PR24

Discussion paper on risk and return

February 2022

United Utilities response to Ofwat's discussion paper on risk and return for PR24

United Utilities

Water for the North West

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1. Executive summary

United Utilities Water welcomes the opportunity to comment on Ofwat's emerging thinking on Risk and Return ahead of the launch of the draft PR24 methodology in Summer 2022.

We are supportive of several of the changes that Ofwat is looking to introduce at PR24 including retaining a fixed cost of equity for the AMP8 regulatory period, a move to full CPIH indexation and assuming that half of the notional company debt is in index-linked form (on the basis that Ofwat also properly takes account of how derivatives are used to achieving this level), albeit we consider it important that this is further split such that 33% is assumed to be RPI-linked and the remaining 17% CPI/H-linked. Such an RPI:CPI/H split reflects the significant proportion of embedded RPI-linked debt currently in the sector with CPI/H remaining relatively scarce at just 10%, but with potential to grow over time.

With regard to Ofwat's proposed approach in setting the cost of debt, we support the continuation of an embedded allowance and indexation for the assumed proportion of new debt raised across the regulatory period. We consider that embedded debt is best assessed with reference to actual sector embedded debt positions (including swaps), i.e. this should also take account of the impact of derivatives on companies' debt profiles and also therefore effective interest rates. Not to do so would depart from reflecting the true economic position and it is acknowledged that for certain instruments (e.g. currency debt) swaps are intrinsically linked to the underlying debt, and we would contend that that is the case for the vast of majority of swaps that companies enter into. Any swaps that are identified as 'kick the can' swaps could legitimately be disapplied in the sector cost of debt assessment.

It should also be acknowledged that index-linked derivatives (swaps) are a material component of the overall proportion of index-linked debt (in getting to 50% and in increasing the proportion of CPI/H-linked debt where the bond markets remains extremely limited). So to disregard derivatives for this purpose whilst recognising the benefit of derivatives in the index-linked debt mix would highlight an inconsistent approach.

On the use of benchmark indices as a cross-check and Ofwat's observation that companies seem to be comfortably outperforming the existing benchmark, we would caution that the chart in Figure 4.1 (page 37) might be overstating the position in that comparing the 'spot' level at issue to the prevailing index yield at that time is not technically the same as how the actual index works (which takes the 'year average' yield on the benchmark index from 1 April to 31 March for the relevant year).

Even so, it is important to retain strong incentives for companies to raise debt efficiently, and it should be recognised that whilst any 'outperformance' at the time of issue against the new debt benchmark index will benefit companies 'in period' for a limited time, such debt will also benefit customers in the longer-term through the incremental improvement as that new debt moves into the embedded debt component, which generally should be a far more enduring position than any 'in period' benefit. Such action demonstrates the essence of incentive based regulation and one that will drive better long term outcomes for the sector.

We are also broadly supportive of Ofwat's proposed approach to financeability assessments at PR24, and welcome the acknowledgement from Ofwat that most prominence should be placed on key credit metric calculations that are performed exactly in line with ratings agency methodologies (so called 'adjusted' ratios) to avoid the risk of ratios showing a flattering position relative to the actual metrics that are used for ratings purposes. However, in solving for ratios that only 'just' meet the required ratings thresholds - for example, Moody's current Adjusted Interest Cover (AICR) range for a Baa1 rating is ≥1.5 to 1.7x so 'solving' to meet 1.5x (as per the impact of full CPIH illustrated in the Appendix) provides no headroom at all, and we consider that targeting key metrics in the central point of any key ratio range would be a more appropriate test, rather than placing the notional company on a ratings 'cliff-edge'.

We also recognise the role that equity can play in addressing financeability issues, particularly if the sector is faced with large investment requirements. We consider that the focus here should be on making the Price Review package compatible with attracting new equity investment to the sector, with due allowance for equity issuance costs. It is not legitimate or appropriate for Ofwat to impose on companies an assumption that

dividends would be below the real cost of equity, as listed equity water company stocks are predominantly an income driven investment – price control assumptions should reflect the expectations and requirements of the company's investors. Also the Funds From Operations (FFO) to net debt metric (Standard & Poor's prime ratio) would be practically impossible to fix through dividend adjustments alone, rather it would require either significant revenue uplift or equity investment to resolve.

