Ofwat's discussion paper on risk and return at PR24

Severn Trent Water response

2 February 2022

WONDERFUL ON TAP

SEVERN TRENT

Contents

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Dear Aileen,

SEVERN TRENT'S RESPONSE TO OFWAT'S DISCUSSION PAPER ON RISK & RETURN AT PR24

I welcome the opportunity to contribute to the development of the approach to risk and return at PR24.

At Severn Trent we support Ofwat's vision of a water sector that provides high-quality services that reflect customers' expectations, delivers environmental improvements including healthy rivers and net-zero carbon emissions and continues to provide one of the most affordable water services in the world.

Severn Trent is a high-performing company across many measures. Ofwat recognised Severn Trent as an industry leader on financial resilience in its Financial Resilience Report 2020-21 and placed Severn Trent in the sector-leading category in its Service and Delivery Report in December 2021. The Environment Agency awarded us 4-star status (the top grade) in July 2021 for environmental performance for the second year in a row. For the DWI, we are the best performing water and sewerage company on its water quality compliance risk index (CRI).

We find ourselves in the unusual position of having fundamental concerns with Ofwat's proposed approach to risk and return at PR24, which we consider will not deliver the best outcome for customers, will reduce financial resilience and will result in disproportionate burdens for listed companies.

We have five fundamental concerns with Ofwat's approach.

Concern 1: The cost of equity

I believe we all agree that there are inevitable uncertainties associated with estimating the cost of equity, which is not directly observable. These uncertainties will be more pronounced if Ofwat is considering using new data sources and approaches. Such uncertainties make it critical that Ofwat takes a balanced approach to the cost of equity assessment. We are very concerned about the cumulative effect of Ofwat's views on four elements of the cost of equity:

- **Removing aiming up** – We disagree with Ofwat rejecting aiming up on the cost of equity. We are disappointed that after the CMA's independent, expert and in-depth analysis of aiming up on the cost of equity, Ofwat is rejecting aiming up and effectively proposing to reduce the cost of equity by 25 basis points. The CMA identified a number of reasons why aiming up is beneficial, including to promote efficient investment. Ofwat's consultation suggests that there is no need to aim up on the cost of equity because it will make sure the price control incentives are balanced. However, Ofwat's own financial monitoring report for 2020-21 shows that the PR19 regulatory package is already downward biased, with the sector earning a 2.29% return on regulated equity (RoRE) compared with the PR19 base return of 4.05%. In addition, the recent Ofwat consultation on outcomes proposes significantly reducing the use of bespoke ODIs, which will create further downward bias in the ODI package in AMP8. By way of illustration, in 2020-21 removing bespoke ODIs would have left a £117m net penalty for the sector, equivalent to a 40 basis points reduction to the cost of equity. This suggests that the PR24 package will be more downward skewed than the PR19 package on which the CMA considered aiming up was necessary.

- **The risk-free rate (RFR)** – We disagree with Ofwat rejecting the CMA's changes to the RFR, which would effectively reduce the cost of equity by around 10 basis points. There is no theoretically definitive answer to the correct RFR to be used in the CAPM model, however, the CMA considered the yield on AAA-rated non-government bonds to have exceptionally low default rates, making it a suitable input into the RFR estimate. Given this context, we support the CMA's PR19 approach of a RFR above the return available from index-linked gilts, but below the level suggested by the return on AAA bonds, taking the mid-point between the two. We also disagree with Ofwat that there is evidence to reduce the long-term RPI-CPIH wedge in the RFR calculation from the 1% used at PR19, or that investors in index-linked gilts would accept a lower total yield if the wedge tapered down to zero.

- **Total market returns (TMR)** - We disagree with Ofwat rejecting the CMA's approach to TMR, which would effectively reduce the cost of equity by around 25 basis points. After considering the TMR, the CMA concluded that it should place limited weight on forward-looking estimates of the TMR compared with estimates based on actual historical data. We consider Ofwat should continue with the CMA's PR19 approach to the TMR.

- **The calculation of beta** – Professors Mason and Wright mention five alternative approaches to calculating beta compared with water and energy sector established practice. The approach Ofwat refers to in its discussion paper uses the listed companies' market asset ratios (MARs). We disagree with this approach, which would reduce the cost of equity by around 70 basis points. First, using listed companies' MARs would be a selective use of data, that has the appearance of credibility only because MAR gearing and Ofwat's proposed notional gearing just happen to be similar currently. Second, the listed companies' MAR premia are due to the high-performance of Severn Trent, UU and Pennon, which are not representative of the whole sector. Third, the approach is inconsistent with CAPM theory, whereby the market value of the (neutral performing) notional company should equal the RCV if the cost of equity is set correctly. We consider Ofwat should continue with the established approach in the water and energy sectors of de-levering and re-levering beta.

