PR24 draft methodology webinars: Risk and return – questions and answers

14 July 2022

1. How will the RCV run off range be determined? (South Staffs Water)

RCV should be recovered in a way that represents the use of assets that provide the service to customers. We've put forward average remaining lives as a fair way of allocating this investment between customers. This is only one way of informing the narrow band in the final methodology. There might be other suggestions that companies may put forward in their responses that we will look at.

We have further work to do on this ahead of final methodology, and we invite the views of companies on the best ways to do this. One point worth noting is that if you look at the energy sector, Ofgem sets a single rate for that sector. The issue that we have been grappling with is the circumstances when RCV run off rates are high, which leads to quite a large proportion of the opening RCV being run off within a period. There is a question on whether that is sustainable over the long term.

2. Is the reference to a possible ex-post adjustment to the cost of new debt, the same as the reference to sharing company new debt outperformance? Quoting the draft methodology: "We are considering how to share new debt outperformance against our benchmark index". The current halo adjustment seems to be more about aligning Ofwat's view of the true cost of new debt to the relative cost to water companies. Are we now saying we are moving to a "sharing" of outperformance, which is a change in direction? (Severn Trent Water)

The issue is more about cost reflectivity; we are aiming to set an allowed return on new debt for the notional company that is fair to both customers and companies. This is distinct from an exercise that sets a fixed benchmark and then aims to share financial out- and under-performance against this benchmark with customers.

We have observed for several years that sector has on average issued bonds at a discount to our benchmark index (the average of the 'A' and 'BBB' rated iBoxx GBP 10+ non-financials indices). The question we are therefore seeking to answer is a) what level of discount-to-benchmark index should we expect for the notional company; and b) what data should we use in this calculation?

To calibrate the appropriate adjustment, we are minded to take an average of discount-at-issuance for water bonds, controlling for factors not relevant to the

notional water company. For instance, it would not be appropriate to assume a discount based on an unadjusted sample of bonds with better credit rating than Baa1/BBB+ (our target for the notional company).

In terms of data sample used to calculate the adjustment, we could set a fixed adjustment ex-ante using pre-2025 spread-to-benchmark data or we could use an ex-post adjustment using spread-to-benchmark data from the period 2025 to 2029. Both approaches have pros and cons which we discuss in Appendix 11.

To clarify: the 'ex-post' approach referred to does not imply an intention to make company-specific adjustments to the allowed return on debt of individual companies based on the extent to which they have individually been able to beat our benchmark index with their issuance at PR24. It is rather an attempt to infer based on (suitably adjusted) outturn spread-to-benchmark issuance what level of discount to the benchmark index we should assume to set an accurate new debt allowance for the notional company.

3. Might we split run off rates between remaining lives for existing assets and full lives for new investment? (Northumbrian Water)

The business plan tables and the financial model allow for separate RCV run-off rates for existing assets and for new investments. That is something that we will consider if this is an issue that emerges from company responses.

4. With the transition to full CPIH, how will companies with significant RPI linked debt be dealt with? (South Staffs Water)

We have signalled for a long period of time (since 2015-16), our proposal to transition to CPIH, therefore by 2025 there will have been c.10 years whereby this has been signalled to companies. We have transitioned over a longer period than Ofgem has, who made an overnight transition to CPIH.

When we set a determination, we do so for the notional capital structure, companies are then free to choose their own financing arrangements and capital structures within that. To the extent that companies depart from the notional capital structure, that is an issue that companies and investors will need to manage.

If the UKSA (UK Statistics Authority) sees through its reforms to RPI from 2030 then in theory any mismatch from RPI and CPIH should be eliminated at that point. Therefore, it is just a 5-year transition issue which we expect companies to manage.

There are potentially benefits to our proposals such as the enterprise value of companies becoming less volatile because CPIH is a less volatile measure of inflation than RPI, so the value of RCV will move around by less.

5. How will Ofwat make the RoRE range for ODIs symmetrical (as per the graph) if we have two compliance ODIs with a zero deadband (contributing -0.1% each according to the estimate in the methodology consultation)? (Severn Trent Water)

It is important to note that our RoRE ranges are indicative and 2% has been used to demonstrate the strength of our proposed incentives at PR24.

We support the principle that efficient companies should have a reasonable opportunity of earning the base allowed return on equity, and that overall the expected outturn RoRE range should be broadly symmetric. We will continue to review this through the price review process, noting companies have significant management control and influence over their actual performance.