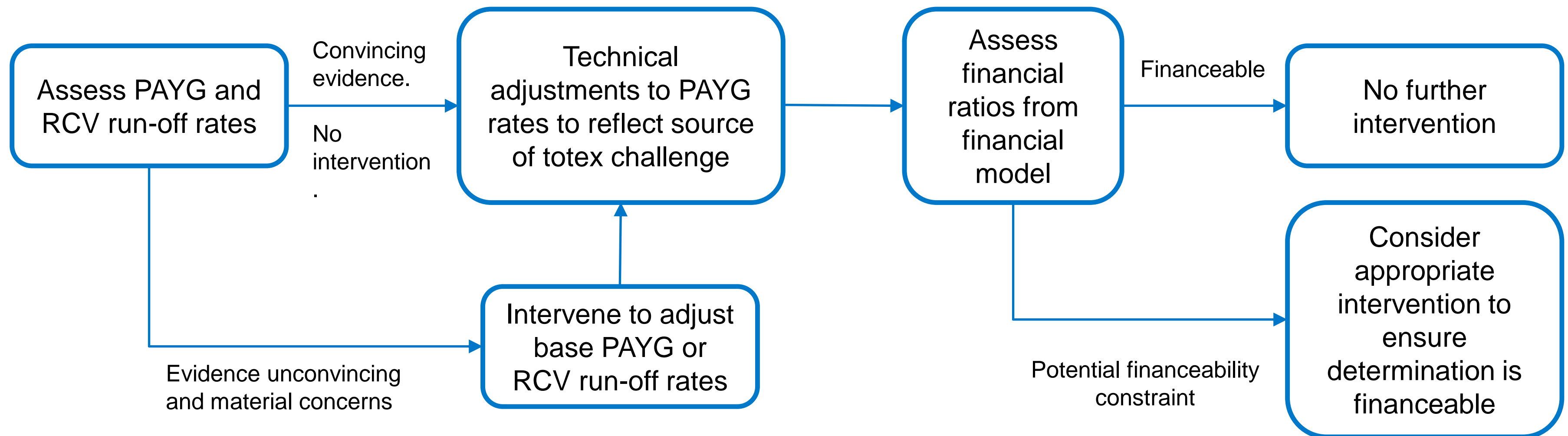
Risk and uncertainty

Draft determination RoRE ranges for the slow track and significant scrutiny companies