Additionally, we do not accept any need or indeed consider that any robust evidence has been put forward to justify a lower gearing assumption for the notional company from the 60% used at PR19. This is slightly lower than the actual RCV gearing of UU and its listed peer, Severn Trent. Although Mason and Wright (M&W) put forward potential issues around the measurement of gearing, we see no compelling evidence for departing from existing practice. Deviating from well-established corporate finance theory and regulatory precedent should only be considered where there is irrefutable and compelling evidence from multiple sources with detailed cross-checks by many parties. Such rigour should prevent unintended consequences - without it, internal inconsistencies could arise and undermine investor confidence. Enterprise Value gearing (similar to MARs) might require adjustments so the perceived under-gearing issue might not be as large as is posited by M&W, and calculations of what constitutes debt (e.g. taking account of any pensions deficits as per the ratings agencies) might also be needed.

We also note that 60% is the mid-point of Moody's RCV gearing range plus an AICR band of ≥1.7x to 2.0x to attain an A3 rating. From a financeability perspective therefore, lowering the notional company gearing assumption is unlikely to alter the ratings assessment unless RCV gearing was pushed comfortably below 55% plus AICR was 'solving' for in excess of 2.0x. This looks like it would push the financeability envelope beyond the bounds of credibility versus actual sector gearing and AICR. Further, the notional company would also potentially differ from the debt benchmarking reflecting actual company structures (which seems broadly well aligned from a ratings perspective with a 'composite' of the iBoxx A and BBB corporate bond indices that were adopted at PR19[1]).

Finally, whilst we are supportive of Ofwat's decision not to index the cost of equity (or components thereof), we are concerned with the proposals in relation to the estimation of the cost of equity (TMR estimation approach, dispensing with de-levering and re-levering betas etc.), as we do not find the M&W report either sufficiently compelling nor thoroughly researched to dispense with many years of established regulatory practice.

Further, we note that in several places Ofwat discusses the differences of approach by the CMA in the PR19 redeterminations versus the CMA Ofgem RIIO-2 redeterminations (pointing to several examples, where the CMA did not disagree with Ofgem's approach). We would observe that the remit of the CMA for a water sector referral is materially different to that for an energy sector referral. As such, we are not convinced that weight should be ascribed to a perceived endorsement by the CMA of Ofgem's position on certain elements referenced in the paper.

We consider it appropriate that Ofwat works with the industry to undertake further studies into estimation approaches for key components of the cost of capital, and that those studies are taken into account before Ofwat publishes any early PR24 WACC guidance.

We would also comment that broader cross-checks in setting the cost of equity should also be used in addition to MARs, such as use of the Dividend Growth Model and taking account of investor surveys.

[1] With A3/A- and Baa1/BBB+ being the median ratings in that composite index.

2. Balance of risk and return

2.1 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 agree that the framework for reconciliation mechanisms should be reviewed before use at PR24 and taking a principled approach, as Ofwat has set out, would be sensible. Reconciliation mechanisms are essential in protecting customers or companies when there is sufficient uncertainty over future assumptions.

It is important to recognise that there is a direct relationship between price control complexity and the need for adjustment mechanisms - if the price controls are more complex, then typically more mechanisms are required to ensure that forecasts are not erroneous. Whilst we support any attempt to reduce the regulatory burden, we do not believe that simplicity - in of itself - should be the goal, particularly where there is a clear need for these mechanisms. Pursuing a simplified approach that removes ex-post mechanisms that are required could ultimately harm customers and/or companies. Whilst we agree with Ofwat's premise of review, we can foresee that the only reconciliation mechanism that is likely to fall out because of this is the water trading incentive mechanism. All others are likely to have the potential for material reconciliations for at least some companies.

If Ofwat decides to use these principles to assess the validity of future reconciliation mechanisms, we would highlight the following additional points for consideration:

- The materiality of reconciliation adjustments needs to be assessed on an individual company basis and not in aggregate, as materiality can vary significantly between companies and the mechanism should not be removed even if the results only make a difference to a subset of companies;
- Whether some mechanisms could potentially be run as Price Control Deliverables (PCDs) instead of specific reconciliations e.g. the WINEP cost adjustment mechanism. Whilst this might not seem like a reduction in the number of reconciliations, making use of pre-existing frameworks - in this case the outcomes and in-period reconciliation - can further streamline the process, with the added benefit of additional regulatory certainty, consistency and predictability;
- We agree that the full transition to CPIH for indexation of the RCV would not only significantly simplify the price control building blocks and increase transparency, it would remove the need for future reconciliations of the RPI:CPIH wedge – which we support;
- For PR19, reconciliations are run in isolation through separate models and then aggregated, but there are potentially opportunities to combine PR24 reconciliations into combined models to reduce the regulatory burden as well as improving transparency e.g. the cost of new debt and the tax reconciliation model are required to be run concurrently in order to generate the correct outputs;
- The requirement for a reconciliation mechanism to account for developer activities will depend upon the future structure of the price controls and how developer revenues are accounted for within these. If the AMP7 approach is retained then this mechanism will continue to be required for PR24/AMP8;
- Whilst there is no doubt that such mechanisms place additional burden on companies and Ofwat to run the reconciliations, it is likely that they will be substantial and offer protection where forecasts are less well specified or areas that are subject to significant change e.g. due to Covid.

2.2 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.

UUW strongly supports a more prescribed approach to developing and assessing the RoRE risk ranges to improve consistency between companies. We agree that the RoRE and its ranges of incentive outcomes can be a useful sense check on the overall incentive package but that it should not be used as a measure by which to calibrate the base allowed return. There was minimal alignment between companies and Ofwat for PR19 risk ranges, which

meant that assessments of risk and opportunity were very different. We see sense in Ofwat developing and calculating its own assessment of the notional company RoRE and risk ranges as this will improve the consistency between companies but we are not as confident that companies providing the assessment for the actual company (even with improved guidance) will offer any meaningful value.

At PR19, insufficient attention was paid to the linkages between the component parts, which meant that the resulting risk ranges might not have been appropriate, for example cost-service. The assessment of price control benchmarks on service and efficiency levels must be appropriately calibrated at PR24, regardless of the difficulties measuring risk and correlations in a consistent manner across all companies. If employed again at PR24, Ofwat's PR19 approach of upper quartile performance for upper quartile efficient cost allowances would need to have been sustainably achieved by a resilient business over AMP7.

3. Allowed return on equity

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

Many perceived issues have been raised in the discussion paper and related M&W report relating to estimating the cost of equity, approach to estimating beta, de-levering and re-levering betas, the estimation of TMR and RFR, plus appropriate cross-checks (with seemingly a reliance on MARs). Some of the proposed solutions to the perceived issues would represent a material departure from established regulatory practice and corporate finance precedent. We are not persuaded that the findings in the M&W report are sufficiently researched, well-evidenced and cross-checked to warrant such a departure. We are therefore reluctant to endorse any proposals without first Ofwat working with the industry to commission further studies to consider whether these add weight to the concerns raised in the M&W report and Ofwat's paper, along with the appropriateness of any potential solutions.

We therefore consider it appropriate that the industry is given that opportunity and the output from any studies is available for consideration by Ofwat, the industry and wider stakeholders prior to Ofwat finalising its early WACC guidance. We would suggest a timetable of early Summer 2022 for any reports to be published.

With regard to Covid-19 related uncertainties, these are still ongoing and have the potential to create distortions to benchmarks and parameters. How best to take account of this period can also be covered in any studies, albeit the findings may require refreshing depending upon how the pandemic further evolves from here.

UUW welcomes Ofwat signalling that less reliance will be placed on shorter estimation periods, and that evidence from a range of estimation periods and frequencies will be taken into account. Ofwat notes in the discussion paper that the CMA's PR19 decision made use of estimation periods from 2-years to 10-years, using daily, weekly and monthly beta estimates in contrast to Ofwat's PR19 focus on daily data.

3.2 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?

As highlighted in our executive summary and the answer to question 3.1 above, UUW is not persuaded that the findings in the M&W report are sufficiently researched and well evidenced to warrant a departure from established regulatory practice. Deviating from well-established corporate finance theory and regulatory precedent should only be considered where there is irrefutable and compelling evidence from multiple sources with detailed cross-checks by many parties. We are concerned that such a departure might create internal inconsistencies given the circular nature of CAPM, leading to unintended consequences. For example, the risk of a sub-optimal outcome could have a material impact on investor sentiment and related equity financeability considerations.

If Ofwat considers that such findings are so material as to merit a departure from well-established regulatory practice, then we consider that further studies are warranted before that decision is cemented in Ofwat's approach to setting the cost of capital.

As such, UUW considers it appropriate that that the industry is given the opportunity to work with Ofwat to commission further academic and/or economic consulting studies in this regard, and that those studies are taken into account before Ofwat publishes any early PR24 WACC guidance. We would suggest a timeframe of early Summer 2022 for the publication of any reports.

