Wessex Water
YTL GROUP

By email:

Direct line:
Email:
Date: 2 February 2022

Dear PR24 team

Discussion paper on risk and return – Wessex Water response

Thank you for the opportunity to comment on your discussion paper on risk and return.

This discussion paper raises some potential concerns.

- Firstly, although we agree that we should challenge and try and improve approaches over time, this paper disregards the precedent set by the CMA during the recent water appeals. It seems to defend this by referencing the CMA energy appeals – these are not comparable and are appealed under different grounds. Not finding an error is not the same as saying this is the best way to do something.
- Secondly, it does not seem consistent in its consideration of some aspects. For example, ignoring the impact of swaps to arrive at a cost of debt, yet including them to justify a higher proportion of index linked debt. Equally, considering the beta points from the NATS CMA appeal, the cost of debt points from water and cost of equity from energy to maximise the challenge on the WACC.
- Thirdly, it seems to think that a full transition to CPIH will solve the financeability issues that plagued all companies at PR19. This is not the case. Large investment programmes are required to deliver the stretching targets around storm overflow spills and net zero. This will place different stresses on financial resilience, that it is not appropriate to expect equity to outright fund.

It is critical that the final methodology in this area is not only internally consistent, but consistent with the overall regulatory package. The overall balance of risk depends on the overall incentive package, ODIs, totex, etc. and then the decisions here critically impact the discussions on financial resilience.

I hope you find this response helpful and would welcome further discussions on any of these points as we look to work collaboratively to deliver a progressive framework for PR24.

Kind regards

Director of Economic Regulation

Detailed answers

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

No. We expect that there will continue to be real financeability constraints for a lot of companies. These will be driven by the substantial investment programmes required to achieve the stretching long-term outcomes.

Unjustified changes to the notional structure and continued incorrect calculations of interest cover metrics could present a false view of financeability that should not be relied upon.

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?

There is an inconsistency in the logic set forward here. One of the rationales for reducing the notional gearing was the expectation of large capital investment, then as the investment is made it is funded through equity rather than debt to maintain this reduced gearing. This then contradicts the argument for the initial reduction in gearing.

Regardless of the inconsistency we do not fully agree with the proposition that gearing should be held constant. This is saying that, because of large statutory obligations, shareholders should see reduced immediate returns. We have seen these obligations come in every price control since privatisation, and with increasing pressure to deliver long-term service improvements, we do not expect them to stop.

This could result in a world that the notional company never pays dividends. When would this become a problem? At some point investors will require cash returns, rather than RCV growth - this is not a sustainable policy position.

Finally, as real RCV growth is often driven by statutory or legislative drivers, it is not the investors' decision to make this investment and so represents another risk to investors that exogenous decisions trigger a "cash lock-up" situation.

A useful cross check would be to consider the assumptions on debt/equity financing of direct procurement or other large infrastructure projects. For example, Thames Tideway is very highly geared and funded through debt – why should it be different for significant capital investments for incumbents?

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 completely support the decision to review and challenge the number and balance of the reconciliation models in line with principles of Better Regulation. The growing number of reconciliation models adds unnecessary complexity and potential uncertainty about the true performance and value that companies generate.

The principles outlined in the paper, although sensible, seem to miss any reference to ensuring that the incentive properties for good performance remain. This is key in incentive-based regulation. There should exist a real, material incentive for companies to maintain leading service and efficiency. This needs to be a key principle in setting reconciliation models, we would suggest:

- Incentive properties: Does the reconciliation reduce the incentive for companies to strive for top quality service and efficiency.

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.

We see no mileage in producing notional risk ranges for an efficient notional company. Ofwat does not have the knowledge of operating a company and it will not be possible to set a consistent approach considering the regional challenges differ significantly from company to company.

Further, when setting stretching service and investment targets, these are unlikely to be a central position with symmetric risks. For any notional range to be meaningful, this would need to be discussed and understood.