Together these proposals would result in a substantial reduction in the cost of equity of approximately 130 basis points compared with the CMA's PR19 final determination, which Ofwat has not demonstrated is appropriate and would be based on highly selective use of data. The changes Ofwat is considering for outcomes are likely to lower the effective cost of equity by a further 40 basis points.

Setting the cost of equity at such a low level would discourage innovation, stifle efficiencies and penalise investment in the sector because companies will be insufficiently rewarded for putting their capital at risk. 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 urge Ofwat to reconsider its overall approach to the cost of equity for its draft methodology in July.

Concern 2 – The cost of new debt

We fundamentally disagree with Ofwat's premise in question 4.2 that there is a "persistent issuance discount of water company bonds against the iBoxxx A/BBB index" and that there might be a case for applying an outperformance adjustment. The CMA removed the **outperformance wedge** at PR19 because it found the wedge did not exist once timing and tenor was controlled for. We consider Ofwat's analysis of its Figure 4.1 is misleading. The dots under the index line occur when the new debt issue was short-dated at tenors below 10 years. The 15-30 years new debt issues are much closer to or on the line as expected. Reinstating the wedge could incentivise water companies to issue more short-tenor debt, creating additional re-financing and interest rate risk for the sector, which would be at odds with Ofwat's financial resilience aspirations for the sector. We consider Ofwat should drop the cost of debt outperformance wedge for PR24 because it does not reflect market evidence and could weaken financial resilience.

We strongly consider that **efficient swaps** should be included in the cost of embedded debt allowance. Excluding swaps distorts the principle underlying Ofwat's proposed balance sheet approach, which is for the embedded cost of debt allowance to match sector average financing costs. We also note that Ofwat has included swaps when estimating the proportion of index-linked debt in the water sector.

Concern 3 – The notional capital structure

We fundamentally disagree with Ofwat's proposed changes to the notional capital structure assumptions. The purpose of the notional capital structure is to represent an efficient, financially resilient capital structure, so that Ofwat does not have to take account of inefficient or risky capital structures when considering financeability. It also means that companies' shareholders assume the risks of deviating from the notional company capital structure.

As such, any changes to the notional capital structure should be driven by compelling evidence that it has become inefficient, or no longer provides appropriate financial resilience. Ofwat has provided no such evidence. Indeed, its proposal to reduce gearing at a time of abundant debt finance at historically low cost, benefitting from an increased tax shield, would seem to most stakeholders to be heading in the opposite direction to an efficient capital structure. The proposed changes therefore appear more motivated by the objective of making the notional company look financeable (as measured by one credit metric) at a much lower cost of equity allowance.

We are very concerned about three elements of the notional company assumptions:

- **Notional gearing -** We fundamentally disagree with any reduction in the notional gearing assumption. Aside from there being no evidence that it is needed, it is unhelpful for investors (particularly those of the listed companies) for the notional gearing assumption to vary every five years, especially by the unprecedented five percentage point reduction Ofwat is considering for AMP8. The assumption that equity finance is readily available and "on tap" to meet a moving gearing target fundamentally misunderstands the importance of stability – both in the regulatory framework and equity distributions. Listed company investors value such stability and are willing to accept the sector's relatively low cost of equity in return. Without compelling evidence that a change in the notional gearing level is needed for efficiency or financial resilience such a change would undermine confidence in the sector and likely increase expected equity returns. We consider Ofwat should be aiming for a notional capital structure that is stable and efficient over the long term

Ofwat's proposal would also imply that a sector leading company on service performance and financial resilience, such as Severn Trent, would have to raise significant amounts of equity in 2025-30 (or ask its shareholders to forego more than two years' worth of dividends) to remain financeable, which cannot be right. A listed company making such a request (as distinct from a request to fund exceptional growth opportunities such as the Green Recovery) might be taken as a sign of financial distress by the financial markets and equity investors would require a higher return for their new equity. Ofgem recognised in its RIIO-2 final determinations that raising equity is expensive, by giving companies a 5% equity issue allowance. It is not clear that these extra costs are in customers' best interests.

If the intention is to discourage companies away from highly geared capital structures, we believe that an approach that targets those companies would be more appropriate than reducing the notional gearing assumption, which affects all companies including the best performers. We suggest approaches for improving financial resilience in our recent response to Ofwat's financial resilience discussion paper.

