Centre City Tower, 7 Hill Street, Birmingham B5 4UA
21 Bloomsbury Street, London WC1B 3HF

Meeting summary

Thursday 20 January 2022
11.00 am to 3.00 pm

Risk and return workshop

Attendees

Michael Blake	Affinity Water
Nicky Fomes	Affinity Water
George Hay	Anglian Water
Wayne Young	Anglian Water
Kevin Hayter	Bristol Water
Iain McGuffog	Bristol Water
Charlotte Beale	Dŵr Cymru
Eleri Rees	Dŵr Cymru
Andrew Beaver	Northumbrian Water
Crawford Winton	Northumbrian Water
Chris Milner	Portsmouth Water
Van Dang	SES Water
Paul Kerr	SES Water
Jonathan Ashley	Severn Trent Water
James Grant	South East Water
Steve Collins	Southern Water
Martin Roughead	Southern Water
Kei Kuki	South Staffs Water
Philip Saynor	South Staffs Water
Judith Corbyn	South West Water
Louise Rowe	South West Water
Peter Trafford	Thames Water
Steven Zhang	Thames Water
Sam Crook	United Utilities
Brendan Murphy	United Utilities

Matt Greenfield	Wessex Water
David Peacock	Wessex Water
David Gregg	Yorkshire Water
Liv Walton	Yorkshire Water
Dene Bridge	CC Water
Steve Hobbs	CC Water
Andy Manning	Citizens Advice Bureau
Martin Hurst	Sustainability First

Ofwat attendees

Aileen Armstrong
William Godfrey
Jack Shone
AnaMaria MorenoRuiz
Andy Titchen
Stefano Ficco
Thomas Jones
Jamie Tunnicliffe
Andrew Chesworth
Fleur Pujos
Jack Kingham
Sunny Mehta
Robert Thorpe
Kirsty Stober
Emma-Jane Daly

Introduction

Ofwat opened the meeting, set out the agenda and workshop approach. Noted that colleagues from the Ofwat Financial Resilience workstream were also in attendance, as their open consultation aligns with the topics discussed.

Ofwat provided an overview of the PR24 goals and the PR24 timetable, including the next steps for the draft methodology and the Risk and Return discussion paper.

This note summarises points made by attendees, and responses made by Ofwat, during the workshop. Slides for the event available here.

Balance of risk and RoRE risk ranges – presented by Jack Shone

Points made included:

- Proposal to have actual company views and notional company view from Ofwat is a different approach and it could be viewed more as a forecast than a price review. This is a particular challenge for listed companies and how it would be perceived externally. There was support for the need for consistency in approaches between companies, but feedback given that there may be a lack of consistency if Ofwat use actuals and that it may be difficult to compare companies if there are a lot of ranges. Ofwat advised they want to avoid conflation of company views.
- Understand that the aim of risk and return was to test notional assumptions and if risk ranges are reasonable. Can Ofwat look at company risk ranges to test if they are reasonable against the notional risk ranges? There is a need to separate company specific risks from judgement, so helpful financial resilience test, with embedded debt given as an example. Ofwat advised they are open to consultation on notional views. Ofwat needs to be clear which view everyone is using so they can compare across companies, justify notional views earlier in the process, and to be able to test for embedded debt.
- Request for guidance on how to account for differing components of risk, identifying both endogenous and exogenous elements. Ofwat advised they can explore where guidance would be helpful and welcome views on this area as Ofwat noted that there is a balance to be struck between additional guidance and too much guidance restricting companies.
- Consideration on the purpose of risk ranges, and a sense check on how hard or soft the incentives are as a package. Ofwat advised that asymmetry will be dealt with at the package level.
- Where are PR29 risks factored in, particularly regarding where long-term risks could accumulate? Ofwat noted that RoRE will just focus on the five-year period and recognises the limitations of RoRE as an AMP-focused mechanism, but it's important to maintain a proportionate approach.
- Does this approach consider the long term and adaptive planning goals, and how should companies approach pilots or activity that may increase risk over the long term? Ofwat advised that RoRE focuses on the five-year period, so long term approaches would be reflected where they were applicable as an in-period risk.
- Further points on long-term aspects, and that the link with RoRE does not come out in the consultation. Consideration required on how companies can anchor their long-term programme plans and risks into RoRE as a five-year metric and to address the challenge of long-term certainty and investment. Ofwat will consider further but asked companies to use the consultation to feed in ideas.

