Investor roundtable: PR24 risk and return and financial resilience

January 2022

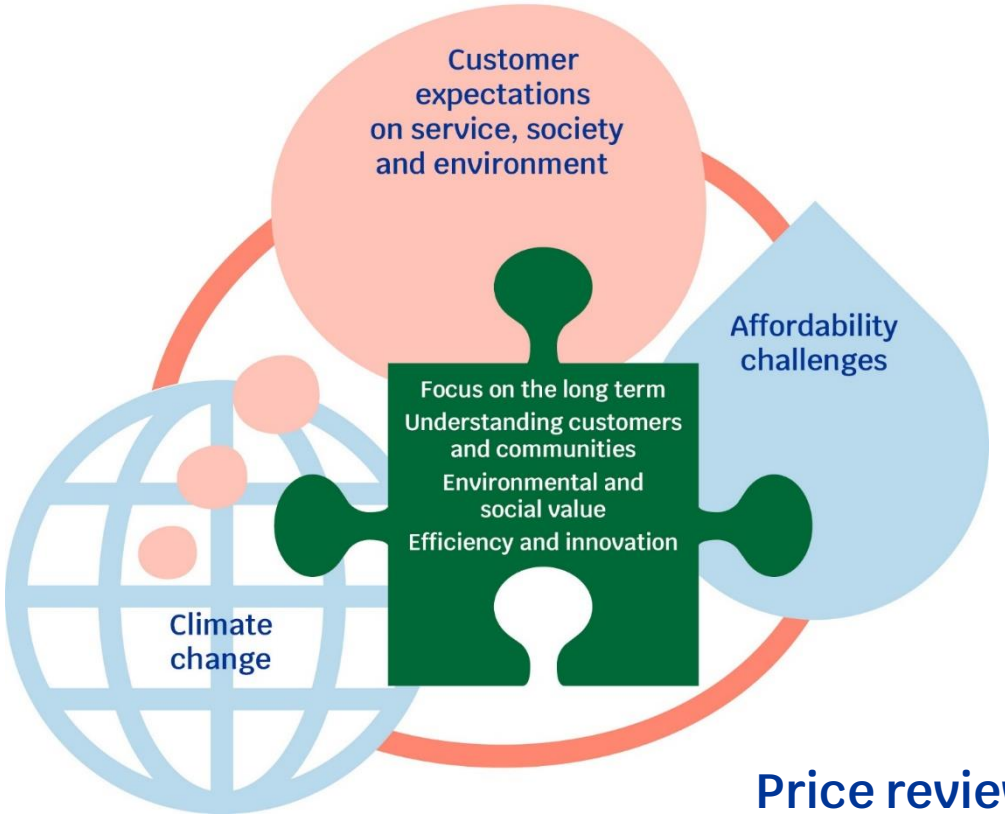
Ofwat

Ambitions for PR24

The sector faces **several interrelated challenges**:

- Climate change
- Evolving customer expectations
- Affordability

To help meet them, we've set **four goals for PR24** and considered how we'll **design the price review**



