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Yorkshire Water's response to "PR24 and beyond: Discussion paper on risk and return"

We welcome this opportunity to respond to the discussion paper and to incorporate our thoughts from the points discussed at the recent workshop held on 20 January 2022. Our detailed responses to the questions posed in the discussion paper are appended to this letter.

The approach to risk and return requires consideration of a set of detailed points; many that are theoretical and technical. We have therefore drawn out the more important aspects of Ofwat's proposals and their consequences within this letter. These are summarised below.

Notional capital structure

We do not agree with and cannot see any compelling reason for the proposed changes to the notional capital structure. In addition, Ofwat has presented inconsistent or irrational explanations for the proposed changes and we are concerned that this will dent the confidence of external stakeholders in the price review process. Ultimately this is likely to result in increased costs being borne by customers in the future.

The narrow focus on gearing appears to have carried across from the discussion paper on financial resilience in the water sector. We do not believe this is in the best interests of customers since there appears to be no credible analysis to support increasing a notional company's equity buffer. We would go further and note that a sector geared on average for a number of years at 70% is indicative of an efficient level of gearing.

Financeability

The question on financeability raises particular concern, due to the early presumption that this is a less critical issue now, than at PR19. There are several important aspects of PR24 yet to be determined by Ofwat e.g., the overall rate of return ("WACC"), cost assessment and the ODI incentive package, that will have significant bearing on the assessment of financeability.

We do not agree that financeability is purely a test of sufficiency of cash flows in PR24, especially if revenue advancement is included. This a repeat of the short-term focused approach taken by Ofwat for PR19, which we continue to believe will undermine confidence in the integrity of the price review process.

CMA PR19 redeterminations

Generally, Ofwat has chosen to disregard the conclusions reached by the CMA in redetermining PR19 for Yorkshire Water and the other referring companies. However, Ofwat has sought to use aspects of the CMA's recent conclusions from the RIIO-2 appeals in the energy sector as an effective overruling of the PR19 redetermination conclusions.

We recognise that the CMA's PR19 conclusions will need to be considered against the circumstances of PR24. However, when considering the CMA's conclusions on other appeals, it is essential to consider the scope of these appeals, the criteria for the CMA to overturn a regulator's determination and the different characteristics of regulated sectors. It is noticeable for the NATS, PR19 and RIIO-2 appeals that the CMA did treat each as distinct and separate in reaching its conclusions.

Given the CMA steps into a regulator's shoes for appeals, we believe a high bar of evidence should be applied to any material deviations from the CMA's PR19 conclusions. From our review of the discussion paper, this would include the following:

- the primary role of WACC in ensuring the notionally efficient firm is financeable;
- CAPM remains the best approach to set an estimate for cost of equity and market cross checks (e.g., MAR analysis, broker estimates) suffer from serious limitations and are unreliable;
- total market return (TMR) should be assessed primarily based on historic evidence;
- beta and the risk-free rate (RFR) should be assessed from as wide range of relevant data as possible (e.g., AAA corporate bonds included within RFR assessment); and

- the embedded debt assessment should include all instruments.

Estimating equity beta

We note the analysis performed by Professors Mason and Wright, including a number of alternative approaches to the re-levering of beta, in the form of five options and the observation from these alternatives that PR19 WACC would have been lower than determined by Ofwat.

We believe this analysis by Professors Mason and Wright is incomplete, due to the narrow focus on beta. Our detailed response sets out extensive analysis that rules out the alternative approaches as credible "solutions". Instead, we have identified the counter-intuitive relationship disappears if (i) Ofwat separates out the allowance for embedded debt and focuses on the marginal WACC, and (ii) an appropriate point estimate for the RFR is used.

Consistency of proposals

Within the discussion paper there is a lack of consistency on the justification for proposed changes that reference actual sector data (e.g., cost of embedded debt, proportion of index-linked debt) but notably ignores it when considering the level of notional gearing.