Return on equity – presented by AnaMaria MorenoRuiz

Points made included:

- If a broader range of risk-free rate proxies are used the effect of having a Cost of Capital that increases with notional gearing disappears, so using a more accurate risk-free rate proxy will address this issue. Ofwat noted the illustration in the presentation is based on PR19 data and will consider this.
- Queries raised on the weight being placed on CMA decisions, as Cost of Equity does not appear to consider CMA determination, but the Cost of Debt does seem to. Ofwat responded that they are aware of and appreciate the work undertaken on both PR19 and the CMA process by companies, CMA and Ofwat. There is not a unique regulatory view, and there are different panels and decisions that will be taken into consideration. Ofwat do value consistency and progression, so each methodology and price review are based on benchmarks and relevant factors from that point forward.
- Reflection on the reason why risk-free rate is such a matter of debate and how much focus should be on small elements. Ofwat advised they will be focused on the in-round assessment and full package of returns.
- When looking at individual elements, Cost of Equity is looking lower. Therefore, Ofwat should consider the impact this could have on incentives and aspiration for fast-track status. Ofwat again assured they will focus in the round.
- Point made that some of these questions are broadly the same as energy appeals, so asked if there could be a different way of doing this or a coordinated approach or consideration of total market returns. Challenge was given that the regulation industry keeps covering common areas, and queries if the consultancy spend on the Cost of Capital topic alone is of benefit to consumers. Ofwat recognised the point about consistency and reminded how they use cross checks and benchmarking. The cost and effort on Cost of Capital was recognised by Ofwat.
- Question regarding the principles used to cross check to CAPM. Ofwat responded that it anticipated using sense checks - CAPM provides a range, alongside market information and wider analysis. Additional point on using a wide range of cross checks such as financeability, risk ranges and the long-term view. Ofwat reminded that the CMA rejected forward rate adjustments. The full risk and return package should build on the past. Ofwat recognised importance of long-lived investments and taking a long-term view.
- Need to consider where competition can be a factor and must consider external affects which can have influence. Ofwat agree the need for stability and signalling.

RCV – presented by Stefano Ficco

Points made included:

- General support given for the change to CPIH, although the impact on smaller companies was noted where it presents challenges to adapt where they have RPI linked finance. Ofwat reminded that RCV indexation is not designed to accommodate a particular financing option, but to preserve real value of the asset base. Ofwat will adopt a framework that considers costs and benefit of each option to transition to full CPIH.
- Consideration if individual components of inflation grow at different rates, and where CPIH may not cover or align with costs. Ofwat to consider further.

Notional capital structure – presented by Andy Titchen

Points made included:

- Challenge that Ofwat are not looking into index linked swaps as an approach for Cost of Debt (with some noting that currency swaps would be included in the allowance). Ofwat consider that not looking at index linked swaps in assessing the Cost of Debt will give a fair result and set the right allowance. Swaps NPV neutral at time of issuance – Ofwat concerned with setting an efficient benchmark level, not mimicking individual treasury management choices.
- Query regarding notional structures and why low gearing is considered most competitive, with example of competitive infrastructure such as Thames Tideway which is highly geared. Noting that only one company is below 60%. Ofwat confirmed the aim is to divorce the structure of the notional company from the financing decisions made by each companies' management and investors. Ofwat needs to consider a wider range of stakeholders including customers. Reminder that looking at water and infrastructure companies across Europe and in other sectors, gearing tends to be lower. Ofwat are looking at a broad range of comparisons for benchmarking gearing.
- Comment regarding what is best for customers, as raising equity can cause more costs for customers. This is a particular issue for listed companies where it can be difficult to raise equity. Concern that removing money from companies will detrimentally impact the extra costs needed to address issues such as storm overflows and environmental adaptations.
- Concerns regarding lowering gearing below 60% and reference to Moody's range for target rating. Ofwat mentioned any assessment would be made in the round, not on the basis of a single source. Question if Ofwat are considering changing its gearing calculation in financeability assessments and what evidence they are using? Ofwat advised it remains debt to regulated RCV basis.