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

We consider this specific question, along with a broader assessment of how to set the RFR for the 2025-2030 period worthy of further technical study.

For example, Ofwat's paper contrasts the CMA's approach of not using forward rates as justification for placing limited weight on forward rates to inform Ofwat's RFR at PR24. We would contend that the use of forward rates

is entirely valid when considering how to estimate the cost of debt for a 5-year regulatory period commencing in around 3-years' time. This is in contrast to the CMA's redeterminations, which took place during the applicable regulatory period.

We agree that the use of RPI-linked gilts and the proposals by the UKSA to reform RPI in 2030 creates complications in producing an equivalent CPIH real risk free rate. We also note that RPI market implied inflation currently appears to largely discount an expected convergence in RPI to CPIH post-2030. It is currently unclear what is causing that apparent distortion - e.g. do RPI-linked gilt holders consider there might be some prospect of compensation and/or do not consider that the reform will be carried out? Or is it more a case that the inflation risk premium embedded in index-linked gilts has materially risen beyond historic levels? However, we agree that CPIH remains broadly compatible with CPI and therefore the Bank of England's 2% CPI inflation target remains a valid long-term assumption for CPIH too.

We suggest that cross-checking the output of any RPI-linked gilts analysis to equivalent duration nominal gilt yields (deflated using a 2% fixed CPIH assumption) could be a useful exercise in 'sense-checking' any RPI-linked gilt derived output.

4. Allowed return on debt

4.1 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?

With regard to Ofwat's proposed approach in setting the cost of debt, we support the continuation of an embedded allowance and indexation for the assumed proportion of new debt raised across the regulatory period. We consider that embedded debt is best assessed with reference to actual sector embedded debt positions (including swaps), i.e. this should also take account of the impact of derivatives on companies' debt profiles and also therefore effective interest rates. Not to do so would depart from reflecting the true economic position and it is acknowledged that for certain instruments (e.g. currency debt) swaps are intrinsically linked to the underlying debt, and we would contend that that is the case for the vast of majority of swaps that companies enter into.

It should also be acknowledged that index-linked derivatives are a material component of the overall proportion of index-linked debt (in getting to 50% and in increasing the proportion of CPI/H-linked debt where bond market demand remains extremely limited). So to disregard derivatives for this purpose whilst recognising the benefit of derivatives in the index-linked debt mix would result in an inconsistent approach, that would not reflect the company costs of finance.

We recognise Ofwat's concerns regarding so called 'kick the can' swaps but it should be possible to ascertain which companies have executed such swap restructurings and effectively strip out or disapply those specific swaps.

UUW therefore considers that prominence should be given to actual sector average balance sheet debt on an 'effective cost' basis, taking account of swaps and hedging transactions. Use of benchmark bond indices commensurate with actual credit ratings in the sector and comprising bonds of long-duration (i.e. the existing iBoxx A and 10-year plus corporate bond indices) looks appropriate although the trailing average might need to be extended beyond the 15-years used at PR19 to reflect that a significant proportion of embedded debt in the sector was raised pre-2010.

4.2 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?

With regard to Ofwat's observation that companies seem to be comfortably outperforming the existing benchmark, we would caution that Figure 4.1 in Ofwat's paper may overstate the position - comparing the 'spot' level at issue to the prevailing index yield at that time is not technically the same as how the actual index works. Rather, the index will take the take the 'year average' yield on the benchmark index from 1 April to 31 March for the relevant year. So any outperformance may be overstated. Further, the ratings and maturities of the debt issued might also have a bearing on the level of outperformance.

Even so, UUW agrees that it is important to retain strong incentives for companies to raise debt efficiently. It should be recognised that any 'outperformance' at the time of issue against the new debt benchmark index will benefit companies 'in period' for a limited time. However, such debt will also benefit customers in the longer-term through the incremental improvement as that new debt moves into the embedded debt component. This customer benefit is likely to be a far more enduring position than any 'in period' benefit for the company. To illustrate, a company may benefit from the issue of new debt at a yield lower than the benchmark index yield during the relevant price control. However, if that is an 18-year bond and issued 2-years into the price control, for example, then customers should gain the long term benefit as the debt moves into embedded 15-years beyond the price control in which it was raised.

4.3 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?