This lack of consistency extends to the discussion paper on financial resilience, where it is unclear how the proposed increase to the credit rating threshold for cash lock-up does not result in an increase in a higher target rating. This then impacts the target credit metrics to be used for financeability analysis.

Conclusions

Whilst this is a discussion paper at the start of PR24, it does indicate a direction of travel that has focused on selected aspects of risk and return, lacks sufficient justification and consistency for proposed changes to the determination of WACC and the notional capital structure, and a lack of progress since PR19 on an imperfect method to assess financeability.

As noted within our response to Ofwat's 'PR24 and beyond: Creating tomorrow, together' paper, it was critical to step back and consider the overall risk and return 'in the round' in conjunction with the WACC, financeability and the other core areas of the price review, such as cost assessment and outcome incentives. In light of this, it is important for Ofwat to consider the cumulative impact of all the changes they are proposing and not just focus on each issue individually. For example, Ofwat states within the paper that "*Water companies are expected to face substantial investment needs over PR24*"; therefore, it is critical that this increased investment requirement is appropriately reflected within Ofwat's cost assessment.

It is therefore disappointing to see the same narrow focus previously adopted at PR19, whilst also seeking to break the clear links between WACC and financeability that were a core element of the CMA's redetermination. Individually, all of the proposals highlighted within the discussion paper appear to point to a reduction in the allowed cost of equity. When assessed cumulatively 'in the round' the combined impact of all these changes could lead to a material departure from the WACC determined by the CMA in March 2021.

It is critical to the long term financeability of the sector that the recent conclusions of an independent arbiter, such as the CMA, are not ignored otherwise this will impact long-term investor appetite, in turn resulting in increased future costs for customers.

We have noted in our response to the discussion paper on financial resilience that a piecemeal approach has been taken by Ofwat to its proposals for PR24 and beyond. This approach means it is not possible at this stage for companies to fully assess the implications of the changes towards risk and return. As such, we consider that this can only be achieved once there is clarity on all of Ofwat's considerations and proposals for PR24 and beyond.

We look forward to further engagement with Ofwat on this critical set of proposals.

Yours sincerely,

[redacted]

Director of Strategy and Regulation

Appendix: Detailed 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?

We support the principle of reducing complexity where appropriate, but do not have any specific concerns in relation to any of the existing reconciliation mechanisms.

We recognise the difficulty of weighing up the mechanisms using the proposed criteria as materiality, risk allocation and cost benefit for individual companies will vary significantly from an industry level assessment. This may introduce bespoke risk profiles for individual companies that will then need to be managed through the risk and return package.

The introduction of a materiality and cost benefit assessment will also be difficult to develop on a practical level, as it is not possible to determine how material a risk will be until the end of the period. For example, the current inflation position means that the net impact of the RPI-CPIH wedge mechanism will probably be much higher than originally envisaged. A risk that is immaterial to one company is also not necessarily immaterial to the rest of the sector.

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.

Generally, we fully support a move towards greater clarity and comparability across the risk ranges within the sector.

We believe there is a need for further detailed consultations with the sector on this complex and key matter so that a clear, transparent methodology can be determined, for both notional and any company specific risk ranges. This would ensure a constructive approach to address aspects of the proposals where there is a lack of clarity, not just within the required detail of the actual calculations, but also the overarching principles.

There are some specific aspects that we believe require further consultation, particularly when considering external stakeholders. These are:

- The conflation of notional and actual risk and the ambiguity around the use of the term 'notional' – i.e., is this the notionally efficient company or purely an assumption of notional gearing?

- Different risk ranges being produced by Ofwat and companies, which will add to confusion and complexity. The purpose and value of each risk range needs to be carefully considered, e.g., company specific risk analysis may be better addressed by companies as part of their financial resilience assessment.

- Further clarity on the calculation of the chosen probability points in the risk ranges, such as the P50, P10 and P90 points. Whilst we accept that the P50 might not necessarily be the simple average of the P10 and P90, this would be the reasonable starting point and clear evidence would need to be provided to illustrate why that would not be the case in relation to any particular risk range.