- **Proportion of index-linked debt** - We fundamentally disagree that there is a need to increase the proportion of index-linked debt above 33% in the notional capital structure. Ofwat justifies increasing the proportion of index-linked debt in the notional capital structure because it moves the proportion towards the actual sector average. This is inconsistent with Ofwat's approach to gearing (where it is proposing moving the notional gearing assumption away from the actual sector average). In addition, the industry average for index-linked debt includes swaps, which Ofwat says it will not consider in the context of the cost of embedded debt. Also, the industry average is pushed higher by highly-securitised companies that use index-linked debt to achieve higher levels of gearing, meaning the industry average is unlikely to be a fair reflection of an efficient capital structure.

  Index-linked debt markets tend to be less liquid and more expensive than nominal debt markets, with investors usually requiring a "linker premium", which can be around 10-15 basis points. The higher proportion of index-linked debt proposed would increase borrowing costs for companies, and eventually feed into higher customer bills.

  Ofwat commented disapprovingly in its recent discussion paper on Financial Resilience on the risky use of swaps "to alter the profile of cash interest payments, for example, to reduce short-term effective interest costs at the expense of highly likely future cash outflows, without any improvement in long term, underlying financial resilience". But by increasing the proportion of index-linked debt for the notional company, Ofwat is effectively advocating a similar outcome, one that achieves lower interest payments in the short term (we assume to improve credit metrics at a lower weighted average cost of capital (WACC) allowance) by deferring the cost of servicing debt onto future generations of bill payers.

If Ofwat does demonstrate that increasing the proportion of index-linked debt for the notional company at PR24 is in customers' interests, we consider it should provide an allowance for companies (which will need to be higher than Ofgem allowed in the energy sector due to higher levels of RPI-linked debt). In our view, Ofwat should also recognise that the efficient way to increase index-linked debt is very likely to involve swaps; the index-linked debt market is simply not big enough for companies to maintain a higher proportion of index-linked debt higher without the efficient use of swaps.

- **Notional dividends** – We fundamentally disagree with Ofwat's proposal to adjust the dividend assumptions in the notional capital structure on a company-by-company basis as this represents a further method for reducing the cash the notional company needs to remain financeable. Such company-by-company adjustments go against Ofwat's view that "decisions about the declaration and payment of dividends are the responsibility of the board of each company" in its Financial Resilience discussion paper.

Concern 4: The financeability test

We fundamentally disagree with Ofwat's conclusion that the artificial changes it is proposing for the notional capital structure will make financeability less of an issue at PR24.

We believe that Ofwat should first determine an efficient notional capital structure and then assess whether there are any financeability issues that require an increase in the cost of equity. Ofwat is instead proposing to change the notional company capital structure (arguably making it less efficient) to make it appear more financeable. In extremis, Ofwat could make the notional company appear even more financeable by lowering notional gearing further, raising the proportion of index-linked debt higher and reducing the notional dividend assumption. But this would be unlikely to result in an efficient capital structure that benefitted customers or provided a return for equity investors that encouraged 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."

Concern 5: Real RCV growth funding

We believe that companies should have the flexibility to determine how to fund real RCV growth, within acceptable financial resilience parameters and this should be reflected in the notional capital structure. Companies like Severn Trent have demonstrated that they can combine responsible funding of real RCV growth with a stable dividend policy that is attractive to investors (including retail customers, pension funds and insurance funds) who are willing to accept the sector's relatively competitive cost of equity in exchange for a predictable income stream. Ofwat's proposal for the notional capital structure assumes equity is as flexible a source of finance as debt, which is not the case in the real world. It gives primacy to the achievement of a gearing target, implying companies can and should annually flex dividends or raise equity capital to meet it, with no adverse consequences. This would further undermine the listed companies' ability to provide the stable, predictable dividend returns that are valued by investors and which benefit customers through a relatively competitive cost of equity.

Areas of agreement

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 and allow for new ones, which, for example, might be needed for the adaptive planning approach that Ofwat has consulted on.
- 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.
- 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 Ofwat will need to consult on the methodologies it is considering.

Overall view

We recognise this is Ofwat's first discussion paper on risk and return for PR24 and that Ofwat is still developing its thinking. We also recognise Ofwat is currently working with the UK Regulators Network (UKRN) taskforce on the WACC. However, we have fundamental concerns with Ofwat's proposals as they currently stand and we would welcome early engagement with senior staff.

Yours sincerely,

Shane Anderson
Director of Strategy and Regulation
Severn Trent Water

Response to questions

Chapter 2 - Balance of risk and return

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 Ofwat's criteria for assessing the continuing need for reconciliation at PR24 i.e. materiality, efficiency of risk allocation and cost-benefit.

