Risk and return PR24 Draft Methodology webinar

Thursday 14th July 2022

Ofwat

Agenda

Item	11:00 to 12:00
Introduction	11:00 to 11:05
Balance of risk and return	11:05 to 11:25
Allowed Return	
Inflation and RCV indexation	
Notional capital structure	
Financeability & Financial Resilience	
Next steps and consultation questions	
Q&A	11:25 to 12:00

Introduction

The purpose of this webinar is to provide an **overview of our proposals on risk and return,** covering the overall balance of risk and return, the allowed return on capital, financeability, and financial resilience.

Further information on our proposals is published in:
- **Chapters 7, 8, and 9 of our consultation document;**
- **Appendix 10 – Aligning risk and return, and**
- **Appendix 11 – Allowed return on capital**

There will be an opportunity for questions at the end of the webinar. The purpose of the question and answer session is to **provide clarification** on our proposals.

We are recording this webinar, primarily to help us to draft minutes of the discussion. But it may be shared with Defra and the Welsh Government.

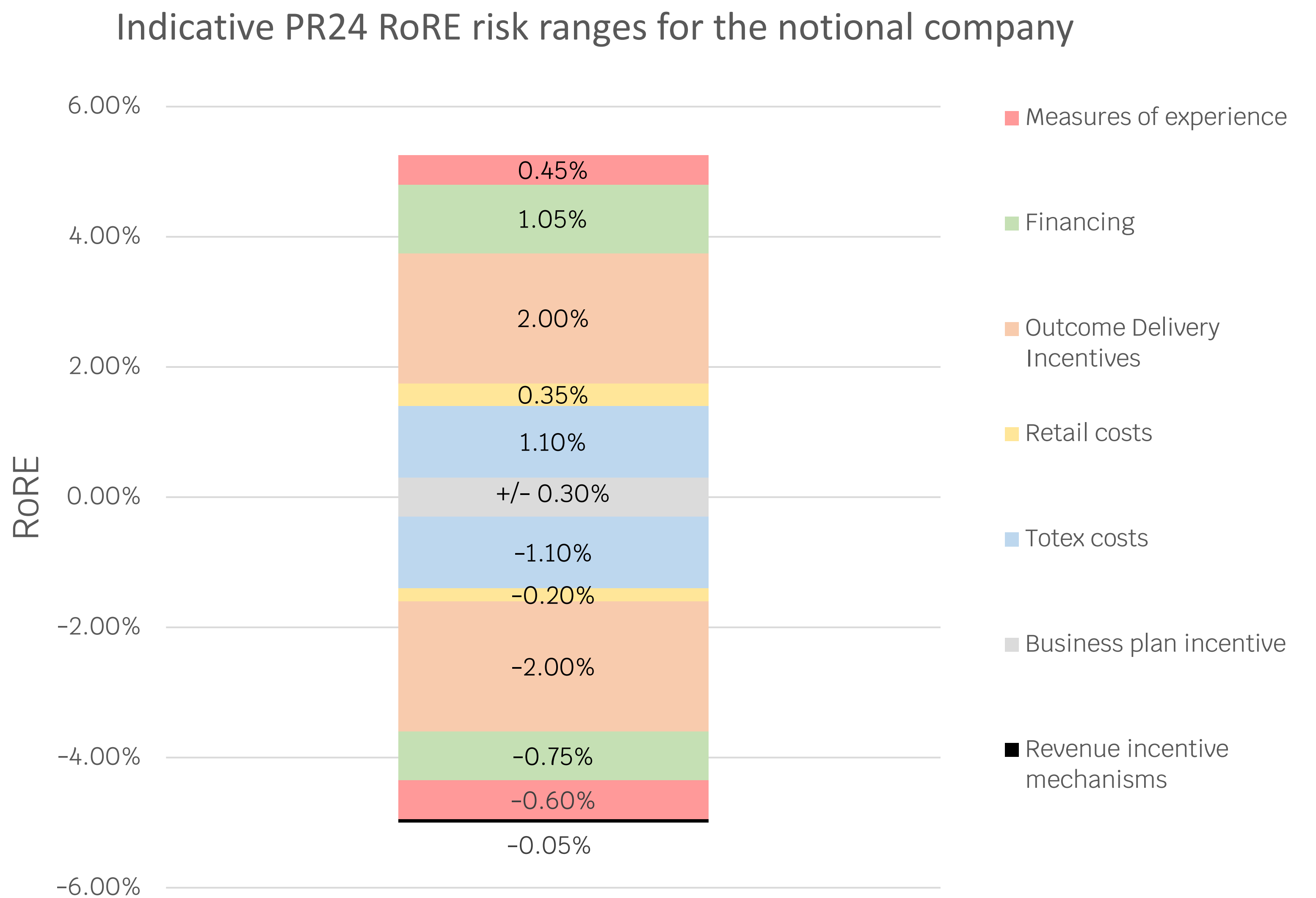
Please ensure you are on mute, and **we ask that questions are submitted via the chat function** to ensure all companies have an equal opportunity to ask questions.