Moving forward, we believe it would be more appropriate for notional risk ranges to be produced by Ofwat in collaboration with water companies and other stakeholders, with a clear linkage to the new long-term planning approach. This would ensure a full range of views is considered in the determination of the risk range process, resulting in an appropriately balanced risk and return package. This would provide confidence to customers and investors on the integrity of the price review process. We believe this would be best achieved through an iterative process between Ofwat and the companies throughout PR24 to deliver a package with a fair balance of risk and return in the final determinations at the end of 2024.

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

The consultation document states an intention to consider evidence on beta using a range of estimation periods and data frequencies. This is in line with the approach that Yorkshire Water advocated during PR19.

We consider that it is premature to decide at this stage exactly how market data from any particular time period should be treated. The rationale for casting the net wide and looking at the full range of possible beta estimates is that Ofwat can interpret in the round what the data is saying about investors' risk perceptions going into the next regulatory period. Such an assessment must be made in the context of the full set of information that will be available to Ofwat when it makes it decision in late 2024, including data from 2022-24.

Pending sight of the full data set, we recommend that Ofwat should defer any judgments about the usefulness or otherwise of data from 2020 and 2021 until a later date.

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?

Mason and Wright's analysis conflates two distinct and separable issues, i.e.:

- the allowance that Ofwat needs to make for embedded debt costs; and
- the relationship that one would intuitively want to see between gearing, beta, and the cost of capital.

This can be seen clearly in Table 1 below. The table reproduces Mason and Wright's calculation of the Ofwat PR19 WACC at two debt-to-RCV levels: 54.2%, in line with Severn Trent's and United Utilities' actual historical enterprise gearing; and 60%, in line with Ofwat's notional PR19 balance sheet.

Table 1: Wright & Mason's WACC calculations	Actual gearing	Notional gearing
Debt : equity	**54.2% : 45.8%**	**60% : 40%**
Embedded debt : new debt : equity	**43.4% : 10.8% : 45.8%**	**48.0% : 12.0% : 40.0%**
Cost of new debt	0.53%	0.53%
Cost of embedded debt	2.42%	2.42%
Proportion of new debt	20.00%	20.00%
Fees etc.	0.10%	0.10%
Cost of debt	**2.14%**	**2.14%**
Risk free rate	-1.39%	-1.39%
TMR	6.50%	6.50%
Asset beta	0.36	0.36
Debt beta	0.125	0.125
Equity beta	0.63	0.71
Cost of equity	**3.61%**	**4.19%**
Vanilla WACC	**2.81%**	**2.96%**

The second row of the table highlights that Mason and Wright's calculations provide for materially different amounts of embedded debt financing. This is important because embedded debt raised prior to 2020 is more expensive to service than both new debt and new riskless assets. It is therefore wholly unsurprising that Mason and Wright should find that the cost of capital increases when they increase the proportion of the RCV that is assumed to be financed by embedded debt by approximately 5 percentage points.

Corroboration that Mason and Wright's findings are first and foremost a function of a different approach to debt costs can be obtained by focusing attention on the value of the marginal WACC – i.e., the weighted average of the cost of new equity and new debt, ignoring all embedded debt costs – at different levels of gearing. Table 2 provides the relevant calculations.

Table 2: Marginal WACC calculations	**Actual gearing**	**Notional gearing**
Debt : equity	**54.2% : 45.8%**	**60% : 40%**
Cost of new debt	0.53%	0.53%
Cost of embedded debt	n/a	n/a
Proportion of new debt	100.00%	100.00%
Fees etc.	0.10%	0.10%
Cost of debt	**0.63%**	**0.63%**
Risk free rate	-1.39%	-1.39%
TMR	6.50%	6.50%
Asset beta	0.36	0.36
Debt beta	0.125	0.125
Equity beta	0.63	0.71
Cost of equity	**3.61%**	**4.19%**
Marginal WACC	**1.94%**	**1.99%**

Table 2 shows that the computed marginal WACC varies slightly at different levels of gearing. However, the magnitude of the change is small, especially when considered alongside the margins of error that there are in the calculations of the RFR, TMR, beta, etc.