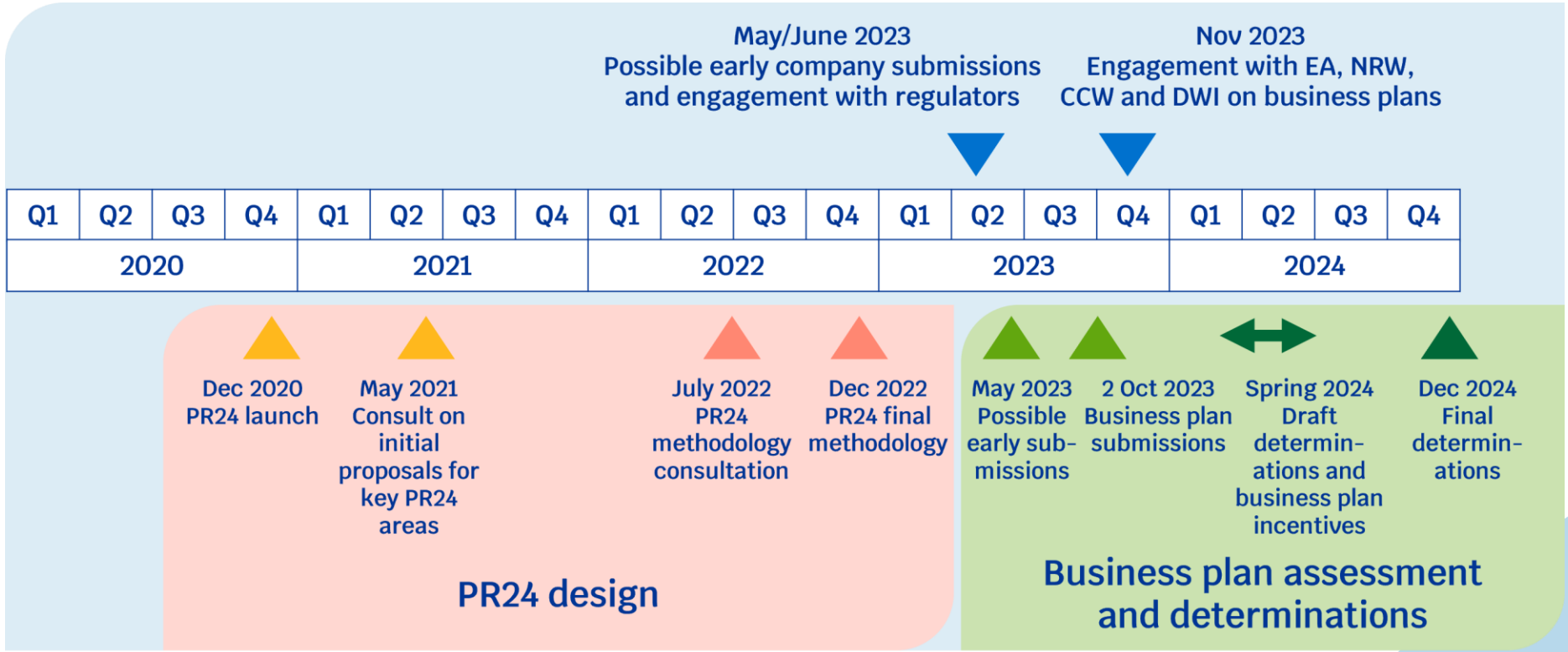
#MoreFromPR24

We'll work with the sector in a way that enables **conversation, collaboration and co-creation**

Price review design

- Clarity for the future vs adaptability
- Sophistication vs simplification
- Regionality vs comparability

PR24 timeline



Risk and return discussion paper

Introduction to PR24 risk and return discussion paper

Our risk and return discussion paper is open for consultation and we'd love to hear your views.

This discussion paper is a further step in the development of our methodology for **PR24 and beyond** on which we will consult in July 2022. It builds on some of the key issues discussed in our May 2021 consultation PR24 and beyond: Creating tomorrow, together.

Our aim is to align the interests of companies and investors with those of customers, so that the sector is attractive to investors, but companies can only earn high returns from great performance.

In the discussion paper we do not cover every issue relevant to risk and return and we do not give a view on the level of expected returns at this stage – we propose doing so in our methodology document.

Written submissions on our discussion paper by Wednesday 2 February 2022. Please submit your responses either by this short form response or by email to PR24@ofwat.gov.uk.

Proposals in the risk and return discussion paper (1 of 2)

Balance of risk and return	• Maintain a presentation of risk exposure using RoRE over the control period • Look at in-period risks from outcomes, costs, financing • Continued role for reconciliation mechanisms, although we are minded to simplify and reduce wherever practicable
Allowed return on equity	• CAPM-based approach, with cross-checks (eg market to asset ratios) • Fixed allowance: not proposing to index the risk-free rate or other components • Total Market Return: Use long-run historical averages for our range, forward indicators to inform choice within the range • Risk-free rate: Looking at suitability of RFR proxies (gilts and SONIA rates) • Beta: looking at sensitivity to pandemic effects and also methodology of delevering listed companies at enterprise value and re-levering at the notional gearing level
Allowed return on debt	• Sector level allowance • Fixed component for embedded debt, retain indexation for the cost of new debt • Embedded debt allowance set by reference to balance sheet costs, cross-checked against suitable benchmark index • Any applications for a company specific allowance will need to provide compelling evidence that it is supported by customer preferences – but we do not propose a separate benefits test

Proposals in the risk and return discussion paper (2 of 2)

Notional capital structure	• Propose a framework for evaluation (balance of risk; investment needs; benchmarks; customer interests) • May be benefits to adopting a lower notional gearing level at PR24 – combined effects of a more uncertain future and revenue at risk from service performance may indicate a greater role for equity to provide a buffer against shocks
RCV indexation	• Propose a framework for evaluation (Legitimacy; Affordability; Financeability; Implementation Costs; Complexity) • Preference to adopt full CPIH indexation from 2025
Financeability	• look at a suite of financial ratios, e.g. gearing, AICR, FFO to net debt (average and trends over the control period) • Focus on a notionally structured company with an efficient level of expenditure • Require companies to provide Board assurance that they are financeable by reference to the notional company and that the actual company structure remains financially resilient • Potential for lower pressures on financeability for PR24 (eg due to reduction in embedded debt costs, choice around CPIH indexation of RCV, notional gearing assumption)

Financial resilience discussion paper

Introduction to the financial resilience discussion paper

Water companies provide an essential public service…	• Investibility and financial resilience are important if companies are to meet customers' needs and finance investment
… and maintain discretion over their capital structure and financing arrangements within the context of price reviews, company licences and company law	• Investors – rather than customers – should bear the risks of the financing and capital decisions • As monopoly service providers, companies must be transparent about their financing arrangements
Poor levels of financial resilience can have real consequences for customers if a company does not have the financial flexibility to turn poor performance around	• Case study – Southern Water
Our role… …to ensure customers are adequately protected from the risks of financial distress and the actions of group companies …and, where appropriate, to encourage companies to strengthen financial resilience	**Recent steps include:** • Enhanced monitoring regime • Expectations on long term viability statements • Focus on financial resilience in price reviews • Set expectations on reasonable dividend policy • Engagement with companies with weaker levels of financial resilience

Our discussion paper sets out several options to strengthen the protections to customers and the environment from weak levels of financial resilience.
We report on financial resilience in our annual Monitoring Financial Resilience report.