Ultimately, any ranges would be meaningless and thus any conclusions based upon them would be flawed. Companies are best placed to perform analysis. They can reflect their individual circumstances and challenges and produce meaningful ranges that can be used.

More detailed guidance will increase comparability but will decrease accuracy. The reality is that risk ranges will differ from company to company based on investment programme / capital structure / regional differences.

General point on setting the WACC:

When setting the WACC we think that a clear ex ante methodology should be put forward based on sound, agreed upon economic and financial theory and precedent, with a series of well-designed and meaningful cross checks. This can then be applied to the prevailing market data and take the contention out of the final WACC calculation.

At PR19, it felt like arbitrary decisions were made throughout the process increasing the uncertainty and trust in how the WACC was set.

We note that the proposal to index the cost of equity has been removed. In principle we are still supportive of this as it reduces the overall complexity and uncertainty facing companies and investors. However, this increases the risks of setting the WACC incorrectly and strengthens the need for forward looking estimates and aiming up.

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

We contend that the market data is the market data. How it responds to exogenous shocks, like Coivd-19, should be included in setting the beta. By stripping out significant risk events that calculation would essentially be not "funding" them within the estimation of the WACC. This is at odds with the position set out throughout the pandemic.

Q3.2. Noting the impact of gearing on betas discussed in the report by Professors Mason and Wright, how should we adapt our approach to specifying beta for a company at the notional gearing?

We do not think that there is any evidence to diverge from a well-established process, supported multiple times at CMA appeals.

They claim real life application of this method is at odds with theory, therefore the application is flawed. Instead, we should also question the underlying theory, as it implicitly assumes a perfectly efficient market and a world with no financing costs or taxes. In fact, if it extended to include taxes, we see higher returns for a company with higher debt

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

Fundamentally, this needs to be done in a value neutral way based on sound economic and financial theory and precedent. This presents a true picture and will be to the benefit of all stakeholders.

At this stage we see no evidence to diverge from the natural indexation. Although we agree, as the transition point approaches in the future, we may see evidence to the contrary.

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?

Firstly, it is unclear what the proposed balance sheet approach is. There are multiple ways to undertake this. We would need an ex-ante definition of the proposed approach to meaningfully comment on this proposal.

However, it should be ensured that no companies are penalised for when they raised debt if it was raised efficiently.

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 are not convinced by the claim here. As was stated in the risk and return webinar, there has not historically been any control for the type and tenor of the debt raised. We therefore question if this halo effect really exists. Clearly, if as we are hypothesising it is shown not to exist then there is nothing to take account of in setting a cost of new debt allowance.

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 agree with the removal of the benefit test.

However, we do not think that any other differences should be ignored if they can be clearly evidenced.

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

The notional structure should be set to divorce management decisions from regulatory decisions. It should be set based on appropriate industry benchmarks and observations.

The first principle for choosing a notional structure makes us uncomfortable. It could be read that once we see the risks to the company (i.e. the financial resilience) we can then come back and alter the notional structure to solve these risks. Instead, we think that it needs to be justified upfront by looking across the industry and similar sectors (see previous comments on Thames Tideway). We can ask the question as to what size equity buffer is efficient; currently the actual equity buffer is about twice the annual total expenditure of the industry – we can see no evidence why this is inefficient.

There also needs to be consistency with the overall risk and return package. A reduced notional gearing due to a higher risk than before, needs that higher risk to feed through into the assessment of the overall risk and return package (risk ranges, WACC etc.).

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?

It is fundamental to look at all aspects with a consistent lens. A change in one area based on observed industry data followed by changes elsewhere deviating from that same observed data cannot be justified.

Secondly, the treatment of swaps needs to be consistent across the risk and return and financeability piece. Here they are excluded from calculating the cost of debt but included to justify a higher index linked debt proportion.

If, when considered consistently across the piece, there is evidence to increase the proportion of index linked debt, we would not oppose it.

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?

We agree with this proposal.