We encourage you to ask as many of your clarification queries as possible in this webinar. If there are any that occur to you later, you can send them to the PR24 inbox (PR24@Ofwat.gov.uk) before 4 August 2022 so that we can answer them before consultation responses are due on 7 September 2022.

Balance of risk and return

Jack Shone

Balance of risk and return



Allowed return, inflation, RCV indexation and the notional capital structure

Martin Malinowski

Allowed return: Equity

Risk-free rate

- Focus on RPI-linked gilts
- Reflecting 2030 UKSA RPI reforms
- 6-12m trailing average
- No forward-rates uplift
- No indexation

Equity beta

- Daily data
- 2y, 5y, 10y estimation periods
- No exclusions or re-weightings of data affected by Covid-19.
- Debt beta chosen so forward-looking WACC is invariant to gearing

Total Market Return

- Range based on historical ex-post / ex-ante
- Simple arithmetic averaging, 10-20yr holding periods.
- Deflated using historical CPIH

Cross checks

- Starting point is central point estimate from CAPM-derived cost of equity range.
- Compelling evidence from market cross-checks (e.g. Market-to-Asset Ratio Analysis) could lead us to deviate from this central point estimate.
- High evidential bar for deviating, with any adjustment modest and final estimate within overall CAPM range.

Allowed return: Debt

Embedded debt

- Large company benchmark focusing on actual 'pure debt' costs
- Index-led approaches only used as cross-check for upper limit

IN:	OUT:
• Bonds	• Interest rate swaps
• Loans	• Debenture stock
• Debenture	• Preference shares (unless debt-like)
• Private placements	• Intercompany/holdco debt
	• Liquidity facilities / RCFs
	• Junior / subordinated debt

Excludes instruments with more equity-like characteristics & those that relate to other cost allowances

New debt

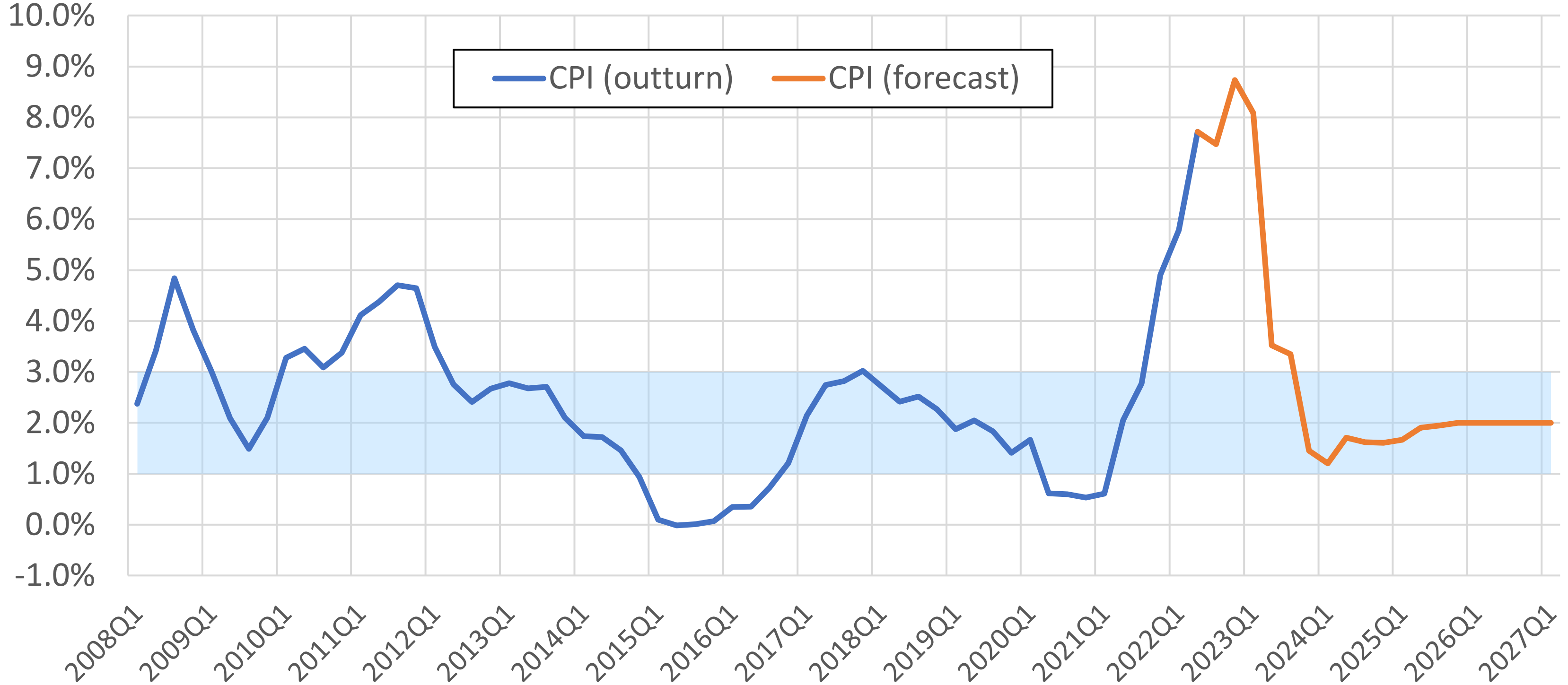
- Expect to use simple average of A/BBB-rated iBoxx GBP non-financials 10+ indices
- Indexed allowance subject to end-of-period reconciliation using outturn index data.
- Exploring index adjustment for final methodology – evidence from post-2015 bond issuance that notional company may issue at a discount to iBoxx A/BBB.

