South West Water

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Ofwat
21 Bloomsbury Street
London
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By e-mail:

Dear Sir,

PR24 AND BEYOND: DISCUSSION PAPER ON RISK AND RETURN

We welcome the opportunity to respond to this discussion paper. We have included our responses to your specific questions in Appendix 1.

We have consistently stated that it is our belief that retaining investor confidence in the sector is paramount to effectively managing risk and securing long term efficient finance for the business which contribute to lower costs for customers in the longer term.

Investors in the water sector value long-term stable returns and therefore whilst we welcome Ofwat's approach of not indexing the allowed return on equity (which would introduce a further element of uncertainty) we believe that the proposals introduce a downward bias to the allowed return on capital.

Ofwat's recent discussion paper on Financial Resilience outlines concerns over the overall resilience of the sector and offers proposals for greater scrutiny over and transparency in companies' financial resilience. This requires robust equity investment as well as access to efficient debt financing – however the approach proposed in this risk and return paper appears to introduce changes which reduce the cost of equity (and therefore equity returns) at time when the regulatory framework appears to be moving towards lower gearing and hence requiring equity support. In addition, the likely requirement for considerable investment for PR24 and beyond also appears to be at odds with his proposal to reduce the cost of equity and debt.

We believe that this continued downward trend of allowed returns will impact on equity investors who will find it less attractive to invest in the UK water sector – but at a time when Ofwat is seeking an 'equity buffer' with investors taking a higher risk but with lower returns.

In addition, we believe that any approach to setting the returns for PR24 should take account of the exceptional impact of COVID-19 on recent market values – both in the cost of equity and the cost of debt. During the pandemic we saw unprecedented impacts on the economy through lockdown

periods which resulted in investors seeking the 'defensive stocks' of utilities as well as debt investors also seeking secure and stable funding. This has resulted in potentially higher equity values and reduced financing rates for transactions completed over this time and expect that these are likely to unwind in the future. Therefore, we believe that careful consideration is required to reflect the unprecedent impacts of COVID-19 on future assessments of the cost of capital.

We support the CMA position that there is no evidence for any 'halo effect' for water debt financing and the time frame assumed for setting the cost of debt needs to ensure an approach and basis that can be consistently applied across multiple price reviews to enable companies to plan financing for the long-term.

We disagree with Ofwat's proposal to increase the level of index-linked debt above the PR19 notional level. We note from the financial resilience reporting for 2021, that whilst the average industry index-linked debt is c.50% this underpins average gearing levels for the industry of c.72%. In addition, all but three of the seventeen water companies with index linked debt above 30% have gearing over 70%. Given Ofwat's proposal to target reduced gearing for improved financial resilience as well as driving efficiency in the cost of debt we would be concerned if the notional structure moved into line with less resilient company funding structures.

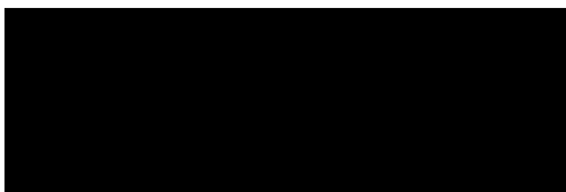
South West Water has consistently achieved one of the lowest cost of debts in the industry with index-linked debt of c.25%, and therefore the increase in index-linked debt does not necessarily benefit customers through increased efficiency. In addition, increasing index-linked debt results in short-term benefits for cash-flow but does not necessarily improve the long-term financial resilience of a company.

Underpinning the regulatory framework is the RCV being a focus for investors as well as key in setting the notional company structure and returns. At PR19 the allocation of RCV into four wholesale revenue controls was a fundamental shift in the regulatory framework – but key to this was retaining the RCV and not impacting the overall stability of returns or RCV growth through a minimum of inflation. We are therefore concerned that the separate Bioresources consultation which seeks a different approach to funding this activity, is a significant shift from the existing regulatory framework and adds greater uncertainty for investors who expect returns to be anchored in RCV.

We believe that there is a need for significant investment now and into the longer-term as we face considerable challenges of climate change as well as a step change in environmental expectations for storm overflows and river quality, we need a stable regulatory framework to attract and retain investment in sector – with appropriate returns for equity investors and allowances to support debt funding.

If you have any queries, or would like any further detail, please do not hesitate to contact us at finreg@southwestwater.co.uk .

Yours sincerely



South West Water Regulatory Director

APPENDIX 1

Given the technical nature of the discussion papers and supporting papers we have commissioned a third-party report from Frontier Economics to provide an independent assessment of the cost of capital. This assessment has helped to inform our 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?