Whilst not directly relevant for UUW, Ofwat's proposed approach would appear reasonable.

5. Notional capital structure

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

UUW does not accept any need or indeed considers that any robust evidence has been put forward to justify a lower gearing assumption for the notional company from the 60% used at PR19. This is slightly lower than the actual RCV gearing of United Utilities and its listed peer, Severn Trent. Although Mason and Wright (M&W) put forward valid issues around the measurement of gearing, we see no compelling evidence for departing from existing regulatory practice, with a prime focus on RCV gearing. We are concerned that any departure could create unintended consequences /give rise internal inconsistencies, which could undermine investor confidence. Enterprise Value gearing (similar to MARs) might require adjustments so the perceived under-gearing issue might not be as large as is posited by M&W, and calculations of what constitutes debt (e.g. taking account of any pensions deficits as per the ratings agencies) might also be needed.

We also note that 60% is the mid-point of Moody's RCV gearing range plus an AICR range of ≥1.7x to 2.0x to attain an A3 rating. From a financeability perspective therefore, lowering the notional company gearing assumption is unlikely to alter the ratings assessment unless RCV gearing was pushed comfortably below 55% plus AICR was 'solving' for in excess of 2.0x. This looks like it would push the financeability envelope beyond the bounds of credibility versus actual sector gearing and AICR. Further, the notional company would also potentially differ from the debt benchmarking reflecting actual company structures (which seems broadly well aligned from a ratings perspective with a 'composite' of the A and BBB corporate bond indices that were adopted at PR19[2]).

To maintain the credibility of the notional company financing assumptions, we consider it important that the financing assumptions used are (broadly) reflective of the conventional capital structures employed in the industry, as the purpose of the notional company is to demonstrate financeability with reference to an efficient company reflecting the totality of the price control, which must have some relation to actual companies in the sector.

When assessing each company's gearing relative to the notional company, reported pension deficits should also be included as debt (consistent with the treatment by the credit ratings agencies) for the purposes of assessing a company's financeability under its actual capital structure.

Further, there should be explicit allowance to reflect the impacts of DPC on companies' actual gearing. Moody's has indicated that in relation to UUW's HARP DPC project the lease liability created when the asset comes into use will be recognised as debt with a corresponding addition made on a notional basis to UUW's RCV. This will have the effect of increasing UUW's debt:RCV compared with the position had the DPC asset not been in existence and/or funded via the conventional debt:equity mix.

5.2 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?

UUW supports increasing the proportion of index-linked debt in the notional company to 50%. We consider it important that this is further split, 33% RPI-linked and the remaining 17% CPI/H-linked. Such an RPI:CPI/H split reflects the significant proportion of embedded RPI-linked debt currently in the sector with CPI/H remaining relatively scarce at just 10% albeit with the potential to grow over time.

The 50% looks to be in line with the sector average and is well aligned with UUW's hedging policies. However, it should be acknowledged that derivatives have a role to play in companies attaining and maintaining 50% index-linked (in particular in growing CPI/H exposures) given the scarcity of investor demand for corporate index-linked bonds, provided companies are largely replicating the attributes in any derivatives (e.g. bond style inflation accretion) that are beneficial features of index-linked debt from a financeability perspective.

[2] With A3/A- and Baa1/BBB+ being the median ratings in that composite index.

It should also be recognised that the move to 50% index-linked debt will not improve Standard and Poor's (S&P) primary credit metric – funds from operations (FFO) to debt, as the inflation accretion (due to indexation) on index-linked debt is included by S&P in both the finance expense and the net debt position. So increasing the proportion of index-linked debt will only partially solve any financeability constraints and can lead to more volatile FFO/debt metrics depending upon where inflation outturns across the applicable regulatory period.

6. RCV indexation

6.1 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?

UUW agrees with Ofwat's proposal to move to full CPIH indexation at the start of PR24, and we recognise (all other things being equal) that this improves Moody's AICR in the 2025-2030 regulatory period.

However, as noted in Ofwat's paper, there is a basis risk/implementation costs associated with full transition, given the legacy RPI-debt issued by the sector. We would observe that the sector efficiently raised RPI-linked debt at the time of issuance and RPI-linked debt will likely remain a core component of embedded debt for a long time (reflecting index-linked debt investor preference for long-dated assets and reflecting index-linked funding being a good match for long-life infrastructure assets). This has generally extended sector debt duration profiles, with this debt being raised at a time of higher real rates relative to the current environment. We do not consider that companies such as UUW that have pursued responsible financing strategies, should be penalised for having a material portion of long duration index-linked debt.