Given the above analysis, four of Mason and Wright's proposed solutions can immediately be ruled out as inadmissible responses to the perceived problem at hand:

- option I (set notional gearing equal to actual gearing), option IV (assume that the WACC is constant) and option V (departing from MM) are all, in effect, a downsizing of Ofwat's allowance for embedded debt costs and, hence, lead to an understatement of the amount of pre-2020 debt that companies are actually carrying forward into future control periods; and

- option II (use the CAPM for both debt and equity) is tantamount to the complete disallowance of all embedded costs.

This leaves option III (use the raw equity beta) which is also unacceptable in that it is founded on the mistaken and indefensible assumptions that:

a) the cost of equity is invariant to the level gearing, notably a proposition that the CMA rejected outright in the PR19 redeterminations; and

b) the WACC reduces inexorably as a company increases its debt-to-RCV ratio towards 100%.

Yorkshire Water has observed during its CMA referral that if a correction to the tried-and-tested WACC formulae is required, then it is better to direct any effort towards the setting of a more accurate RFR.

In this context, we note that Mason and Wright observe that the relationship shown in Table 2 above arises from the insertion of a debt premium (i.e., the difference between the cost of debt and the RFR) that is too big to be explained by conventional CAPM. However, Mason and Wright have clearly failed to diagnose that the unexpected size of the debt premium is a direct consequence of Ofwat assigning a very low value to the RFR.

The CMA reached very clear conclusions on this matter in its PR19 redeterminations, including:

- yields on index-links gilts (ILGs) are lower than the rates that would be accessible by even the highest-rated private investor;

- a regulator cannot assume – as CAPM requires – that investors face the same RFR whether saving or borrowing; and hence

- it is important to look to other proxies for the RFR of return, and particularly to AAA-rated non-government bonds that carry a stronger rating than gilts.

Table 3 confirms that the counter-intuitive relationship shown in table 2 all but disappears if one uses an appropriate estimate of the RFR.

Table 3: Marginal WACC calculations Alternative risk-free rate	Actual gearing	Notional gearing
Debt : equity	**54.2% : 45.8%**	**60% : 40%**
Cost of new debt	0.53%	0.53%
Cost of embedded debt	n/a	n/a
Proportion of new debt	100.00%	100.00%
Fees etc.	0.10%	0.10%
Cost of debt	**0.63%**	**0.63%**
Risk free rate	-0.50%	-0.50%
TMR	6.50%	6.50%
Asset beta	0.36	0.36
Debt beta	0.125	0.125
Equity beta	0.63	0.71
Cost of equity	**3.94%**	**4.45%**
Marginal WACC	**2.09%**	**2.10%**

Note: -0.5% risk-free rate set in line with yields on AAA non-government bonds in period prior to Ofwat's PR19 FD

This response to Question 3.2 should also be read in conjunction with the later response to Question 5.1 which notes the inappropriateness of using a notional gearing figure of less than 60%. Also, we note that the enterprise gearing of 54.2% used in Tables 1 to 3 above is lower than Severn Trent's and United Utilities' actual RCV gearing as a result of the inclusion of outperformance in the enterprise valuation, which would not be reflected within the notional company and so understates the relevant gearing for a notional company.

Therefore, we do not agree with the proposals in Mason and Wright's paper as they have not been substantiated and consider that Ofwat's concern is both overstated and misdirected. We believe our response sets out a solution to demonstrate that WACC does not increase with gearing and there is no need to address an issue that does not exist.

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

As noted in the previous question, there has been a good deal of criticism in recent years about the use of ILGs as a proxy for the riskless asset. We consider that the impending changes to the RPI measure of inflation further weakens the case for using ILG yields within the RFR calculation and further strengthens the case for using alternative metrics.

