South Staffs Water
Green Lane, Walsall WS2 7PD
www.south-staffs-water.co.uk

By email: [redacted]

2 February 2022

Dear Ofwat,

PR24 and beyond: Discussion paper on risk and return

We welcome the discussion paper on proposals for risk and return at PR24 and that there is recognition that smaller companies face certain challenges compared to larger ones. We support Ofwat's review of PR19 performance data to understand any differences in risk and performance between WoCs and WaSCs.

We also agree with the proposal that the benefits test should be removed as part of the justification for a company specific uplift to the cost of debt. We do however propose that the choices made around the timing and tenor of debt should be included in any assessment if companies demonstrate that the debt was secured efficiently at the time of issue.

More generally, we have a particular concern around the direction of travel for the WACC which could have significant consequences for the sector:

- Removing the 'aiming up' on the cost of equity which could make the sector less attractive to investors, increase pressure on financial metrics and reduce incentives to invest;
- Removing the adjustment to the equity beta to reflect the difference between observed gearing and notional gearing;
- Significantly increasing the outperformance on the cost of new debt by basing it on a short time period which covered the covid-19 pandemic that may have led to a 'flight to quality' for debt holders;
- Reducing the notional gearing further away from the industry position without evidence as to why the current 60% level is inefficient or increases risk.

Please refer to the remainder of this document for our specific responses to the questions in the discussion paper.

Yours sincerely

[redacted]

Strategy and Regulation Director

PR24 and beyond: Discussion paper on risk and return

South Staffs Water and Cambridge Water consultation response

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?

We support the streamlining of reconciliation mechanisms which have added a significant level of complexity to the regulatory framework. We agree with the application of the three criteria of materiality, risk allocation and cost/benefit.

We think the approach could be improved further by adding a trigger threshold to mechanisms so that the true-up is only applied above a certain level. This could be calibrated based on % of revenues or % of RCV. This would help to make the process more efficient and allow companies and Ofwat to concentrate on the most significant mechanisms.

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.

Although we support the approach, we would like to understand better how Ofwat will take company specific risk ranges into account.

We saw in 2020-21 for example that our RORE was negative, driven by a significant financing underperformance reflecting the difference between the interest rate assumed at PR19 and our actual rate predominantly made up of RPI-index-debt. This is likely to persist throughout the whole period and possibly beyond if the same approach is taken at PR24. This limits the usefulness of the RORE analysis when comparing to the Final Determination and we would like to see company specific risk ranges also being set out in PR24 Final Determinations where there are material differences to the notional risk range.

We support Ofwat's review of PR19 performance data to understand any differences in risk and performance between WoCs and WaSCs. However, we think that the analysis should focus on the difference between the water service and wastewater service rather than simply between WoCs and WaSCs.

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

We would support an approach similar to the CMA where less weight is placed on beta estimates from March 2020 if it is materially lower than pre-covid levels.

Analysis should be undertaken to understand the length of period over which any adjustment should be made. More recent data may suggest that the beta has returned to historic levels as a result of less severe restrictions.

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?

We support the approach used at PR19 where observed gearing of listed companies is adjusted to match the notional level of gearing.

We do not agree it is correct to adjust listed company gearing to take account of the market value of debt, pensions and derivatives. We note the Mason and Wright report, however other academics and commentators disagree with their view. (Specifically, in the UK Regulators Network Study in 2018[1] authorised by Messrs Mason, Wright along with Philip Burns, there was disagreement on this point amongst others). Burns states:

'What de-levering and re-levering achieve is to take the actual gearing level of the beta comparators out of the beta estimates and to assess what the equity beta of a company with similar risk would be, at an independently estimated 'notional gearing' level. It is therefore not equal to the actual observed equity beta of comparators unless those comparators happen to have an actual gearing level equal to the 'notional gearing level'.

Therefore we continue to believe the established precedent of de-gearing the listed company data and re-gearing to notional assumptions is valid.