Further, as noted in Ofwat's paper, the UKSA's intention in 2030 to align RPI with CPIH may not in itself align existing RPI-linked debt instruments with CPIH. Depending on the terms of the applicable debt item, companies might be required to compensate RPI-linked bondholders for this change. If that were to happen, then any coupon adjustment (re-couponing) would be reflected in post-change embedded debt costs. Given the uncertainties at this time as to whether the UKSA will implement its plans, we agree with Ofwat that this is something that is best addressed at PR29.

7. Financeability

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

Whilst noting Ofwat's assessment at this point in time, it is too early and there are too many unknowns about the PR24 price control - balance of risk, incentive regimes, and underlying macro/financial market conditions (and to what extent the Allowed Return/WACC is reflective of these) - to confirm whether financeability at PR24 is likely to be less constrained than at PR19.

Whilst we support Ofwat in seeking to assess the financeability of a notionally efficient company and in taking appropriate actions to maintain or regain financial resilience, any practical constraints to achieving this need to be recognised.

For example, Ofwat's proposal that gearing should remain constant through the issuance of equity would unlikely be a course of action that an efficient company would or could replicate. Raising equity every year is not the action of an efficient company. Proposing this as a solution creates the illusion of financeability, as would any lowering of notional company gearing, but this is unlikely to be replicated efficiently by the listed companies in the sector. Likewise, an assumption that dividends can be restricted such that they are below the real cost of equity might impair equity financeability and raise the cost of capital, given listed UK water stocks are primarily income investments.

Ofwat should therefore consider what actions are feasible for an efficient company, taking account of 'real world' constraints, and assess financeability of the notional company on that basis.

That said, we are broadly supportive of Ofwat's proposed approach to financeability assessments at PR24, and welcome the acknowledgement from Ofwat that most prominence should be placed on key credit metric calculations that are performed exactly in line with ratings agency methodologies (so called 'adjusted' ratios) to avoid the risk of ratios showing a flattering position relative to actual metrics for ratings purposes. However, solving for ratios that only 'just' meet the required ratings thresholds provides no headroom at all which is not how an efficient and financially resilient company would operate. For example, the indicative impact of full CPIH illustrated in Ofwat's Appendix 2 targets 1.5x ACICR cover which is at the lowest end of Moody's current Adjusted Interest Cover (AICR) range for a Baa1 rating (≥1.5 to 1.7x). We consider that targeting key metrics in the central point of any key ratio range would be a more appropriate test for an efficient company, rather than placing the notional company on a ratings (and potentially, considering Ofwat's proposals in their December 2021 discussion paper on financial resilience, therefore also potentially a licence) 'cliff-edge'.

7.2 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?

Depending upon PR24 investment requirements, there might be a need to attract additional equity into the sector (i.e. to maintain a stable gearing profile). However, such action should reflect whether it is efficient (or even feasible) to do so, for an individual company's circumstances, and for that decision to be taken by the company. It would therefore seem inappropriate for Ofwat to assume that new equity would always be sought – that would imply that a company would have done so regardless of the availability of equity and regardless of whether it would not have been efficient to do so.

Where it is clear that company investment needs cannot be financed out of free cash flow, or by new debt alone, in the notional company (e.g. due to the scale of RCV growth), then it may be appropriate to assume that this is (in part) funded by a (one-off) equity raise (not a dividend cut below the real cost of equity) as this would better reflect the economic environment in which companies operate. Due allowance should be made for the costs of equity issuance and we note that in RIIO-2 Ofgem provided a 5% allowance to fund its view of issuance costs associated with additional equity required. We consider that such allowances are appropriate to reflect 'real world' equity issuance costs.

As noted in response to question 7.1, we also consider that an efficiently run company would not be in a position to frequently seek to issue equity (equity may not always be available either). Therefore when ensuring that a company can finance its functions, Ofwat should test financeability against the assumption that the notional company might only be able to finance new investment from debt.

We also consider that the CMA's principle of 'aiming-up' is a legitimate approach when setting the cost of equity and the Allowed Return as part of the PR19 final determinations and could therefore be an appropriate principle to follow for PR24 - particularly if material investment or additional equity requirements are identified - given the estimation issues in setting the cost of equity and the asymmetrical risk in getting this wrong.

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