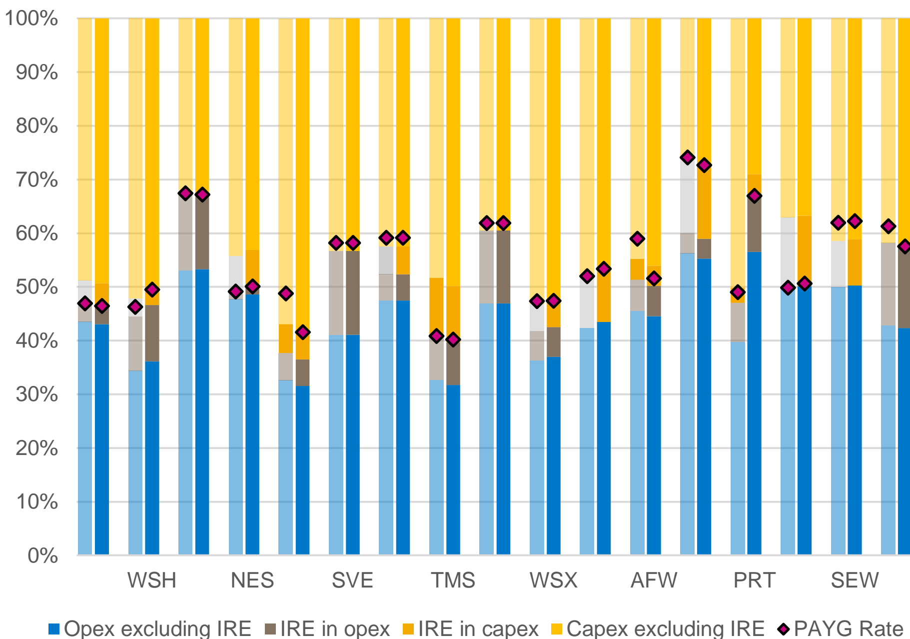
Financeability

Approach to cost recovery and financeability

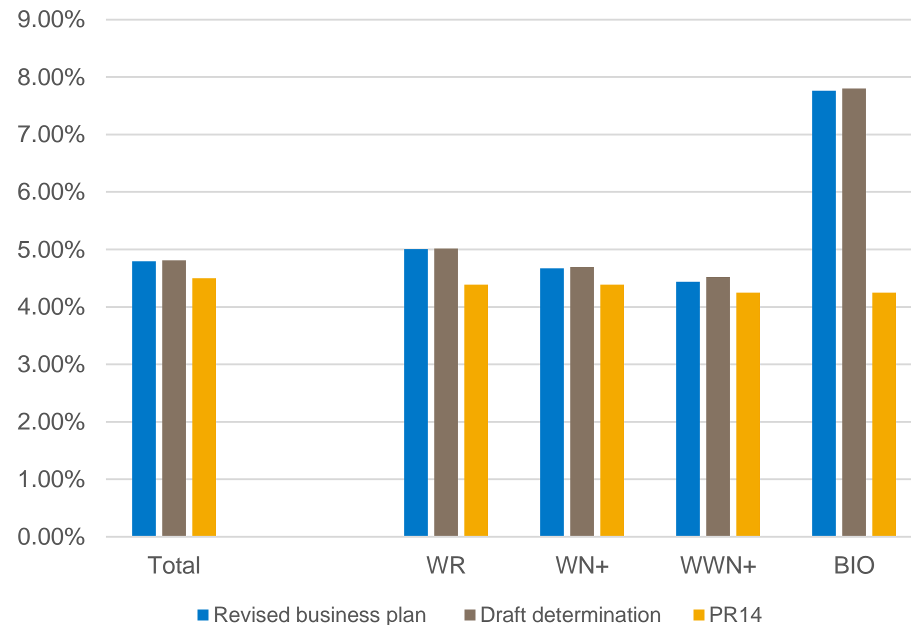


Cost recovery and financeability - interventions

Average pay-as-you-go rates for the period 2020-25 across the wholesale controls as a proportion of totex (business plan vs draft determination) (%)

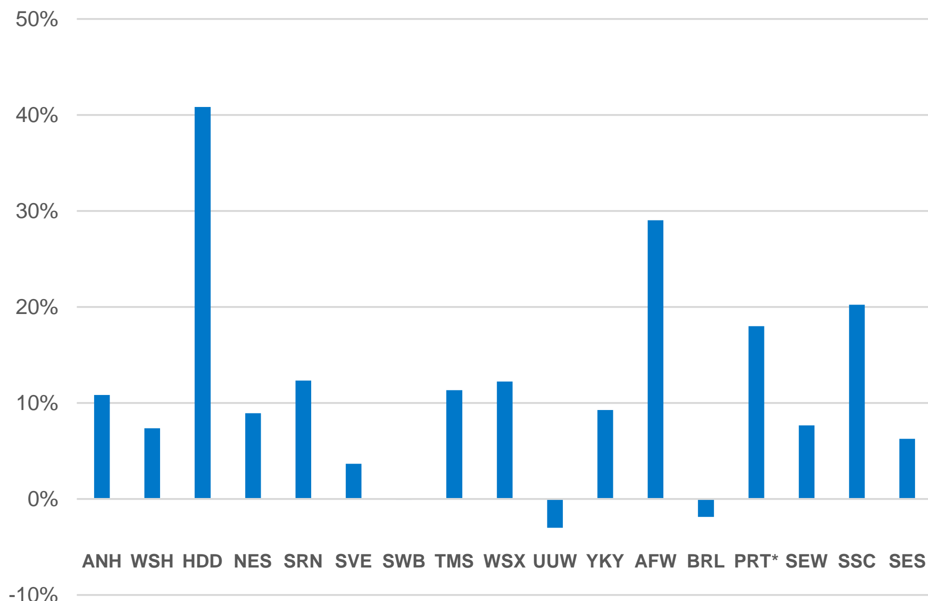


Average RCV run-off rates for each wholesale control (%)