Cost of Debt – presented by Andy Titchen

Points made included:

- Point made that individual recommendations make sense, but that they do not work if you ignore swaps element as you can only get CPIH indexed debt by issuing swaps. Ofwat advised all points are under consideration and will consider liquidity of CPI/CPIH market.
- Question on what is meant by removing outliers. Ofwat responded they are using standard averaging techniques to avoid the sector balance sheet approach from being unduly influenced by individual companies.
- Request to understand more about how calculations will be made, such as the averaging techniques and benchmarks used. Reflection that these areas were complex during the CMA appeal. Ofwat advised they have presented the proposed basic process and are keen to construct something uncomplicated, alongside the role of cross checks. More detail will be provided in the PR24 methodology document.
- Query if there is enough data to benchmark efficient costs. Ofwat responded that there are 17 companies, alongside the role of benchmarking.
- Consideration of using an average/balance sheet approach, rather than outperformance mechanism. Ofwat clarified the outperformance wedge related to the market index benchmark for new debt.
- Point made that the outperformance seen on new debt issued to date may not be there when controlling for tenor and rating.
- Additional requests and considerations:
    - To understand the principles for cross checks and how calibrated.
    - The role swaps have in managing cash flow.

Financeability – presented by Andy Titchen

Points made included:

- Question if gearing drops why the proportion of new to total debt does not change in the example? Ofwat responded that it is an illustrative example, but also dependent on how the gearing level is set from the start. The challenge around the effect of embedded debt, and how to mimic the competitive nature we see in wider markets. There is a challenge of how to set the right level for the notional company.
- Further challenge provided on the balance of how far we go down a competitive market framework and that the cost is higher for smaller companies. Clarification needed on the gearing point and if need to allow for new Cost of Equity. Ofwat responded that PR09 allowed for equity issuance and at PR19 dividend payments were reduced to bring gearing down - and Ofwat are planning to consider these again.

- Point made that a lot can happen over two years, so do we need to make a judgement on financeability now? Ofwat agreed that a lot can change and responded that the illustration is meant to show the direction of travel and how some things may change the financeability landscape, such as speed of transition to CPIH, or roll-off of expensive embedded debt.

Financial modelling – presented by Thomas Jones

Points made included:

- Positive feedback of the alignment of the financial model to the business plan table – noting there was a lot of duplication at PR19. Request that Ofwat do not duplicate data and tables. Ofwat responded that this area is a challenge, but they are working to reduce duplication as they develop the business plan tables and models.
- Question on approach to indexation of RCV in the model. Ofwat responded it will be constructed in a similar way to PR19 but will need to consider how to adapt to CPIH.
- Requests for support with FAST training beyond standard free courses, referencing the helpful support Ofwat have provided in the past. Ofwat suggested two-day Gridlines course.
- Question if the new input table replaces the previous one. Ofwat responded they will use a flat file, but the approach is not fully formed yet. Suggestions made by attendees regarding F inputs, mapping tools and extraction approaches. Ofwat encourages all ideas to be shared with them.

Further questions and next steps

Points made included:

- Observation of inconsistencies across Cost of Capital, notional structure and financeability – so are they seen as separate buckets or aligned? Ofwat advised they need to be consistent and although it is a package, there will be trade-offs and especially where elements of judgement are required. Noted that models cannot mimic the real world entirely.
- Question of how bioresources RCV will be treated in risk and return and financeability work? Ofwat noted the bioresources consultation is still open for input, and they do expect a different approach for RCV additions made after 2020. However, most RCV at PR24 will be pre-2020 protected RCV.
- Looking across discussion papers, are Ofwat considering lifting the expected credit rating for the notional company given the proposal to increase ratings threshold for cash lock-up in licence conditions? Ofwat responded they will be joined up across financial resilience and PR24 work and the teams are working together. Licence

conditions retain requirement for minimum investment grade and proposals are around protecting headroom. Ofwat will need to consider what impact it has on the notional company but do not see any need to change.

- Additional points raised:
    - There are linkages between different open consultations, particularly around incentives balance. Shift towards common ODIs could mean companies look towards risk and return for outperformance.
    - Important to look at the skew of water versus wastewater. Preference for this to be looked at within the outcomes workstream.
    - To consider how Ofwat can avoid circularity in setting the notional company.
    - PR19 tests sat on the cusp of rating agencies' targets and getting to A3 was challenging. Preference to see in PR24 more real-world approach for the notional company.

Ofwat closed the meeting by thanking attendees for their input and reminded attendees the risk and return consultation closes 2 February 2022.