Our Ref: PK/LAT/Ofwat

Your Ref:

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Dear Ofwat

Response to PR24 and Beyond: Discussion paper on risk and return Discussion Paper

Thanks for this opportunity to respond to the above discussion paper issued in late 2021. As always, we appreciate the early thinking provided by Ofwat in this area, and the related workshops facilitated by Ofwat across the sector on risk and return.

During PR19, as part of our business plan submission and the subsequent draft and final determinations from Ofwat, we raised our significant concern that short-term affordability was taking precedent over required investment for long-term resilience.

This concern remains from our review of this PR24 discussion paper. The changes proposed in this document would result in the sector requiring attracting further equity investment to address the proposed notional structure from Ofwat – and at a lower rate of return than the prior price review.

Given the focus of PR24 on the long-term in terms of customer service and the environment we consider the proposed changes in this discussion document directly conflict with such goals and would be considered detrimental to future investment in the UK Water sector.

Our responses to Ofwat's specific discussion questions are provided in the appendix to this paper. As always, we welcome further discussion with Ofwat on this matter in advance of their final PR24 methodology in late 2022.

Yours faithfully

[redacted]

Group Chief Financial Officer

Appendix I – SES Water's responses to discussion paper consultation

Q2.1: Do you agree with our principles for reviewing old and new reconciliation mechanisms and do you have suggestions for further reconciliation mechanisms which could be retired for PR24?

Response

We agree that the reconciliation mechanisms for PR24 should be considered based on materiality, appropriate risk allocation, and associated cost-benefit. In terms of changes to such reconciliation mechanisms, we recommend that land sales be included in one of the "in-period reconciliations" that have an RCV element - this simplification would be aligned to the cost-benefit principle.

In terms of other matters noted in this section of the discussion paper, we would support the ongoing shift to full CPIH. In addition, we support a separation of developer service from network plus control.

Q2.2: Do you have any comments on our proposed approach to producing risk ranges, including but not limited to: a) risk ranges for the efficient notional company prepared by Ofwat; and b) company-specific risk ranges produced by companies.

Response

Our preference is for Ofwat to develop risk ranges for a notional company, with an ability for company-specific adjustments. This option would ensure both consistency and flexibility.

However, we do not support the additive approach to risk ranges (compiling risk ranges from individual factors), which Ofwat have also indicated is not their preference in PR24. This additive method oversimplifies consideration of risks, as risks are often correlated to certain extent and do not operate in isolation. An additive approach assumes that downside ODI is not correlated to Totex, CMex, etc. which is not appropriate (for example as all risks can be affected by a single event (e.g. Covid or a regional environment incident).

We are pleased to note that Ofwat have acknowledged that the particular risk characteristics faced by Water Only Companies (WOCS) merit further analysis (and potentially a different approach to modelling) and that Ofwat will perform further analysis of RoRE for WOC vs WaSCs. Along with our WOC colleagues, we would be pleased to engage in this matter further with Ofwat.

Q3.1: How should we reflect the period affected by Covid-19 in our approach to estimating beta?

Response

Consideration of the period affected by Covid-19 on estimated beta should be data driven. Full benchmarking analysis for the pre-lockdown, lockdown and post-lockdown periods, together with lag effects, should be performed and assessed. In addition, even though Covid-19 has affected both global and national economies, its impact widely varies across sectors and industries. Therefore, a beta produced from the covariance-variance ratio between individual markets should be subject to more granular analysis and adjustment if necessary.

Q3.2: Noting the impact of gearing on betas discussed in the report by Professors Mason and Wright, how should we adapt our approach to specifying beta for a company at the notional gearing?

Response
We agree with Mason and Wright discussion point that de- and re-leveraging from a listed comparator company may not be necessary. However, we urge Ofwat to be cautious in respect of the conclusion about the invariant relationship between WACC and gearing.

Q3.3: How should we convert RPI-linked yields into their CPIH-linked equivalent when deriving a RFR point estimate?

Response
We support the continued use of deflated nominal yields on the CPIH basis. However, the Bank of England's inflation target of 2% should be subject to review, given the recent economic volatility that have resulted in higher inflation rates.

Q4.1: Do you agree with our proposed role for benchmark bond indices in cross-checking a cost of debt allowance based on a balance sheet approach?

Response
We agree with the use of bond indices in cross-checking cost of debt based on a balance sheet approach. We note that having both the sample of 17 water companies and the benchmark indices, with appropriate weight in estimating the cost of debt would reflect both water industry reality and tie the industry to the wider economy as a whole. Having balance sheet data only would detach the industry from the economy's average cost of debt and may entail perverse incentives of self-referencing in borrowing decisions.

Q4.2: Given the persistent issuance discount of water company bonds against the iBoxxx A/BBB index, how should this be reflected in our new debt allowance-setting?

Response
We would support the use of both average and standard deviation of issuance discount of water company bonds against the iBoxxx as a guide to set new debt cost allowances. However, these statistics should be split by periods of different characteristics. The sample period provided in Figure 4.1. happens to be a Covid impacted year when overall market risks tend to be higher and water companies might have been considered as safe investment. This may no longer be the case going forward.

Q4.3: Do you agree with our proposal to restrict company specific adjustments to reflect only factors due to small size, and to remove the benefits test?

Response
We are pleased that Ofwat have acknowledged that in exceptional circumstances a case may be made for a higher cost of debt allowance and that the benefits test applied for the company specific adjustment at PR19 introduced complexity, imposing a considerable resourcing burden on all parties. We therefore support that a company specific adjustment reflects only factors related to size, and to remove the benefit test.

Q5.1: Do you agree with the framework we have set out for determining an appropriate notional structure for PR24 and beyond?

Response
We agree with the framework for determining an appropriate notional structure for PR24 and beyond but are concerned that proposed changes to the level of notional gearing would result in

the raising of additional equity at lower return when the sector is faced with considerable investment challenges.

Q5.2: Do you agree with proportion of index-linked debt should be increased and what are your views on the composition of index-linked debt for PR24?

Response
We agree that the proportion of index-linked debt should be increased. The range of 33-53% would be reasonable.

Q6.1: Do you agree with our proposed framework to evaluate the transition to CPIH indexation, and our proposal to transition fully at the start of PR24?

Response
We agree with the framework to evaluate the transition to CPIH indexation and full transition to start at PR24.

Q7.1: Do you agree that financeability is likely to be less constrained at PR24 than at PR19?

Response
We do not see that financeability is likely to be less constrained at PR24 than at PR19. We consider that the changes proposed in this discussion document would result in the sector requiring attracting further equity investment to address the proposed notional structure from Ofwat – and at a lower rate of return than the prior price review.

Given the focus of PR24 on the long-term in terms of customer service and the environment we consider the proposed changes in this discussion document directly conflict with such goals and would be considered detrimental to future investment in the UK Water sector.

Q7.2: Do you agree that real RCV growth should be funded through a combination of debt and equity such that gearing of the notional company remains consistent with the notional gearing set at the start of the control period?

Response
We agree that real RCV growth should be funded through a combination of debt and equity.