Issues and concerns set out in the financial resilience discussion paper

Companies operating at the lowest investment grade rating, or at risk of downgrade to that level

Risky use of derivatives which undermine existing credit protections

Withdrawal of weak credit ratings

Dividends declared or paid without clear alignment to the long term financing needs of the company or performance in meeting obligations and performance commitments

Concerns where a company with poor operational performance does not have the financial flexibility to turn its performance around

Transparency

Case study

Southern Water

- Covenanted, highly geared structure since 2003 (gearing up to 80% regco, 93% holdco)
- Underperformance across many of the service standards measured by us and other regulators and has been the subject of repeated and ongoing regulatory intervention.
- Swap restructuring in 2018 and in 2020 to improve short term cash flows: Moody's referenced as economically equivalent as new borrowing and masking underlying financial weakness

- 2019 – lowest senior secured credit rating in the sector (Baa3)
- 2019 – largest ever enforcement action by Ofwat (penalty + reparations package £126 million)
- 2021 – highest ever court imposed fine for environmental pollution by a water company (£90 million)

Outcome

- Material dilution in the shareholding of existing investors
- New investors injected over £1 billion to the regco and its holding companies to strengthen financial resilience with existing investors receiving none of the proceeds
- Significant work to be done to improve operational performance

Options in the financial resilience discussion paper

Defining capital / financing structure	Should we define limits?
Strengthen existing protections	Strengthen the existing cash lock-up licence provisions Resilience plans (similar to the inclusion in Ofgem's RIIO-2 determination) Board assurance statements wherever dividends are paid where a credit rating is below a stated target Requirement to maintain at least two investment grade issuer credit ratings and to notify us of changes to rating levels, outlooks, withdrawals or additions Removing licence dispensations from the requirement to maintain an investment grade credit rating Align licence text on dividend policy with our stated expectations
Transparency	Increased transparency on: • Holding company debt • Swaps • Pension deficits
PR24 / Incentives framework on gearing	Request views on how we take forward the PR19 incentives framework on gearing, taking account of proposals in the paper Financial resilience assessment in PR24 business plans

Appendix

Risk and return discussion paper – questions for stakeholders

Written submissions on our discussion paper by Wednesday 2 February 2022

Submit your responses either by this short form response or by email to PR24@ofwat.gov.uk

Balance of risk and return

- 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?
- Q2.2. Do you have any comments on our proposed approach to producing risk ranges, including but not limited to:
- a. risk ranges for the efficient notional company prepared by Ofwat; and
- b. company-specific risk ranges produced by companies.

Allowed return on equity

- Q3.1. How should we reflect the period affected by Covid-19 in our approach to estimating beta?
- 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?
- Q3.3. How should we convert RPI-linked yields into their CPIH-linked equivalents when deriving a RFR point estimate?

Allowed return on debt

- 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?
- 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?
- 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?

Notional capital structure

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

RCV indexation

- Q6.1. 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?

Financeability

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

Financial resilience discussion paper – questions for stakeholders

1. Do you agree that it is not appropriate for providers of essential infrastructure to operate at, or be at risk of falling to, the lowest investment grade credit rating?
2. Do you agree with the notion that a company should be taking actions to improve its credit rating well before it is downgraded to the lowest investment grade credit rating?

Written submissions on our discussion paper by 31 January 2022

Submit your responses either by this short form response or by email to OfwatPandO@ofwat.gov.uk

We welcome views on:

3. Our option not to define limits on capital or financing structures at this time and whether it might be necessary to define limits for companies where financial resilience does not improve.
4. Amending the existing trigger level for the cash lock-up conditions to a higher credit rating and the potential for the trigger to be linked to measures of service performance.
5. A requirement for companies to prepare and potentially publish resilience plans where a rating falls to or below a defined level.
6. A requirement for additional board assurance statements when dividends or other distributions are declared or made, and credit ratings are below the targets stated for the notional capital structure at a price review.
7. A requirement for companies to maintain two investment grade issuer credit ratings.
8. A requirement for companies to formally notify us of any changes to credit ratings (including changes in rating and/or outlook, new ratings assigned or planned rating withdrawals).
9. Removing dispensations from the requirement to maintain an investment grade credit rating.
10. The need to align the licence to our broader expectations for dividend policy.
11. Enhancing the transparent reporting of the use of swaps and how this could be best achieved.
12. Whether disclosure requirements should be set for companies to increase the reporting of holding company debt levels (for example to state holding company gearing levels) in their annual performance reports.
13. The option to improve the transparency of pension deficit reporting.
14. The expectation that PR24 business plans should include a board assured assessment of financial resilience.
15. How the incentives framework around capital structure should evolve at PR24 taking account of the other views set out in this paper and the scope to which companies should provide voluntary sharing arrangements at PR24.