South West Water agrees that there is a sizeable administrative and reporting burden attached to the existing 20 PR19 reconciliation mechanisms, and where appropriate would support a reduction in these. However, whilst some reconciliations may be "unimportant" for some companies, they may be more material for others. Thus, there should be an objective measure of materiality against which the forecast impact could be assessed by Ofwat prior to removing the mechanism.

Whilst in principle we support the reduction in the number of reconciliation mechanisms, there may be other changes in the PR24 regulatory framework where the introduction of a new mechanism may be an appropriate mitigation of uncertainty, and this option should not be discounted at this early stage.

We would welcome engagement across the industry to understand the potential impact of changing existing mechanisms as well as potential other mechanisms required for PR24.

Whilst a switch to full CPIH indexation would remove the need for the RPI-CPIH wedge reconciliation in the 2025-2030 period, the wedge treatment of the opening 2025 RCV and blind year corrections for forecast inflation used at the setting of the PR24 FD would still be relevant. Given the magnitude of the blind year correction for opening RCV in PR19, these could be significant.

SWW would like to see clarification from Ofwat as to how the opening RCV indexation issues will be addressed at PR24 and would be happy to share our findings on analytical work already carried out in this area. Given some of the issues SWW have identified also impact the in-period year end nominal RCV calculations as published by Ofwat, we would welcome early engagement on in this area to ensure clarity prior to the 2022 annual reporting.

SWW note that development is needed of the PR19 tax reconciliation mechanism to account for variation in the in-period PR19 capital allowance rate changes. This flexibility should also carry through to PR24 modelling in case of a similar situation arising again.

Q2.2. Do you have any comments on our proposed approach to producing risk ranges, including but not limited to:

- **a. Notional risk ranges for the efficient notional company prepared by Ofwat; and**
- **b. Company-specific risk ranges produced by companies.**

The PR24 Discussion Paper on Financial Resilience indicates the need for a clear relationship between the level of risk a company is exposed to and the level of returns allowed. For PR24, Ofwat has recognised there are exogenous factors which will increase uncertainty in the planning over the 2025-2030 period (for example, climate change), and are proposing the need for a

financial “buffer” recognising these risks. However, alongside this, Ofwat are also proposing other changes which would likely increase the risk exposure of companies:

- Proposals for Bioresources funding
- Potential changes to regulation of Developer Services
- Removal of reconciliation mechanisms to reduce complexity
- Consideration of long-term scenarios.

However, at the same time as the increased risk exposure both macroeconomic and via the regulatory process, Ofwat is also proposing several changes which would likely present downwards pressure noted on the allowed returns:

- Reduced notional gearing
- Increased outperformance wedge on cost of new debt
- Reduced allowance for embedded debt
- CAPM may not capture forward looking risk and uncertainty over the longer term – this is not consistent with the risk consideration of long-term scenarios.
- Risk free rate with limited or no weight on forward rates.

For the price control to be internally consistent, all aspects of risk and reward should be considered “in the round”, and SWW welcomes the focus on risk analysis in PR24 and improving the comparability and usefulness of the RORE metrics.

There should be an appropriate matching of risk and reward by control type – in the current consultation on the proposed approach to Bioresources funding, there is no reference to the appointee equity beta reflecting any change to the perceived potential risk arising from the proposals. This would imply the risk associated with Bioresources would be reflecting in the returns generated by other areas of the wholesale business which does not seem an appropriate allocation of risk.

Given the RORE metric is linked to the regulatory framework in place, it is more useful as a relative measure of risk than as a cross check on the cost of equity. This relative measure is useful in looking at trends over time and is also helpful when considering different components of the risk and incentives. Improvements could be made to aid comparison between companies within the sector, and this would help Ofwat in ensuring determinations are made fairly with regard to the company specific risks.

The current RORE measure is designed as a measure of relative risk but limited by lack of data consistency. To improve comparability of sector risk ranges, more detailed technical guidance would be helpful.

The preparation of notional risk ranges by Ofwat would support consistency and comparability across the sector, which would be welcome. However, Ofwat would not have as full insights into the risks faced by each individual company as management would have and would be reliant on benchmarks for service and cost efficiencies. Whilst these benchmarks might be appropriate for target setting, they may not be realistic across all companies for RORE comparisons where companies are currently at different points as regards performance and efficiency.

P10 and P90 only capture limited information on risk – a fuller distribution would improve understanding of the risks faced by companies and would allow for more sophisticated modelling. The current assumption is that the expected outcome is average of P10 and P90 scenarios - this is

not necessarily the case, there may be instances where risk is skewed. We would ask that Ofwat considers the asymmetry included within areas such as ODIs reflecting the difference in cost assessments where factors are considered symmetrical.