Share of new debt

- Based on modelling new and embedded balances
- New debt balance assumed to be function of refinancing and new RCV financing.
- Embedded debt balance assumed to be a function of maturity profile and IL debt accretion.

Our approach to inflation and RCV indexation

Inflation is high; official forecasts project it to return to the Bank of England's 2.0% target in c. 2 years time



Source: OBR Economic & Fiscal Outlook, March 2022

- Propose to retain BoE 2.0% (but only if reasonable as an inflation forecast).
- We propose to index 100% of the RCV to CPIH at the start of PR24 – results in modest (typically single digit) increase to bills and improvement in interest cover; both impacts that will unwind in the medium term.

Notional capital structure

Notional capital structure should provide sufficient headroom to allow company to manage risks as they arise and allow efficient access to the debt market through an investment grade credit rating.

Proposed framework for determining the notional capital structure

- incentivise efficient financing choices given the balance of risk faced by water companies;
- reflect the scale and nature of investment needs;
- take account of a range of benchmarks and evidence; and
- allows a price control that is in the best interests of current and future customers.

Further context:

- Notional gearing ranged from 50% to 62.5% between 1995 to 2025
- There may be benefits to adopting a lower notional gearing level at PR24
- Natural reduction to gearing through high levels of inflation
- We will set out our decision in the final methodology

Financeability and financial resilience

Andy Titchen

Financeability and cost recovery

Our proposed approach to the assessment of financeability and cost recovery is designed to ensure that revenues, relative to allowed costs, are sufficient for an efficient company with the notional capital structure to finance its investment on reasonable terms, while protecting the interests of customers now and in the long term.

Overall, our proposed approach is broadly consistent with the approach adopted at previous determinations

- Board assurance that business plans are financeable on the notional capital structure
- Assessment takes account of a range of financial metrics
- PAYG and RCV run-off rates should balance cost recovery between generations
- Propose to set a **narrow band for RCV run-off rates** at final methodology
- **Target credit ratings of at least two notches above minimum investment grade (Baa1/BBB+)**
- Range of options for companies to address a financeability constraints arising under the notional structure
- **Equity has an important role play in funding real RCV growth**

Promoting financial resilience

Financial resilience

- Maintaining strong emphasis on financial resilience – part of proposed quality assessment for BPI
- Board assurance that the actual company is financially resilient over PR24 and beyond under its business plan
- Updated common scenarios reflecting recent experience

Incentivising resilient capital structures

- Separate financial resilience consultation will consider ring-fence licence conditions, and enhanced monitoring and reporting
- May apply an incentive-based mechanism if improvements are not delivered by other means
- We propose to return to this in the final methodology

Dividends and performance-related executive pay

- Policies for dividends and performance-related executive pay form part of proposed quality assessment for BPI
- Alignment between returns to owners and performance related executive pay and what is delivered for customers, society and the environment