We strongly support removing developer services from the network plus price control and instead relying on competition and charging rules to achieve customers' best interests. This would allow the removal of the Developer Services Reconciliation Adjustment (DSRA).

We support indexing the RCV to CPIH from the start of the control period and removing the RPI-CPIH wedge reconciliation.

On a practical note, we consider the spreadsheets used for reconciliation mechanisms at PR19 could be made much simpler at PR24. Ofwat could consider whether some of the models could be combined, so that there are not multiple transfers between models. In addition, we think that the approach to implementing "FAST" models could be streamlined. The aim of the FAST approach is to improve transparency, but if the implementation makes models unnecessarily large and complex then we do not think this objective is being achieved.

Another simplification Ofwat could consider for PR24 is changing the form of control in the licence, so that the wholesale revenue controls are defined as a sum of revenue. This would greatly simplify in-period determinations as it would no longer be necessary to calculate changes to the "K" factor.

We support Ofwat looking again at interim determinations and whether it would be beneficial to provide guidance on how they work. The wording in the licence is dated and hard to follow.

In relation to Covid-19 effects, we wrote to Ofwat on 6 September 2021 about a revenue forecasting incentive (RFI) penalty we incurred for 2020-21, which was due to the unprecedented Covid-19 pandemic and does not reflect poor forecasting by us. Ofwat replied to us on 24 November 2021 saying that it will consider the RFI as part of PR24. This reconciliation, as well as others such as for per capita consumption (PCC), will be important at PR24 to take account of Covid-19 effects.

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.

We support more detailed guidance for companies on calculating RoRE ranges as part of PR24 to increase comparability. We agree that Ofwat will not be able to achieve full comparability but given that Ofwat will in any case compare these RoRE ranges across companies, more comparability seems appropriate.

As we explained in our covering letter, we fundamentally disagree with the changes Ofwat is proposing for the notional company. Therefore, Ofwat focussing on notional company risk analysis will be distorted if the notional company assumptions are inappropriate.

Differing from Ofwat's view, we consider an upwardly or downwardly skewed RoRE risk range can indicate an expectation of RoRE reward or penalty. We expect most stakeholders will reach the same view when looking at skewed RoRE ranges.

We agree that cross-impact correlations and Monte-Carlo simulations, which we carried out at PR19, might capture overall risk more accurately. However, there use should be proportionate given the effort involved and the limited accurate information that is available on correlations and probabilities.

Chapter 3 – Allowed return on equity

In the covering letter we emphasise that there are inevitable uncertainties associated with estimating the cost of equity and that it is critical Ofwat takes a balanced approach to the cost of equity assessment at PR24. We explained in the covering letter that we fundamentally disagree with Ofwat's proposed approach to aiming up, the risk-free rate (RFR), Total market returns (TMR) and the calculation of beta.

Together these proposals would result in a substantial reduction in the cost of equity of approximately 130 basis points compared with the CMA's PR19 final determination, which Ofwat has not demonstrated is appropriate and would be based on highly selective use of data. The changes Ofwat is considering for outcomes are likely to lower the effective cost of equity by a further 40 basis points. Setting the cost of equity at such a low level would discourage innovation, stifle efficiencies and penalise investment in the sector because companies will be insufficiently rewarded for putting their capital at risk. 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 urge Ofwat to reconsider its overall approach to the cost of equity for its draft methodology in July.

The discussion paper makes some more detailed points on the cost of equity that are not covered by the questions, so we have put our views below.

- We consider there are pros and cons to **indexing the RFR in allowed return on equity**. We agree this would add complication and could increase uncertainty, but it could also reduce the scope for windfall gains or losses for companies and customers due to changes in the RFR during the price control period.

- We agree with retaining the **capital asset pricing model (CAPM)** as the main tool for estimating the cost of equity. We support using cross-checks outside the CAPM framework to gain assurance over CAPM estimates.

- We have concerns with Ofwat's proposed use of **Market-to-Asset Ratio (MAR) analysis** as a cross check on the CAPM because it involves the selective use of data, given MAR evidence is only available from the high-performing companies of Severn Trent, UU and Pennon, therefore making it unrepresentative of the whole sector.

- We agree with Ofwat considering evidence from **a range of estimation periods and frequencies** to inform its best view of beta.
- We would like to see the ONS's view of the quality and suitability of using its new **CPIH back series** for financial purposes, when it is available, before forming a view on whether using that series to deflate historical equity returns would be appropriate.