Company-specific risk analysis would allow for more complete use of management information and would be based on actual gearing and forecast operational risk, and other company specific factors and characteristics. However, it should be recognised that any company view on forecast actual risk / returns might be deemed commercially sensitive – particularly for listed companies.

Better understanding of the logic and methodology behind Ofwat's own risk assessment would help companies in developing their plans prior to submission. The impact of Ofwat changes to the plan could also be understood in the context of the impact of those changes to the company risk too.

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

The impact of COVID-19 was evident in financial markets with a large equity crash at the start of the pandemic (triggered by wide-spread lockdowns) and subsequent unprecedented and sustained high level of volatility in the equity market as a reflection of such uncertain times.

In times of high market volatility, many investors move to 'defensive' regulated utility companies as they have relatively stable earnings even in time of economic downturn. This often results in the price of defensive stocks being partially insulated from wider market deterioration (or may even move in the opposite direction). A direct result of this would be a lower beta value if estimates include these periods of volatility.

We also note Ofwat's observations around market expectations implied by premiums to RCV, including Pennon's recent acquisition of Bristol Water. In particular, transaction premiums to RCV have varied significantly from 10-60% in recent years, reflecting may factors which are likely to be specific to a certain stock or transaction, as well as reflecting the macro-economic expectations and conditions at the time. Given the range of factors involved it is difficult to draw a parallel to only the allowed cost of capital.

We believe that Ofwat should consider the impact that the period of COVID-19 is having on estimating the beta, as this impacts all companies to identify the scale this unprecedented one-off event is having and consider how this may be adjusted in the beta estimates. Options may include taking a longer estimation window to ensure that this period is not dominating the data estimate or consider rolling averages over time to smooth out the sudden impact of the beta value.

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?

The paper notes that currently publicly listed water company shares are traded at a premium to their RCVs, which means that the gearing level observed from the beta estimation using market equity data is lower than the corresponding RCV gearing because the denominator using market equity value is higher than using RCV implied regulated equity.

The fact that the traditional calculation of the cost of equity produces a higher WACC at a higher level of gearing does not necessarily mean a lower level of gearing is better for customers. This is because a lower level of gearing would introduce other costs, most notably tax which could more than offset the benefit.

In addition, the suggestion to use the observed gearing based on market value equity rather than one based on actual RCV gearing ignores the regulatory framework for the UK water sector, where a rate of allowed return is remunerated on the regulatory capital value rather than the market value of capital. It is therefore arguably more suitable to use a WACC adjusted to reflect the RCV gearing rather than the market value gearing.

Furthermore, we note that these two concerns above are separate and independent. The first one almost always holds true as long as debt default premium is present in the cost of debt (which is likely) and that Harris-Pringle formula continues to be used. The second one is only true when the market value of equity is higher than the regulated value. In cases where market value is lower than the regulated value, the market value gearing would be higher than the RCV gearing, and the traditional method would result in a lower notional gearing and (as the first point always holds true) a lower allowed return.

In reviewing the options for changes to the de-gearing/re-gearing calculation suggested in the M&W paper, we have identified none of the proposed options to be superior to the current approach.

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

At PR19 Ofwat opted to use the RPI-CPIH wedge, from the latest OBR forecast. Whilst this may be a reasonable and consistent way forward, there is potential that the RPI-linked gilt yield is likely to under-estimate the risk-free rate. Other recommendations have been to use AAA-rated corporate bonds or use nominal gilt yields which avoid the requirement to use the RPI-CPIH wedge to convert the RPI-linked yields. This approach would be consistent with Ofwat's aim of moving to fully CPIH inflation.

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?

In principle, South West Water agrees with using a variety of data sources to support the industry allowed cost of debt estimate, however it is not yet clear how either benchmarking or a balance sheet approach would be calibrated.

We note that the overall approach based on sector average costs (the balance sheet approach) is consistent with CMA methodology based on sector average. However, the exclusion of swap costs is not consistent with the CMA position and could create distortions.

There are a number of areas that require consideration, and clarity on Ofwat's approach would be welcomed:

- Which companies would be included within the average and why
- Averaging methodology to be used
- Period covered
- Treatment of different instruments
- Assumptions used (e.g. debt mix)

Similarly, further detail is required about the use of benchmark bond indices and the assumptions inherent in the calculations.

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

We believe that the iBoxx indices for A-rated and BBB+ rated corporate bonds are the appropriate independent benchmark to use to assess the costs of financing. It is a well-established index and both companies and regulators are familiar with it and comfortable with it as a benchmark. In our view this should be the primary tool to assess the cost of debt.

The observed outperformance wedge reflected in recent debt allowances may be driven by short term factors for which it would not be appropriate for setting PR24 allowances, these include the relative attractiveness of water sector in COVID for AMP7 issuances and the tenor of some of the recent issuances.