In order to continue using ILG yields in PR24, Ofwat would have to have some rational basis for inferring the expectations that investors have formed about future RPI inflation. Ofwat would also have to be sure that there were no distortions in the market that were pulling prices and yields apart from economic fundamentals. We do not see how Ofwat could make any sort of pronouncements on either of these fronts:

- absent binding confirmation from the UKSA by no later than 2024 about the date and form of the reforms to RPI, it will not be possible to say anything meaningful about the expectations that are forming in investors' minds about the worth of future inflation indexation; and

- as we get closer to 2030, it is likely that there will be some institutional investors who will be compelled to buy ILGs regardless of price and whose behaviours will therefore distort market ILG yields and cause an even greater divergence than we see at present to the true RFR.

Given this backdrop, we are concerned that Ofwat may be considering the conversion of ILG yields to a CPI-stripped equivalent using its own composite RPI/CPI forecast. Such an approach indicates Ofwat saying it believes what investors should be expecting, rather than ascertaining what investors actually are expecting. As such, it brings considerable risks of estimation error.

Given that there exist other available proxies for the riskless asset, we believe Ofwat would be better incorporating alternative benchmarks when setting a range for a point estimate, rather than try to redeem an inherently irredeemable measure.

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?

We agree with an overall approach for assessing the cost of embedded debt allowance that focusses on a balance sheet approach, supported by a cross check to relevant benchmark bond indices.

For the determination of a point estimate for cost of embedded debt, we appreciate that there is a preference for the balance sheet approach on a sector wide basis as opposed to a more appropriate, individual company basis. We note the use of a sector wide approach is flawed by creating a split of companies between 'winners and losers' that is not solely due to efficiency differences. We believe that this should not be ignored when market data (e.g., market asset ratios) is used to support any proposed changes to the notional capital structure, or the cost of equity assessment.

From our experience with the CMA, it is critical that Ofwat provides further clarity and transparency on how the balance sheet approach will be defined for PR24.

The methodology adopted by the CMA provides a clear precedent and we believe that a high bar of evidence should be adopted for any potential deviations from this policy.

In particular, we note that the CMA included all derivative instruments within their assessment. The information presented by Ofwat to attempt to support the exclusion of derivatives displays a lack of understanding of the importance of derivatives for companies in managing their debt portfolio and their exposures to market rates and inflation.

The use of swaps can offer efficient financing solutions not available in the debt capital markets, as is the position currently when considering the illiquid market for inflation linked bonds that can be avoided by issuing fixed rate bonds and using inflation swaps. Also, it is clear all swaps assist with the management of exposures by reprofiling cash flows (e.g., between fixed and floating interest rates or between real and nominal interest rates) and they will continue play such a role across the sector.

The portrayal of certain swaps as “risky” appears to be based on the hindsight view that swaps are expensive in comparison to new debt. This is incorrect as the comparison should be to standard fixed rate or index-linked bonds raised at the same time as swaps were executed. A counterfactual exercise conducted by Yorkshire Water for the CMA showed that there would be no material difference in interest costs if it had raised index-linked bonds, rather than index-linked swaps. Therefore, it would be inappropriate to seek to treat swaps differently

It will also be important that all the companies within the sector are considered and there are no exclusions, based on narrow gearing or ratings-based assessments. The CMA’s use of a median provides sufficient protection against the impact of outliers that would distort a point estimate for cost of debt.

In relation to the chosen benchmark indices, it will be important to consider 20-year trailing averages as these are more representative of the average maturity of the sector’s debt. For example, the current sector weighted average maturity of 13 years equates to a 26 year trailing average.

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?

Significant amounts of evidence on this matter were presented to the CMA, who concluded that the variances to the index were a result of differences in rating and tenor to the notional assumption, rather than any actual ‘outperformance’. It is concerning that Ofwat has not considered these valid differences in its analysis presented in the discussion paper. As such we do not believe there has been any fresh evidence presented to support the assertion of a persistent issuance discount that should be considered when setting the allowance for new debt.