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

In the CAPM the beta is intended to capture a share's variance relative to the overall market over the long-run. We therefore suggest Ofwat should be careful to avoid beta estimates being distorted by the Covid-affected period.

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?

Professors Mason and Wright mention five alternative approaches to calculating beta compared with water and energy sector established practice. The approach Ofwat refers to in its discussion paper uses the listed companies' market asset ratios (MARs). We disagree with this approach, which would reduce the cost of equity by around 70 basis points. First, using listed companies' MARs would be a selective use of data, that has the appearance of credibility only because MAR gearing and Ofwat's proposed notional gearing just happen to be similar currently. Second, the listed companies' MAR premia are due to the high-performance of Severn Trent, UU and Pennon, which are not representative of the whole sector. Third, the approach is inconsistent with CAPM theory, whereby the market value of the (neutral performing) notional company should equal the RCV if the cost of equity is set correctly. We consider Ofwat should continue with the established approach in the water and energy sectors of de-levering and re-levering beta.

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

We consider the most robust approach is to use the established long-term RPI-CPIH wedge based on the average "formula effect". Ofwat used 1% at PR19 and the CMA updated this to 0.9%. The discussion paper does not provide evidence that investors are pricing RPI reform into bond yields and that Ofwat should move away from the established RPI-CPIH wedge. In fact, the short-term wedge is currently around 2% rather than falling below 1%.

For bonds that mature before 2030, the RPI reform in 2030 should have no influence and we consider Ofwat should take this into account.

It is also worth considering the effect on the real yield. It would not reflect real-world investor behaviour if Ofwat reduced the RPI-CPIH wedge and did not change the underlying real rate. There is no reason to expect that a reduction in the inflation-based component of index-linked gilts should result in investors accepting a lower total yield. All else being equal, if the long-term RPI-CPIH wedge that investors price in is expected to taper down towards zero then one would expect the real yield that investors require to increase by the same amount.

We consider that using a long-term view of the RPI-CPIH wedge of around 1% is consistent with Ofwat's proposals not to index the RFR and not to use forward-looking evidence for the risk-free rate.

Chapter 4 - Allowed return on debt

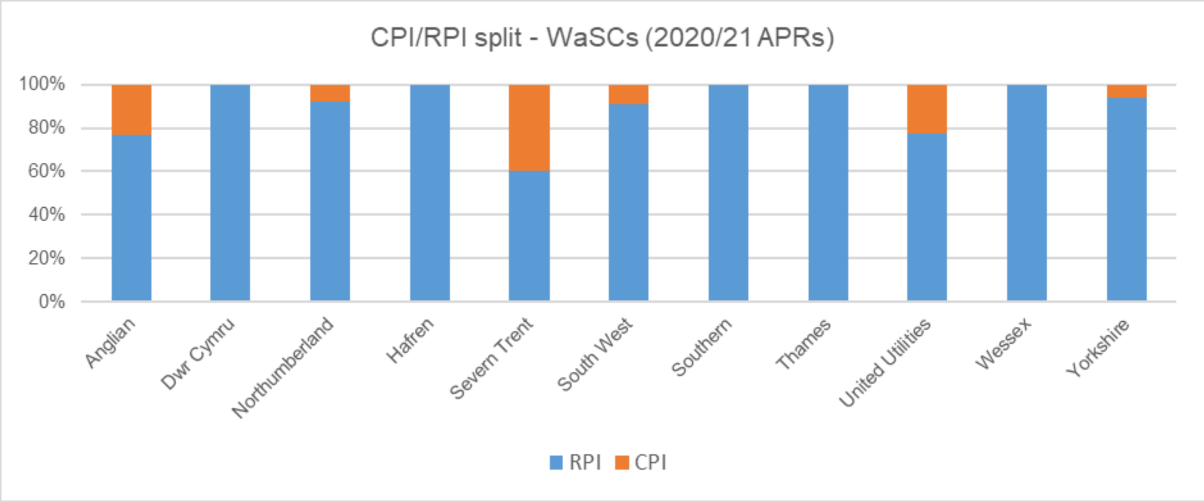
Q4.1. Do you agree with our proposed role for benchmark bond indices in crosschecking a cost of debt allowance based on a balance sheet approach?

We agree with Ofwat's proposal to look at **balance sheet approaches** for the cost of embedded debt. At this stage the discussion paper does not explore detailed approaches and we look forward to engaging with Ofwat on them ahead of the draft methodology in July. We consider Ofwat should be aiming for a clear and transparent ex ante policy for the balance sheet approach based on robust principles.

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.

