Respondent

1 | Anonymous

287:52

Time to complete

1. **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?

In short, the feeling was too much data was required, it was being manipulated and presented in too many ways (and often inconsistently) and thus the output had little incremental information content (or had the potential to be confusing). One example was the P10/P90 analysis performed in the context of PR19 seemed not to be numerically accurate or to quantify risk (especially cumulative risk) in an understandable and true way. Finally, the audience and thus the purpose of this analysis could be clarified; for example, can customers realistically be expected to understand and interpret it and how do boards and investors use the information? Accordingly, we would agree with the sentiment that there should be a significant reduction and simplification in what is being requested and presented.

2. **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.

Apart from being a bespoke form of variance analysis and intercompany comparison, our perspective has been that notional risk ranges have limited utility for boards and investors in companies, given what is most relevant to those stakeholders is actual outcomes. Actual company ranges, and reasons for variance, would appear to have the greatest utility. We do agree that the particular risk characteristics faced by WoCs may merit a different approach to this sub-sector.

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

Future beta is not observable. This, in the context of it being a subjective judgement, the preference would be for it to based as closely as possible on objectively observable figures and uninterrupted historical time series. Our general view is therefore that attempts to make manuscript (and subjective) adjustments to parameters to seek to adjust for "unusual" events potentially risks undermining the basis and veracity of the analysis.

4. **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?

Consistent with our general philosophy, we would like to see a consistent approach on beta to that adopted by the CMA took in its PR19 redeterminations. Similarly, we believe that the benefits of consistency of approach (ie. de-levering and then re-levering beta's in accordance with long-established regulatory precedent) well outweighs any alternative considerations. The merit and consequence of the points made by Mason and Wright are debateable having regard to alternative points of view.

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

At PR19, it was a concern that the use of an estimated wedge exposed companies to basis risk. We think it is appropriate, especially in the context of elevated inflation at present, to continue to observe how RPI and CPIH move relative to each other before settling any approach. Further, because this element of the regulatory regime transfers basis risk to companies, we would be concerned if a hypothesis about future movement of the RPI-CPI differential in advance of 2030 underpinned downward changes to the wedge.

6. **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?

Our general view would be that cost of debt allowance is best based on a balance sheet approach. Indices can be blunt instruments and the scope for basis risk and interpretative

error is material, which has the potential to introduce an unnecessary level of judgement into what could otherwise could be a relatively objective analysis. Having been considered by the CMA in its PR19 redeterminations, we would imagine that any alternative to the CMA's considered position should need extremely strong grounds to be preferred.

7. **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?

The CMA made no adjustment having considered this issue in depth in the PR19 redetermination, having the benefit of significant body of in depth materials prepared by appellant companies. Accordingly, the reference to a "persistent issuance discount of water company bonds" appears flawed, taking into account prior detailed investigation of the issue. The possibility of seeking to relitigate what should be settled issues is problematic for companies and their investors. Accordingly, we think the regulator should adhere to the settled CMA position.

8. **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?

The (subjective) benefits test has been struck down by CMA in two successive price control appeals so we agree that it should be removed. Further, small company premia are a well established feature of the regime and supported by CMA redeterminations. We are concerned about the potential arbitrariness of determinations by on what is "small", having regard for Ofwat's differing positions on companies in PR19 and the PR19 redeterminations (where, for example, Bristol Water was argued not to be small notwithstanding that South Staffordshire). There is also a concern about a comment in the slide deck that ".. any applications for a company specific allowance will need to provide compelling evidence that it is supported by customer preferences …" because, inter alia, experience is that surveys on the subject are never perfect enough, what is "compelling" is entirely subjective and there is the potential for this leg to become a subjective benefits test proxy by another name.

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

We have not had an issue historically with the approach to notional gearing but do not feel in a position to comment further at this point given uncertainty as to what the commentary in the consultation would mean in practice.

10. **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?

> Prima facie, this may be seen to be a justified approach. However, the implications should be carefully considered and understood before a material change of the scale proposed is made, especially because of changes in real interest rates over time. Index-linked debt is long-lived and a substantial portion of debt is "out-of-the-money", having been raised in the 2000-2007 period. Distortions in index-linked gilt markets, illiquidity in corporate index-linked bond markets and the lack availability of robust and deep benchmarks for corporate index linked bonds are amongst the issues that may need to be factored in to such an analysis.

11. **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 disagree with the transition being implemented as at PR24. We note that there is a significant amount of RPI linked debt, so there is the risk associated with a material mismatch in basis that would fall on companies. If any change is to be contemplated, we expect it would be far more appropriate to do so in PR29 when, inter alia, the implementation of the 2030 RPI reform is better understood. It is also noted that there is a significant amount of index linked debt becoming due in the 2030-2035 quinquennium, so maintaining the existing position at least through 2025-2030 would have strong merit.

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

> We do not believe that the question of financeability being greater or less constrained can be determined in advance of the full detail of a price control emerging. We have concerns that the acceleration of returns in order to address financeability issues is not an appropriate response to the issue; for example, it could reduce RCV which results in actual financeability issues emerging elsewhere and it does raise questions about intergeneration funding of long-lived infrastructure.

13. **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?

In the context of WACC formulation, a constant notional gearing level is the settled norm of regulators. There are issues with tying financeability assessments exclusively to the notional company, which have been compounded in the past by differences between the measures used to assess financeability and those employed by ratings agencies. With the move to long term viability assessments being required of company boards in respect of their submitted business plans and then in relation to a regulatory determination, it should be expected that regulators should perform a thorough cross-check of actual financeability to understand what is being asked and expected of companies and their investors. In the context of expectations that new equity is raised, regulators have allowed for an incremental cost to equity raisings in past price controls (and this has also been the case for new debt raisings).

14. Any other comments/feedback

There were a number of other issues which have not been dealt with in the questions posed, on which we would like to express our position:- 1. In relation to risk free rate, we agree with the CMA's decision in its redetermination regarding use of a synthetic index of RPI-linked gilt yields and AAA-rated bond yields to estimate risk free rate. Regarding the references in the consultation to CMA's findings in the RIIO-2 redetermination, these should be noted to be in the context of the "error" standard which applies to such energy sector appeals. 2. In relation to total market return, we did not believe that the ex ante and forward looking approaches to TMR adopted in PR19 had a robust basis and are concerned about the consultation intimating that PR24 may follow a potentially similar path. 3. In relation to share of new debt, we do think that different parameters may be applicable to the WoCs (as compared with the WaSCs) because of generally lower RCV growth being experienced by the WoCs. Applying the same share of new debt to the two, substantively penalises WoCs versus WaSCs at a time of low interest rates in a historical context.

15. Which type of stakeholder group do you represent (pick all that apply)? *

- [x] Water company
- [ ] Consumer Body
- [x] Equity investor

16. Name of your organisation: *

iCON Infrastructure LLP

17. Contact details: *

[redacted]