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

We recognise the difficulties in converting RPI-linked yields to their CPIH equivalent and think that consideration should be given to using a base position of deflating nominal gilts by the 2% Bank of England CPI target with a cross check for the OBR forecasts of CPI at the time of setting the price review spot rate.

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?

We can see that the approach to using industry balance sheet data would work for those companies that can benefit from the portfolio effect of holding a varied mix of debt. However it would not reflect the higher embedded debt costs that smaller water only companies face. This should be accounted for by setting a separate cost of embedded debt as part of a company specific adjustment (see our answer to q4.3 below).

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?

We do not support a further outperformance adjustment to the cost of new debt. The evidence used to show issuances have been at 55bps below iBoxx is only based on a recent 18-month period which is not statistically significant. The CMA did not apply any outperformance, recognising the difficulty in measuring an exact comparison of bonds, tenor and credit rating between a relatively small sample of company bonds and a broad index

It should also be noted that small companies are unlikely to achieve any outperformance on the cost of new debt due to the size and frequency of issuance. We think that Ofwat should consider a different cost of new debt for small WoCs by setting a separate rate as part of a company specific adjustment.

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?

We support the removal of the benefits test, although we recognise that Ofwat's proposal to require companies to demonstrate customer support for any adjustment means that the difficulty in explaining the issue to customers still remains.

We do not agree that the choices made around the timing and tenor of debt should be excluded from any assessment. The financing options available to small companies have always been very different to those available to larger WOCs and WASCs and as such, the index-linked Artesian bonds raised by South Staffs and other small WoCs provided a competitive and long-term source of financing and represented an efficient strategy at the time when they were raised. Where companies can demonstrate that that the debt issued was efficient, it should be allowed in full as part of any specific uplift.

To avoid the need to revisit the allowance for a company specific adjustment at each Price Review, we think that once it can be demonstrated that embedded debt was taken out efficiently, it should then be allowed at subsequent reviews until the debt matures. This should also apply to new debt taken out going forward each year.

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

We do not agree that the notional level of gearing should be reduced below the current 60% level as we have not seen any evidence that this is inefficient or exposes customers to an unacceptable level of risk. We think that the current level still provides headroom for any significant uplift in investment at PR24.

Ofwat themselves have a duty to ensure that companies are appropriately funded to finance their functions and this includes setting a WACC and capital structure commensurate with the target rating required by the sector. For example, Moody's guidance for a target rating of Baa2 is a gearing level of greater than 72%.

Any reduction in the gearing assumption for the notional structure will also move it further away from the sector level whose average in 2020-21 was above 70%, with only two companies at or below the notional gearing level.

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

We support the increased proportion of index-linked debt which better reflects actual company structures.

As recognised in the discussion paper, the vast majority of index-linked debt is RPI linked. These sources of finance tend to be have long tenors and so we think that the majority of debt should still be assumed to be RPI-linked during the PR24 period. We do not think that it is realistic that the notional company would have entirely CPIH-linked debt.

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?

We recognise the benefits from moving to full CPIH-indexation at the start of PR24. However, it will increase the mismatch between RCV growth and Ex-Ante RPI-linked debt and we would therefore support an allowance to recognise the basis risk that companies will face with such a mismatch.

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

Although financeability may be less constrained at PR24 as a result of switching to full CPIH-indexation, there are a number of offsets to this:

- There is likely to be a significant uplift in the capital programme to address future challenges such as climate change and net zero commitments.
- The level of long-term RPI-linked embedded debt which will continue to put financial metrics under pressure if not appropriately funded.
- Moving the notional company further away from industry position means that the improvement in perceived financeability is not aligned to the reality that companies are operating under.

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?

From the discussion paper, the main driver for keeping the notional gearing level constant is to resolve a financeability constraint. However, interest cover metrics used by credit rating agencies, such as the Moody's AICR, are insensitive to equity injections. These metrics can only be improved by securing an appropriate return and sufficient revenues.