Many swaps, such as currency swaps, nominal to index-linked interest rate swaps and RPI to CPIH index swaps are often necessary for responsible risk management, enabling resilient financial structures and efficiently aligning with Ofwat's policy objectives.

For example, swaps help companies efficiently convert legacy RPI debt to CPIH debt (improving alignment with the changes to the indexation of the RCV). As the diagram below shows, Severn Trent had the highest proportion of CPI/CPIH linked debt of the water and sewerage companies on 31 March 2021, some of which was done through swaps. Making this transition would have been much more expensive if done by re-financing RPI debt as CPIH debt (indeed it is highly likely there would not be enough investor demand for CPI/CPIH debt for companies to meet Ofwat's policy goals).



We recognise it might be reasonable for Ofwat to exclude risky “kick the can” swaps that re-profile cash flows over time, but as the CMA recognised efficient swaps should be included in the sector average. To achieve this approach we would support Ofwat in collecting the data needed to distinguish between types of swaps.

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 fundamentally disagree with Ofwat’s premise in question 4.2 that there is a “persistent issuance discount of water company bonds against the iBoxxx A/BBB index” and that there might be a case for applying an outperformance adjustment. The CMA removed the outperformance wedge at PR19 because it found the wedge did not exist once timing and tenor was controlled for. We consider Ofwat’s analysis of its Figure 4.1 is misleading. The dots under the index line occur when the new debt issue was short-dated at tenors below 10 years. The 15-30 years new debt issues are much closer to or on the line as expected. Reinstating the wedge could incentivise water companies to issue more short-tenor debt, creating additional re-financing and interest rate risk for the sector, which would be at odds with Ofwat’s financial resilience aspirations for the sector. We consider Ofwat should drop the cost of debt outperformance wedge for PR24 because it does not reflect market evidence and could weaken financial resilience.

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?

No comment.

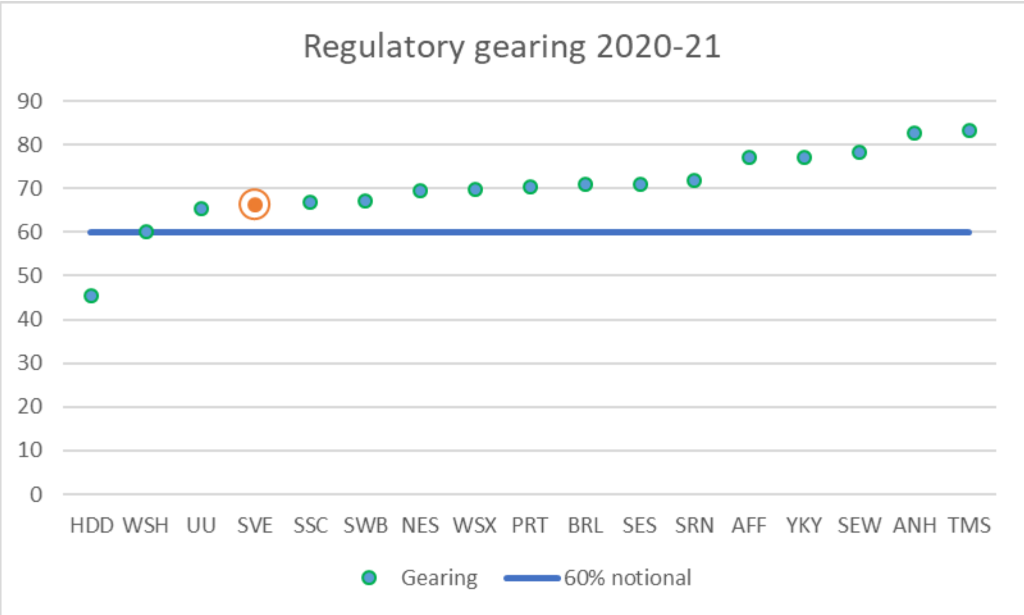
Chapter 5 - Notional capital structure

We fundamentally disagree with Ofwat's proposed changes to the notional company assumptions. Ofwat appears to be proposing cumulative changes, not supported by evidence, that would make the notional company financeable at much lower equity returns without taking account of the real world consequences its changes would have.

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

We fundamentally disagree with a reduction in the **notional gearing assumption** and suggesting a five-percentage point reduction to 55% in one price control period is unprecedented, as Figure 5.1 in the Ofwat discussion paper shows.

The diagram below uses data from Ofwat's Monitoring Financial Resilience Report 2020-21 and shows Severn Trent has one of the lowest levels of regulatory gearing in the sector. Ofwat's proposal would imply that a sector leading company on service performance and financial resilience, such as Severn Trent, would have to raise significant amounts of equity in 2025-30, (or ask its shareholders to forego more than two years' worth of dividends) to remain financeable, which cannot be right.



