

Ofwat

Centre City Tower

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31st January 2022

Dear Ofwat

Re: Response to consultation on risk and return

On behalf of Dŵr Cymru I am writing in response to “PR24 and beyond: Discussion paper on risk and return” published on 9th December 2021.

We welcome the publication of this paper and the opportunity to consider Ofwat’s early thinking on risk and return in the context of PR24. We support the proposal to again provide companies with an indicative view on the WACC in advance of business plan submission. This will aid transparency and the efficiency of the price review process.

Overall approach

Much of the paper focuses on relatively granular issues in the application of the Capital Asset Pricing Model (“CAPM”). Indeed, the discussion is essentially framed as a continuation of the approach adopted at PR19 with a number of suggested modifications to specific components of the methodology.

We would encourage a wider approach to the derivation of the allowed return on capital, including an “in the round” appraisal of the answer implied by the modifications to the application of the CAPM proposed in the paper. As Ofwat has acknowledged, PR24 will herald an era for the sector characterised by new and stiffer challenges (notably climate change and rising customer expectations) against a backdrop of increasing uncertainty and risk. The WACC is the rate of return that investors and creditors require in order to commit capital to the sector. There is no single calculation that provides “the right answer” to this question, and it is necessary to exercise judgement. Whatever the merits of the case for tweaking individual assumptions and methodological choices in the application of CAPM (and we note that almost every proposal in the paper would reduce the calculated WACC, whilst no proposals are made that would increase it) it seems paradoxical that PR24 brings the prospect of significant investment requirements in a more uncertain and risky environment yet investors and creditors are expected to require lower returns than was the case at PR19. The CAPM undoubtedly offers useful insights and provides relevant

evidence but it is not without its flaws and drawbacks (as acknowledged in the paper by Mason and Wright).

Ofwat's decisions on the WACC should therefore be consistent with the prevailing circumstances and should reflect a coherent interpretation of all relevant evidence, including reasonable cross-checks. In particular, since the WACC is the return on capital that investors and creditors require in order to finance the business going forwards, an answer that indicates that the business will not be financeable cannot be right, which indicates that the calculation should be re-visited.

The Cost of Equity and Notional Gearing

We think coherence and consistency are important in the question of the gearing level of the notional company and its interaction with the cost of equity. It is suggested in the paper that a lower gearing level might be appropriate to provide a bigger "equity buffer" for the notional company, which is considered desirable in the light of the risks and challenges that lie ahead. But this does not sit well with the view that the cost of equity going forwards will be lower than at present, not higher. If the future is riskier than the past, one might expect investors to require higher returns to compensate.

A further possible reason that is given for reducing the gearing of the notional company is that a company may well reduce its debt levels in anticipation of a forthcoming period of heavy capital spending that will naturally take gearing up to higher levels again. We do not think this is a strong argument. During a normal growth phase a company can maintain gearing at a certain level by increasing the proportion of the return on equity that is retained within the business, i.e. suppressing dividends. (This only becomes impossible when the rate of growth in the RCV is so steep that retaining 100% of the return on equity is insufficient to prevent an upward drift in the level of gearing. However, this does not appear likely, given the dramatically higher rates of investment that this would imply.) Therefore, in general there is no need to de-leverage a balance sheet in anticipation of a period of higher capital investment.

We also note, in this context, that there is an expectation in the market that third party providers under Direct Procurement for Customers (DPC) arrangements will adopt highly-g geared financing structures. It would be odd if the gearing of the notional company were to be reduced below the 60% used at PR19 on the basis that more headroom above debt levels was required as a response to heightened risks, yet undertakers were expected to be dependent on third party providers of essential infrastructure operating with comparatively thin levels of equity.

Estimating the Cost of Debt

We are in broad agreement with the proposed approach to the estimation of the cost of debt. In particular, we welcome the continuation of the estimation of separate values for embedded debt and new debt. We note that the proposal to increase the proportion of debt assumed to be index-linked will have an impact on the ratio of embedded to new debt for the notional company, as the need to raise new finance is reduced by the extent to which a company is servicing existing index-linked as opposed to nominal debt.

It is important, however, that Ofwat has regard to all of the costs of debt, which include swaps. Since swaps play an important role in managing risks and improving the efficiency of financing strategies for actual companies, it seems likely that the notional company would do the same. Further, any estimate of the cost of debt should also take account of the costs of subordinated debt

as well as senior debt. The primary motive for issuing subordinated debt is that the consequent uplift in credit quality for the senior tranches offsets the higher coupons payable on the lower grade debt, thereby achieving a lower net cost of finance overall. It would be perverse to use only the cost of senior tranches to estimate the cost of debt for the notional company, because it would not be able to achieve those rates of interest without the contribution of the junior tranches.

Financeability

Our principal over-arching observation on financeability is that it cannot be regarded as a separate issue from the question of the appropriate allowed return on capital.

We have three additional observations to make on specific methodological issues concerning the way financeability tests are applied. First, at PR19 Ofwat used a suite of financial ratios that differed in certain respects from those used by the ratings agencies in practice. We welcomed the introduction of the 'alternative' metrics to Ofwat's own and it would help the process if Ofwat were to use the same definitions and approaches in its financeability tests as those applied in practice by the agencies.

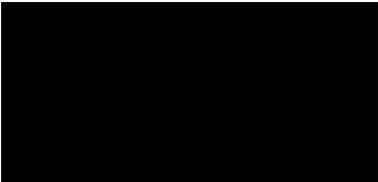
Second, we do not agree that boards should be asked to provide assurance on the financeability of the notional company. As we have indicated before, our board finds the idea of providing real assurance in relation to a hypothetical entity somewhat nebulous. It is, of course, happy to provide assurance as to the financeability of the actual company.

Third, we are not sure of the proposal that financeability should be assessed before the impact of all AMP7 reconciliations is taken into account. There is a distinction between reconciliations that relate to company performance, and reconciliations that are more "technical". So, for example, we agree that it would be wrong to assess financeability after the impact of end-of-period ODI penalties had been taken into account. However, it would be unfair on a company if it were judged to be just financeable before the reconciliation relating to the RPI-CPIH wedge were made, if the impact of that adjustment were then to render it un-financeable. In other words, if a company is holding cash that is due to be returned to customers for reasons other than performance that should be taken into account before financial ratios are calculated for the purposes of financeability tests (and *vice versa*).

We should add, in this context, that we agree with Ofwat's intention to simplify the number of reconciliations at price reviews, where possible, and agree with Ofwat's conclusion to not index the cost of equity. We also support the proposal to move to full CPIH indexation from 1st April 2025 onwards.

If Ofwat would find it useful we would be pleased to elaborate on any of the points made above. In any event we look forward to continuing to participate in the industry discussions on the important subjects covered in the paper.

Your sincerely



Strategy & Regulation Director