Voluntary sharing of outperformance

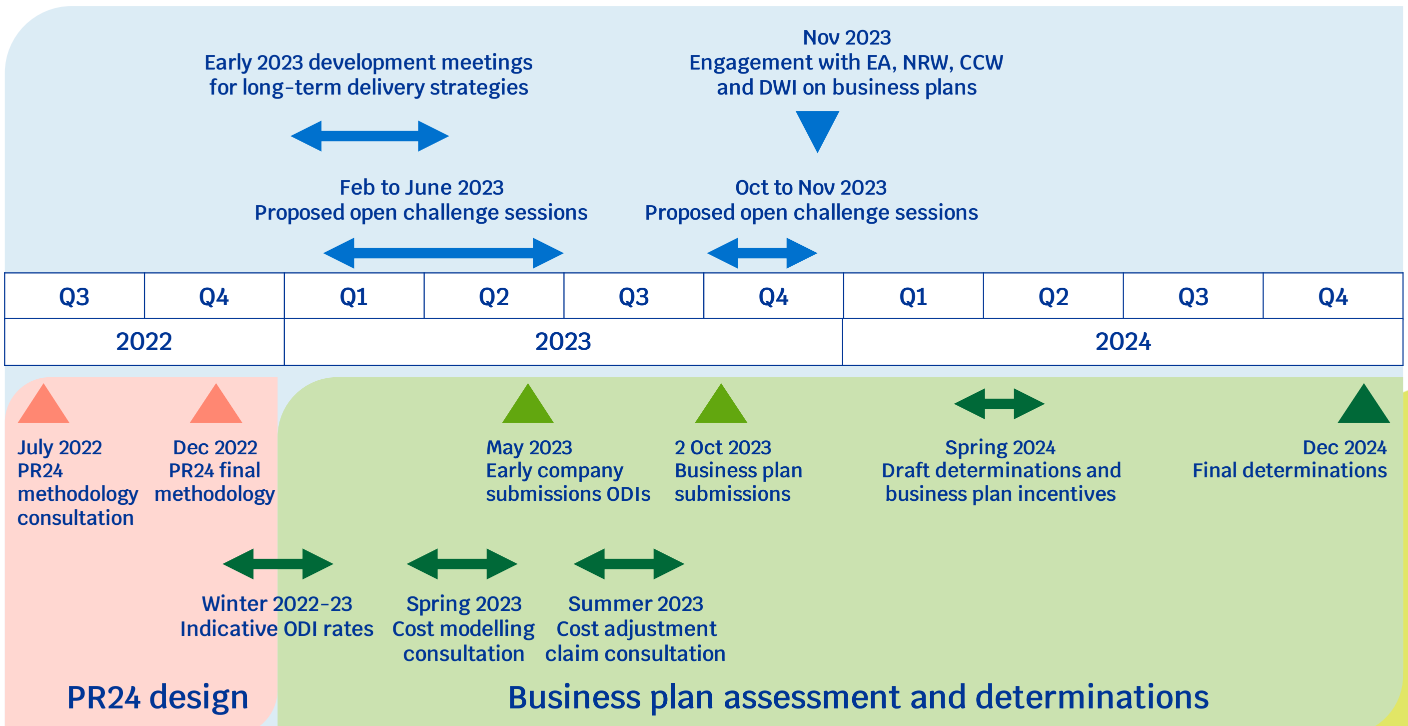
- Focused on areas not subject to sharing mechanisms, such as
    - Cost of debt
    - High inflation
    - Tax benefits not part of tax reconciliation
- Forms part of proposed assessment of ambition for business plan incentives

Next steps

Andy Chesworth

PR24 timeline and next steps

Consultation responses to our draft methodology proposals are due 7th September @ 5pm



Consultation questions – Aligning risk and return

Balance of risk and return

7.1. Do you have any comments on our approach to the overall balance of the PR24 incentive package, our proposed guidance on producing risk ranges, and our view of the balance of risk facing the notional company?

7.2. Do you agree with our proposals on the regulatory regime for managing companies' exposure to uncertainty over 2025-30?

7.3. Is there value in introducing more prescriptive requirements and guidance for company produced RoRE risk ranges? How might this be implemented for: a. Interactions between performance on cost and service? b. Interactions between performance on different ODIs?

Allowed Return

7.4. Do you agree with our proposed approach to setting the allowed return on equity?

7.5. Do you agree with our proposed approach to setting the allowed return on debt?

7.6. What are your views on the options we have set out for estimating the RPI-CPIH wedge for converting RPI-linked yields to a CPIH basis?

7.7. Do you agree with our proposed approach to the notional structure and setting allowances for corporation tax?

Consultation Questions – Financeability & Promoting financial resilience

Financeability

8.1. Do you agree with our approach to assessing financeability?

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

8.3. 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?

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

Promoting financial resilience

9.1. Do you agree with the proposed standard set of scenarios for testing financial resilience?

9.2. Do you agree with our approach to how the board of the company should approach its board assurance statement?

9.3. Do you agree with our proposed approach to dividend policies, performance related executive pay and voluntary sharing of financial outperformance?

Thank you and questions