In addition, Ofwat's proposal to potentially change the mix of notional debt (with a higher proportion of index linked debt) could impact the overall debt market if the industry were required to move towards this for perceived financial resilience / notional expectations.

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 industry approach to assessing the cost of debt which is then applied consistently across the sector and not applied on a company specific basis which may undermine the incentive properties of a notional structure. It is then for companies to make financing decisions that are efficient and effective.

Therefore, we believe company specific adjustments related to small size are not in customers best interests and are a signal that a more efficient approach should be for such companies to merge, consolidate or pool resources releasing efficiencies and lowering bills.

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 consider that there is compelling evidence to conclude that the current notional gearing level is too high. Currently the sector average is higher than the 55% proposed and whilst Ofwat are seeking improved company financial resilience this is at odds with the expectation of further equity investment when returns are reducing and potential risks / uncertainty is rising.

In addition, the proposal for increasing the level of index-linked based on the existing industry average, is inconsistent with the approach to gearing which is in fact moving further away from the current industry position for those companies who seek to remain near the notional gearing.

We believe that if the incentive regime is working as it should, then what companies choose would reveal the most efficient structure, and when that is set as the notional structure this would minimise the cost to consumers in the long run.

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 believe South West Water's financial resilience has benefited from broadly following the current notional funding mix, particularly in comparison to other companies in the industry with higher proportions of index-linked debt. To improve overall financial resilience of the sector we

think companies deemed most a risk and are not currently mirroring the notional structure should be encouraged to do so. We would be concerned if the notional structure moved into line with less resilient company funding structures.

Therefore, we disagree with this proposal noting from the financial resilience reporting for 2021 that whilst the average industry index-linked debt is c.50%, this is within average gearing levels for the industry of c.72%. In addition, all but three of the seventeen water companies with index linked debt above 30% have gearing over at or above 70%. Given Ofwat's proposal to target reduced gearing for improved financial resilience as well as driving efficiency in the cost of debt, is seems counter intuitive that an increase in index-linked debt supports these aims.

South West Water has consistently achieved one of the lowest cost of debts in the industry with index-linked debt of c.25%, and therefore the increase in index-linked debt does not necessarily benefit customers through increased efficiency. In addition, increasing index-linked debt results in short-term benefits for cash-flow but does not necessarily improve the long-term financial resilience of a company.

In addition, the approach of averaging actual company positions is not consistent with Ofwat's approach to assessing gearing – where the industry average would suggest a significantly higher level than the current 60% notional position (2021 average at c.72% consistent with the c.50% index-linked balance sheets).

Furthermore, the majority of industry index-linked debt is RPI based – which therefore results in higher charges than CPIH current at current rates. The requirement for companies to increase debt would not necessarily be beneficial to customers as the cost to companies may increase with high transaction fees as the market for CPIH-linked debt is not deep and CPIH inflation swaps may need to be used to meet this target which will incur additional costs.

Q6. 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?

The RPI indexation in RCV and customer bills has been a fundamental building block of the regulatory framework since privatisation. At PR19 the transition to CPIH was significant – and the approach to transition from RPI to CPIH was to ensure the impact on customer bills could be appropriately managed. Whilst this was not the case for all companies, it was a key approach to removing the potential transition impact for customers.

We note, however, that there would be a significant benefit derived from the reduction in modelling complexity and uncertainty through reconciliation of the 'wedge' at the end of PR24. Given the phasing out of RPI in 2030 this may be a reasonable step, however, consideration should be given to both the impact on bills and long term financeability particularly given the significant investment needs expected at PR24 and the challenging times that customers may be experiencing.

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

Without knowing the overall level of the WACC, it is not possible at this stage to make a judgement on financeability. As noted, Ofwat has already indicated downwards pressures on the WACC, at the same time as increased risk exposure. The combination of which will impact on financeability.

It seems inappropriate for Ofwat to place reliance on the short-term uptick in returns resulting from full CPIH indexation to judge financeability – this is a short-term step change resulting from the indexation and not a reflecting of the underlying economic reality.

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?

To some extent this will depend on the gearing level that is set for the regulatory period and the level of investment required at PR24. Ofwat is already proposing lower gearing which would require equity investment for many companies alongside lower allowed returns and increased risk and uncertainty for investors from other changes proposed. This also needs consideration against the financial resilience and efficiency of each individual company as continued challenges to the regulatory framework could impact investor confidence leading to reduced financial resilience.

However, if the gearing levels were to it be different a phased move over the regulatory period to the target would allow companies to transition their gearing position in a most orderly and efficient way.