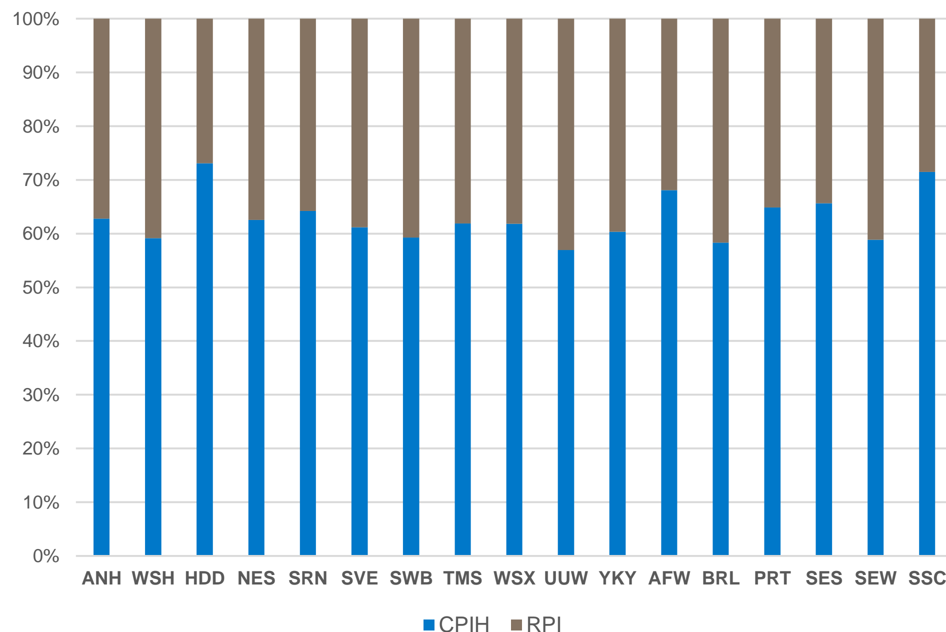


- We are intervening to remove revenue brought forward from future customers for Hafren Dyfrdwy, Southern Water, Wessex Water and South Staffs Water.
- We are intervening to reduce PAYG revenue brought forward from future customers for Affinity Water and Portsmouth Water
- We are intervening to bring forward revenue through an increase in PAYG rates for Dŵr Cymru, SES Water and Thames Water.

RCV – growth and composition by 2025



*The projected cumulative RCV growth for Portsmouth Water excludes the shadow RCV for Havant Thicket



Eight companies have RCV growth that exceeds 10% in real terms in our draft determinations:

- Portsmouth Water and Affinity Water, our financeability assessment assumes equity contributions are necessary in the notional company structure to finance investment.
- Southern Water, Thames Water and Wessex Water our assessment is that notional financeability can be maintained with reductions to the dividend yield we assume for the notional financial structure.

Putting the sector in balance

Dividend policy

- All companies have made firm commitments around transparency of their dividend policies for 2020-25 and have said that their dividend policy will take account of obligations and commitments to customers.
- However, the majority of companies have not provided sufficient explanation or evidence to explain precisely how they will demonstrate they will meet our expectations.
- We expect all companies to continue to take steps to meet our expectations. In particular we expect companies to demonstrate transparently that their dividend policy for 2020-25 takes account of obligations and commitments to customers and other stakeholders, including performance in delivery against the final determination.

Performance related executive pay

- Most companies have taken steps to demonstrate their performance related pay policies will link to performance that matters for customers.
- We expect each company to ensure its performance related executive pay policy demonstrates a substantial link to performance delivery for customers through 2020-25 and is underpinned by targets that are stretching.
- Trust and confidence can best be maintained where stretching performance is set by reference to the final determination and taking account of stretching regulatory benchmarks.
- We expect companies to commit performance targets will be continually assessed to ensure targets will continue to be stretching throughout 2020-25.

Gearing benefits sharing

- All companies have proposed to adopt a gearing outperformance mechanism. Three companies - Thames Water, South Staffs Water and Bristol Water - propose amendments to our default mechanism.
- We have assessed the proposals put forward by these companies, and on balance we have not accepted the amendments and propose that these companies should accept our default mechanism for the final determination.

Voluntary sharing arrangements

- For our Initial Assessment of Plans, we assigned actions to companies to include a sharing mechanism for Outcome Delivery Incentives which will share 50% of any outperformance above 3.0% of regulatory equity. Two revised business plans from Dŵr Cymru and Wessex Water include sharing proposals which go beyond this.
- Across the sector, some companies also committed to making company contributions to affordability support schemes over 2020-25, for example Hardship funds (most popular), Payment matching schemes and social tariffs (less popular).
- The total value of company contributions to affordability support schemes has reduced compared to business plans submitted in 2018.

Q&A