Affinity Water draft methodology response

Chapter 8

Q8.1. Do you agree with our approach to assessing financeability?

A robust financeability test is an essential cross check on the cost of equity as it is the only test explicitly linked to Ofwat's finance duty and the only one capable of directly reflecting the overall financial position of the regulated company under the proposed regulatory package. Ofwat is proposing to apply an in-the-round financeability assessment which is solely focused on debt and whose results will be predicated on the proposed changes to the notional structure. This indicates that the financeability test is not meaningful and in turn risks that price control calibration undermines the financial resilience of the sector as there is no reliable 'check' built into the price control architecture.

We note that at the PR19 re-determination the CMA has followed a clear market-based approach to assessing financeability and its re-determination has set out several principles which represent key decisional practice for financeability assessment at PR24.

Most notably, the CMA recognised that (1) financeability provides a relevant cross check on the choice of the cost of equity, (2) WACC as a key driver for financeability and the primary remedy in addressing financeability concerns, (3) the CMA rejected alternative financeability levers used or proposed by Ofwat i.e. excess PAYG, increase in index-linked debt (ILD), reduction in gearing or increase in rate of transition to CPIH. The CMA approach should be an important consideration into the PR24 process, but unfortunately it has not been reflected in the draft methodology. All else equal, this erodes one of the core pillars underpinning the regulatory framework and the foundations of financial resilience as revenue at risk is projected to increase.

In this context our key observations on Ofwat's proposed approach to financeability are as follows:

- *Sequencing of the financeability test*: Ofwat is proposing to effectively reverse the logical sequencing of the financeability test such that it becomes contingent on the assumptions regarding the notional structure, thereby undermining the test. Collectively all the proposed changes are not only unprecedented in scale, but also have the same directional effect to improve financeability, regardless of their merit. We have set out in the response to FQ7.7 our specific concerns with the proposed approach to notional gearing and proportion of ILD.
- In this context, it would be helpful and informative to undertake the financeability analysis on the basis of PR19 notional structure to ensure that changes at PR24 do not mask deterioration in the underlying financeability position.
- *Disconnect between financeability and financial resilience*: The weakened financeability test cannot effectively diagnose miscalibration in the risk-return balance resulting in an understated cost of equity which translates into

reduction in financial buffer, more limited ability to manage downside exposure and could undermine financial resilience.

- *Role of equity financeability*: The draft methodology sets a clear expectation for equity to contribute significant capital at PR24 both to finance new investment and the reduction in gearing. However, Ofwat does not propose to consider equity financeability and how it is affected by its proposals, inter alia, from exposure to asymmetric risk and curtailed dividends. The provision of an allowance for equity issuance is not alone sufficient condition for equity financeability.

- *In-the-round assessment*: Ofwat's view is that each financial ratio does not need to fall within the guidance range for the BBB+/Baa1 target credit rating for the notional company. However, this is not consistent with how the rating agencies assess ratings in practice which are usually constrained when primary metrics (AICR, Net Debt / RCV, FFO/Net Debt) fall below thresholds.

- *Target credit rating*: We are supportive of the notional credit rating target of BBB+/Baa1 but note that the expected balance of risk at PR24 will require the notional company to target financial metrics above the minimum threshold to provide sufficient buffer to manage downside exposure. This is particularly pertinent given the proposal to increase the cash lock up trigger to BBB/Baa2 (NEG).

Q8.2. Do you agree with the focus on the metrics outlined in section 8.4 for the assessment of financeability?

The proposed metrics are a good starting point for debt financeability analysis although it is key to calculate them consistently with rating agency methodologies and incorporate the right thresholds. Namely:

- The assessment should consider both the scorecard approach and also the primary metric for each rating agency, which can act as a binding constraint on the rating metrics (AICR, Net Debt / RCV for Moody's and FFO/Net Debt for S&P) and have in isolation resulted in rating downgrades in the sector.

- Ofwat should maintain headroom against the minimum threshold for BBB+/Baa1 rating level to ensure companies have headroom to manage downside risks without becoming immediately at risk of a downgrade.

We suggest the following additions to the metrics to ensure that the financeability assessment does not focus too narrowly on debt and gives appropriate consideration to equity which has a critical role to play at PR24: (1) dividend payout ratio, (2) dividend yield, (3) comparison between allowed and expected return (i.e. assessment of the implications of asymmetry) should be included from the equity financeability perspective.

Q8.3. Do you agree with our proposed approach to cost recovery, in particular that we set a narrow range for RCV run-off rates within which companies will be required to evidence their choice of rate which best achieves a fair balance between current and future customers?

We do not agree with Ofwat's proposals to introduce a range for run-off rates at PR24 and a higher bar to change PAYG rates at PR24 from past rates. These represent critical levers to secure affordability, manage volatility of bills and financeability over the short and long term – it is critical that Affinity Water retains flexibility to estimate the natural rate and propose ranges based on bottom-up evidence.

Run off rates

We disagree with Ofwat's proposal which relies on a small sub-set of relevant evidence and is unlikely to be representative of the cost recovery profile for any individual company.

Ofwat is minded to set a narrow range for RCV run-off rates for each wholesale control informed by a consideration of average remaining lives of the assets utilised in each control. The proposed approach appears to be focused on reducing customer bills without taking into account the relevant evidence for setting run off rates based on the natural rate and the impact on financeability.

Ofwat's signalled emphasis on the use of remaining asset lives does not appropriately reflect the other methodologies which could be used to determine run-off rates (of which there are several). This approach may result in a skew of our natural run-off rates.

Ofwat's proposal is based on its comparison of RCV run-off in PR19 final determinations and proposed non-enhancement capital expenditure, however this does not take into account the actual spend by companies so is of limited relevance. Ofwat should look to the cost allowances to appropriately remunerate companies for the costs incurred rather than seeking to artificially reduce run-off rates.

Ofwat's proposal does not account for the fact that the cost recovery profile for each company is materially driven by historical spending and recovery rates. In this context, a narrow sector-wide range does not appear reasonable or well-justified.

Finally, we are also concerned that the financial model has removed the ability to set depreciation as a straight line, as was possible at PR19. There is no discussion or acknowledgement of this change in the draft methodology, despite the material impact it has on the ability to appropriately balance the RCV run off across future and current customers. We would welcome the opportunity to discuss this further with Ofwat.

PAYG rates

The base PAYG rates should reflect the best estimate of the allocation of PR24 Totex between operating and capital expenditure. The starting point of this analysis can be the outturn split observed in PR19, however this will need to be adjusted to reflect the spend profile of PR24. It is not clear to what extent Ofwat's proposed approach is consistent with this given the draft methodology indication that proportion of opex and capex for base totex should be broadly consistent over time.

Q8.4. Do you agree with our proposed approach to resolving a financeability constraint?

We disagree with both the approach to identify and to resolve financeability constraints.

First, given Ofwat's proposed approach which effectively reverses the logical sequencing of the financeability test, there is a real risk that financeability constraints are not identified by the regulator.

Second, the proposed approach to fully disconnect financeability tests and remedies from allowed returns (and wider price control calibration) is (1) inconsistent with Ofwat's financeability duty and (2) inconsistent with the approach taken by the CMA at the PR19 re-determination, and (3) ignores that allowed returns are a primary driver of projected coverage metrics which underpin financial resilience.

Third, Ofwat relies heavily on equity to address financeability constraints on debt (1) without pricing additional risks to equity, (2) without considering the impact on equity financeability in the short and long-term (e.g. from not being able to earn even the allowed returns, having to forgo dividends on a sustained basis).