Ofwat's PR24 discussion paper on risk and return

Hafren Dyfrdwy response

2 February 2022

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Our response

We welcome the opportunity to respond to your discussion paper on risk and return.

At Hafren Dyfrdwy we have a high level of financial resilience reflected in our low level of regulatory gearing, and a responsible and limited use of financial derivatives. We are delivering improving operational performance for our customers and are the best performing water company on the DWI's water quality compliance risk index (CRI).

We recognise this is Ofwat's first discussion paper on risk and return for PR24, but at this stage we have fundamental concerns with Ofwat's proposed approach to risk and return at PR24. We consider Ofwat's proposals will not deliver the best outcome for customers and will reduce financial resilience.

We are very concerned about Ofwat's views on four elements of the **cost of equity**, which together would lead to a very substantial reduction in the cost of equity at PR24.

- First, we consider Ofwat should retain the CMA's **aiming up** on the cost of equity (i) because it is needed to promote efficient investment in the face of uncertainty, (ii) because nearly all companies, including Hafren Dyfrdwy, are earning below the base return in AMP7 and (iii) because Ofwat is proposing to make the ODI framework more downward skewed in AMP8.
- Second, we consider Ofwat should retain the CMA's approach to the **risk-free rate**, which sensibly takes account of the yield on AAA-rated non-government bonds.
- Third, we consider Ofwat should continue with the CMA's PR19 approach to the **total market return (TMR)**, which placed limited weight on forward-looking estimates of the TMR compared with estimates based on actual historical data.
- Fourth, we consider Ofwat should continue with the established approach in the water and energy sectors of de-levering and re-levering **beta** rather than using an approach based on the listed companies' market asset ratios (MARs). These MARs are high at present due to the high-performance of Severn Trent, United Utilities and Pennon, and are not representative of the whole sector.

Together, these proposals would result in a substantial reduction in the cost of equity, which Ofwat has not demonstrated is appropriate and would be based on a highly selective choice of data. The proposals for a lower cost of equity would work against Ofwat's aspiration in its financial resilience discussion paper of attracting more equity into the sector. We ask Ofwat to reconsider its overall approach to the cost of equity for its draft methodology in July.

We consider Ofwat should drop **the cost of new debt outperformance wedge** for PR24 because:

- first, it does not reflect market evidence, with the CMA removing the outperformance wedge at PR19 because it found the wedge did not exist once the timing and tenor of bond issues was controlled for; and
- second, the outperformance wedge could weaken financial resilience by incentivising water companies to issue more short-tenor debt, creating additional re-financing and interest rate risk for the sector.

We disagree with Ofwat's proposal to reduce the **notional company gearing assumption** at PR24. Although our regulatory gearing was temporarily 45.5% in March 2021, we are aiming to keep our regulatory gearing around 60% for AMP7 as Severn Trent agreed with you when Hafren Dyfrdwy was created. If Ofwat is concerned about highly geared companies, we suggest taking a targeted approach to those companies, rather than reducing the notional gearing assumption that affects all companies.

We consider it is really unhelpful for companies and their investors for the notional gearing assumption to vary every five years. We suggest Ofwat should be aiming for a notional capital structure that is stable and efficient over the long term. With interest rates persistently low and with the value of the tax shield increasing, we consider reducing notional gearing is going in the opposite direction to the long-term efficient level of gearing.

We disagree with Ofwat's conclusion that the changes it is proposing for the notional company capital structure will make **financeability** less of an issue at PR24. Ofwat is proposing to change this structure to make it appear more financeable. But this change would be unlikely to result in an efficient capital structure that will benefit customers or provide a return for equity investors that will encourage long term investment. As such, Ofwat's proposals undermine the role of the financeability cross-check as a constraint on the design of its price control. We consider Ofwat should revert to the established approach for the financeability test at PR24, in particular by leaving the key notional company assumptions unchanged. This would be in keeping with the CMA's final determination of PR19 where it said, "Our starting point is that the WACC is the primary factor in the redetermination ensuring that an efficient firm can finance its functions."

We strongly consider that **efficient swaps** should be included in the cost of debt allowance. Excluding swaps distorts the principle underlying the balance sheet approach, which is for the embedded cost-of-debt allowance to match sector-average financing costs. We note that when considering the average proportion of index-linked debt in the industry for the notional company, Ofwat has included swaps in its analysis. We currently have 100% of our index-linked debt linked to RPI. To make a transition to CPI/CPIH-linked debt it will be much more efficient to use swaps than re-financing RPI debt as CPIH debt (indeed it is highly likely there will not be enough investor demand for CPI/CPIH debt for companies to meet Ofwat's policy goals).

All that said, we do support change where there is evidence it is in customers' best interests. There are some areas where we support Ofwat's approach:

- We agree with Ofwat's criteria for **reviewing reconciliation mechanisms** to remove unnecessary ones. Given the small size of our wastewater business, with 21,000 connected properties, we would particularly welcome any simplification of the wastewater reconciliation mechanisms.
- We agree with creating more **consistency around risk ranges** for the notionally efficient company given that Ofwat will continue to use them to compare companies' price control packages. For Hafren Dyfrdwy, we ask for the risk ranges to take account of the potential volatility in our return on regulated equity (RoRE) resulting from our small size .
- We agree with **full indexation of the RCV to CPIH** from the start of the PR24 price control period given that RPI is no longer an official national statistic.
- We agree with Ofwat looking at a balance sheet approach for **the cost of embedded debt**, although there will be a need for Ofwat to consult on the methodologies it is considering.
- We support Ofwat considering **company-specific adjustments to the cost of debt allowance** for small company size at PR24. We support removing the benefits tests, which as the discussion paper says introduced complexity, imposed a considerable resourcing burden and was not used by the CMA in its PR19 determinations.

Conclusion

We recognise that Ofwat is still developing its thinking on risk and return and we're aware that Ofwat is working with the UK Regulators Network (UKRN) taskforce on the WACC. However, at this stage in the PR24 process we have fundamental concerns with Ofwat's proposals on risk and return.