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 disagree with company specific adjustments solely in relation to size. A number of other factors, principally timing, are the main cause of variations in the cost of debt between companies.

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

We do not agree with the proposed amendments to the notional structure and see no compelling reasons presented by Ofwat to support possible changes to the PR19 notional structure.

The changes noted in the discussion paper were all proposed by Ofwat to the CMA, during the review of the PR19 referrals, as potential solutions to the financeability constraint. However, these proposals were either rejected or ignored by the CMA when it published the final conclusions in April 2021.

A high bar of evidence should therefore be required to deviate from the conclusions of the CMA. We do not believe the information presented within the discussion paper, particularly in relation to notional gearing, meets this standard. Specific points to consider include:

- statements indicating the need to reduce gearing to be able to borrow efficiently, which are not supported by many companies borrowing efficiently at higher levels of gearing for a number of years, such that the average sector gearing is c.70%;
- excluding outliers from the gearing range prevailing in the sector, which appears currently to be centred around 70%; and
- continuing to use the widely recognised RCV basis to calculate gearing and not to introduce other measures such as enterprise gearing that will be impacted by actual performance.

In addition, there is a clear lack of consistency in approach across the different proposals. If an 'actual' approach is being applied to cost of debt and the proportion of index-linked debt, then it also needs to be applied consistently to the gearing assumption.

The current inconsistency of these proposals gives the impression of selecting measures specifically to improve modelled cash flows and credit metrics, effectively assuming real-life financeability constraints away. This is likely to dent investor confidence in the price review process, which would not be in the long-term interest of customers. This view is supported by Question 7.1, which is concerning as it is far too early in the process to be able to make such assessments.

Finally, we note that a reduction in notional gearing would most likely result in an increase in the target rating, as 60% gearing is the current threshold for a Baa1/BBB+ or A3/A- rating. It will be important that any change in target rating is appropriately reflected within financeability analysis, with the target thresholds for key financial metrics increased accordingly.

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?

Linking Questions 5.1 and 5.2, we believe that if 'actual' data is used to evidence an increase in the proportion of index-linked debt, then notional gearing also needs to be increased on the basis of 'actual' evidence. It would be inappropriate to use an inconsistent evidence base for these two key elements of the notional structure.

It needs to be recognised that index-linked swaps are included within the index-linked debt percentages reported by Ofwat in Table 5.1 of the discussion paper, whilst it was noted at the Risk and Return workshop that an increase in the proportion of index-linked debt within the notional company would not include index-linked swaps. This point is critical since evidence needs to be presented to support the assumption that the notional company could efficiently achieve an increase in the proportion of indexed linked debt solely by debt issuance.

We believe that the illiquid index-linked bond market means an increase in the proportion of index-linked debt as proposed for the notional company could only be achieved efficiently by using index-linked swaps. It is essential that the treatment of index-linked swaps across PR24 be both consistent and justified.

We believe the current proposals should be reconsidered as they are not supported by reliable evidence that the increase in index-linked debt can be achieved efficiently and they are not consistent with other debt related aspects of PR24 when assessing the role of index-linked swaps.

Another consistency point is the need for the composition of the index-linked debt to be all CPIH related. If the allowed return is to be calculated on a full CPIH basis then it would be consistent to reflect the cost of all index-linked debt on a full CPIH basis.

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?

As noted in our prior response, in principle, we support a move to full CPIH indexation from the start of PR24 as a more appropriate index that will be simpler to administrate.

There is a notable lack of CPI debt issuance by companies, mainly due to absence of any reliable benchmarks to ensure efficient pricing. Consequently, there remains a significant amount of RPI-linked debt currently included within the sector's embedded debt and a full transition to CPIH-linked debt within this proposed timescale could only be achieved through the use of swaps. As also noted in Question 5.2 above, it is essential that the treatment of index-linked swaps across PR24 be both consistent and justified.

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

It is concerning that this question is posed at this very early stage of the price review when there are several important aspects to be clarified by Ofwat, including a discussion paper on ODIs that has not yet been published.