If Ofwat is concerned about highly geared companies, we believe it should take a targeted approach to those companies rather than reducing the notional gearing assumption, which affects all companies including the best performers.

In our recent response to Ofwat's financial resilience discussion paper we suggest some approaches for improving financial resilience that would be more effective and not have the unintended consequences of reducing notional gearing:

- a common performance commitment for financial resilience;
- Ofwat using reputational incentives in its annual reports;
- Ofwat including financial resilience as part of the business plan incentive at PR24; and
- a procedural incentive to require more financial reporting for highly geared companies.

Taken together these suggestions would provide reputational, procedural and financial incentives for companies to be financially resilient.

There are serious, unintended consequences of Ofwat reducing the notional gearing assumption to 55%. The assumption that equity finance is readily available and “on tap” to meet a moving gearing target fundamentally misunderstands the importance of stability – both in the regulatory framework and equity distributions. Listed company investors value such stability and are willing to accept the sector’s relatively low cost of equity in return. Without compelling evidence that a change in the notional gearing level is needed for efficiency or financial resilience such a change would undermine confidence in the sector and likely increase expected equity returns.

Ofgem recognised in its RIIO-2 final determinations that raising equity is expensive, by giving companies a 5% equity issue allowance. It is not clear that these extra costs are in customers’ best

We note that there will be a complication in the calculation of gearing arising from Ofwat’s consultation on the proposed approach to funding bioresources activities at PR24. The consultation suggests using “pre-2025 bioresources RCV plus post-2025 bioresources investment after taking account of depreciation”. If credit rating agencies do not count the post-2025 bioresources assets in their calculations, because of the added risk the assets face, it could artificially increase gearing.

We disagree with Ofwat’s proposal to adjust the dividend assumptions in the notional capital structure on a company-by-company basis as this represents a further method for reducing the cash the notional company needs to remain financeable. Such company-by-company adjustments go against Ofwat’s view that “decisions about the declaration and payment of dividends are the responsibility of the board of each company” in its financial resilience discussion paper.

Ofwat’s proposal is also at odds with the Dividend Growth Model (DGM) that it has always used as a cross-check on its approach to the cost of equity at previous reviews. Encouraging a dividend profile where there are intermittent periods of growth followed by cuts when investment exceeds a given level or when required to meet a moving gearing target will not fit with any DGM profile that is consistent with the true cost of equity.

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 fundamentally disagree that there is a need to increase the proportion of index-linked debt above 33% in the notional capital structure. Ofwat justifies increasing the proportion of index-linked debt in the notional capital structure because it moves the proportion towards the actual sector average. This is inconsistent with Ofwat’s approach to gearing (where it is proposing moving the notional gearing assumption away from the actual sector average). In addition, the industry average for index-linked debt includes swaps, which Ofwat says it will not consider in the context of the cost of embedded debt. Also, the industry average is pushed higher by highly-securitised companies that use index-linked debt to achieve higher levels of gearing, meaning the industry average is unlikely to be a fair reflection of an efficient capital structure.

Index-linked debt markets tend to be less liquid and more expensive than nominal debt markets, with investors usually requiring a “linker premium”, which can be around 10-15 basis points. The higher proportion proposed would increase borrowing costs for companies, and eventually feed into higher customer bills.

Ofwat commented disapprovingly in its recent consultation on Financial Resilience on the risky use of swaps "to alter the profile of cash interest payments, for example, to reduce short-term effective interest costs at the expense of highly likely future cash outflows, without any improvement in long term, underlying financial resilience". But by increasing the proportion of index-linked debt for the notional company, Ofwat are effectively advocating a similar outcome, one that achieves lower interest payments in the short term (we assume to improve credit metrics at a lower weighted average cost of capital (WACC) allowance) by deferring the cost of servicing debt onto future generations of bill payers.