It gives the impression that financeability will be treated as a simple 'spreadsheet solution' for certain key financial metrics in the short-term, without stepping back and considering more broadly the overall balance of risk and return longer-term. It is too early in the process to currently be able to make that assessment; therefore, this question is better asked later in PR24.

Financeability analysis was a crucial element of the CMA's PR19 redeterminations. So, we are concerned that Ofwat continues to see the financeability assessment as purely "a test of the sufficiency of cash flows". This is a very narrow interpretation of Ofwat's financing duty that falls short of the comprehensive "in the round" assessment conducted by the CMA at PR19. It continues to suggest a short-term focus based on flawed solutions such as re-profiling revenues between periods that was rejected by the CMA, rather than addressing core underlying issues.

As noted in our prior response, we believe the CMA provided an enhanced template for future financeability assessments that should be adopted in full. In particular, we note that the CMA's key starting point was that WACC is the primary factor in ensuring that an efficient firm can finance its functions. This is important as it recognises the clear link between financeability and the allowed return to be paid to the providers of debt and equity capital.

Ofwat has highlighted certain changes, such as full CPIH transition and Ofwat's proposed changes to the notional structure, which would result in an increase in financial metrics. However, we would also note that a financeability assessment should not purely focus on certain base metrics, plus there are a number of other factors not apparently considered by Ofwat that would result in a decrease in financial metrics. These include:

- a reduced cost of equity as a result of changes proposed within the discussion paper;

- a cost of debt calculated on full CPIH basis to ensure consistency with return; and

- an increase in target metrics as a result of higher target notional rating

When we consider the points above, together with the proposal that Ofwat also determines the RoRE ranges for the notional company, then there is serious concern that a financeable notional company has been pre-determined by being able to present a low allowed return and balanced risk and reward package. This is unlikely to be consistent with the views of the sector or investors when reflected against the real-world challenges anticipated for companies in PR24.

Such an approach can only erode investor confidence, which will not be in the long-term interests of customers. Therefore, it is critical a robust and strongly evidenced financeability assessment and RoRE analysis are conducted for PR24.

On this basis we do not believe it is currently possible to determine whether financeability will be more or less constrained at PR24. To ensure investor confidence is not further eroded an opinion on this matter can only be provided once there has been a comprehensive assessment of all relevant factors.

For the avoidance of doubt, we would like to clarify that our previous comment should not be interpreted as presented by Ofwat in Section 7.2 of the discussion paper. We agree with the other companies that notional company assumptions should not be used to solve a financeability constraint. Our comment referred specifically to downside sensitivity analysis, which should be conducted as part of any financeability assessment. Purely within this downside sensitivity analysis, a potential increase in equity could be considered as a mitigating solution to the downside sensitivity. We do not believe this is an appropriate solution to a financeability constraint within the base price review figures.

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 disagree with the automatic assumption that RCV growth should be funded through a mix of debt and equity, such that gearing remains constant. In addition, it is not clear at this stage whether real RCV growth would necessarily need equity funding in order to maintain constant gearing for the notionally efficient company.

This presents as a narrow focus on gearing, when there are a number of other factors to be considered in determining how best to finance major investment in a cost efficient manner for customers. The benefits from major investments will span a number of AMP periods. Therefore, we believe a longer-term approach needs to be taken to financing, without a narrow focus on certain annual metrics, such as gearing, which may lead to inefficient choices being made.

Furthermore, we believe it would be reasonable for gearing to increase slightly in a period of relatively high investment, particularly when interest rates are low, before subsequently potentially falling again in later periods when the investment requirement might be lower.

From an equity financeability point of view, this proposal will not be attractive to investors given it would lead to a regular rebalancing of the mix of debt and equity for small amounts, either by dividend retention or equity injections. The prospect for shareholders of irregular and reduced dividend yields or recurring cash calls would neither be efficient nor practical. Such an approach is likely to dent investor confidence in the sector, leading to increased costs for customers in the long-term.