If Ofwat does demonstrate that increasing the proportion of index-linked debt for the notional company at PR24 is in customers' interests:

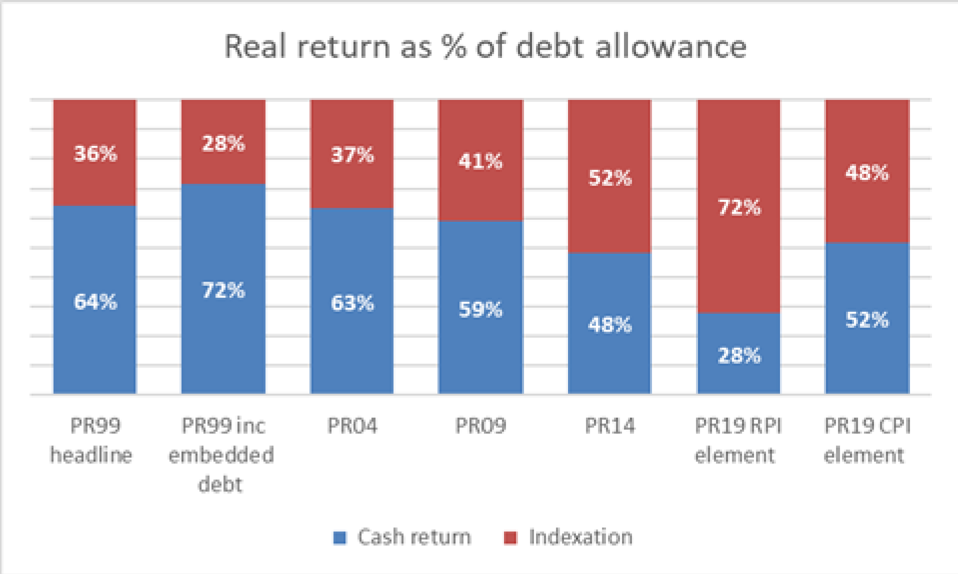
- we think Ofwat will need to make realistic assumptions about how the notional company can transition from 33% RPI-linked debt to 50% CPIH-linked debt over five years;
- we consider Ofwat should follow Ofgem, in its RIIO-2 final determinations, by providing an allowance for the cost of new CPI/CPIH debt as well as an allowance for managing basis risk between RPI and CPI debt (the allowance will need to be higher in the water sector because of the higher proportion of RPI-linked debt in the water sector); and
- we consider Ofwat should recognise that the efficient way to increase index-linked debt is very likely to involve swaps; the index-linked debt market is simply not big enough for companies to maintain a higher proportion of index-linked debt higher without the efficient use of swaps.

Chapter 6 - RCV indexation

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 support full indexation of the RCV to CPIH from the start of the PR24 price control period. It is more legitimate to use CPIH now that the RPI is no longer an official national statistic and it will help reduce complexity in the price review.

We consider the full transition to CPIH is also necessary to at least in part reverse the underlying long-term downward trend in the proportion of company returns the regulatory framework provides in cash compared to RCV indexation (see the diagram below) as interest rates have fallen. The full transition to CPIH in PR24 will improve cashflow and financeability during AMP8. We are confident we can manage the affordability effect on customers, mentioned in the discussion paper, through our overall approach to affordability in our PR24 business plan.



Chapter 7 - Financeability

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

We fundamentally disagree with Ofwat's conclusion that the artificial changes it is proposing for the notional company capital structure will make financeability less of an issue at PR24.

We believe that Ofwat should first determine an efficient notional capital structure and then assess whether there are any financeability issues that require an increase in the cost of equity. Ofwat is instead proposing to change the notional company capital structure (arguably making it less efficient) to make it appear more financeable. In extremis, Ofwat could make the notional company appear even more financeable by lowering notional gearing further, raising the proportion of index-linked debt higher and reducing the notional dividend assumption. But this would be unlikely to result in an efficient capital structure that benefitted customers or provided a return for equity investors that encouraged 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 also note that Ofwat's focus for financeability in the discussion paper has been on Moody's adjusted interest cover ratio (AICR), but the changes to the notional capital structure seem less concerned with Standard and Poor's funds from operations (FFO) / net debt metric, which is equally important for many companies.

The discussion paper refers to when a financeability constraint is due to a shortfall in cash flows. We consider there might be occasions when using revenue advancement (for instance through pay-as-you-go or RCV run-off rates) would be appropriate and in customers' interests balanced over the short and long term.

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?

We believe that companies should have the flexibility to determine how to fund real RCV growth, within acceptable financial resilience parameters and this should be reflected in the notional company assumptions. Companies like Severn Trent have demonstrated that they can combine responsible funding of real RCV growth with a stable dividend policy that is attractive to investors (including retail customers, pension funds and insurance funds) who are willing to accept the sector's relatively competitive cost of equity in exchange for a predictable income stream. Ofwat's proposal for the notional company assumes equity is as flexible a source of finance as debt, which is not the case in the real world. It gives primacy to the achievement of a gearing target, implying companies can and should annually flex dividends or raise equity capital to meet it, with no adverse consequences. This would further undermine the listed companies' ability to provide the stable, predictable dividend returns that are valued by investors and which benefit customers through a relatively competitive cost of equity.