Finance and financeability

RISK, REWARD AND RESILIENCE IN WATER

The water sector in England consists of regulated local monopoly water and wastewater companies, owned and operated by private investors, either through publicly listed shareholdings or private equity funds. The regulator, Ofwat, is responsible for setting the regulatory regime and periodically determining the returns that companies are allowed to make. Private investors demand a reasonable return on their investments commensurate with the level of risk, which depends, among other things, on the regulatory regime itself.

As it approaches the final decisions in the latest price control round, PR19, Ofwat needs to continue to strike the right balance between risk and reward so that investors continue to allocate capital to the sector, as they have done since privatisation. At the same time, the regulator must ensure that companies can maintain long-term financial resilience and that the interests of customers are protected.

Finding the right balance between risk and reward requires consideration of a range of factors: the level of risk facing the companies; the cost of finance consistent with that risk (i.e. the WACC); the ability of companies to raise finance in the markets (financeability); and the degree of financial resilience in the face of adverse shocks.

In its approach to these issues in the new price control round, Ofwat has developed a methodology for assessing financeability and financial resilience. In some cases, it has moved away from established regulatory practices regarding risk and reward. This raises the question whether Ofwat is fully able to test the financial resilience of its determinations.

Risk and reward

Ofwat's approach to risk and reward is framed by its legal duties. One of the regulator's primary obligations relates to the financing of functions and another to ensuring long-term resilience. The financing duty states that Ofwat must *'secure that water companies can (in particular through securing reasonable returns on capital) finance the proper carrying out of their statutory functions'*.

The duty to *'secure long-term resilience'* is new for PR19. Ofwat interprets the term broadly to include financial resilience, which it defines as a firm's ability to avoid, cope with and recover from disruption to its finances. The regulator considers that an efficiently structured and operated company should be financially resilient over the longer term.

Ofwat's risk and reward methodology has different components.

- An assessment of the weighted average cost of capital (WACC) for the sector, to determine an allowed rate of return on the regulatory capital value (RCV). The estimate is based primarily on backward-looking data.
- Assessment of risk. Companies submit estimates of the potential variation in returns to equity investors from upside and downside scenarios. This is referred to as the return on regulatory equity (or RoRE) analysis.

- Financeability assessment. This judges a company's ability to raise finance on reasonable terms by analysing the core financial metrics (principally credit metrics) implied by Ofwat's determination.
- Assessment of financial resilience. Companies are required to submit annual viability statements to confirm that they are resilient to more severe shocks.

Like most utility sectors in the UK, the regulated water companies are given incentives by Ofwat to outperform on cost targets, service quality and customer satisfaction. If they succeed, firms stand to make more money; if they underperform, less. This, in turn, can affect their operating risk.

We consider how Ofwat uses these different components to assess the level of risk with the aim of ensuring that the financing and resilience duties are met.

Cost of capital and RoRE analysis

Ofwat arrives at the cost of capital using market data on the cost of corporate debt and estimates of the cost of equity based on the Capital Asset Pricing Model (CAPM). The riskiness of the water sector is captured by the model's beta parameter, which is typically estimated using data from the past two to five years. These estimates may not fully take into account changes to the regulatory methodology, for example Ofwat's incentive arrangements.

This is where RoRE analysis can be useful. This methodology estimates returns over the next five-year regulatory period under an upside scenario (with a 90% probability that the outturn will be worse than this level, or P90) and a downside scenario (with a 10% probability that the outturn will be worse, or P10). By comparing this range of equity returns with the outcomes of the previous price control period, it is possible to assess whether risk has increased and therefore whether the market WACC based on backward-looking data represents a reasonable return.

RoRE analysis has limitations. For example, assumptions need to be made about future risk factors. Also, the range does not provide information about more extreme upside or downside scenarios beyond the P10 and P90 range.

For PR19 Ofwat has collected RoRE information from companies. It is not clear how the regulator has used it in its assessment of reasonable returns.

Financeability assessment

The goal of the financeability assessment is to test whether companies have sufficient financial headroom (assessed by metrics such as interest cover ratios) to maintain the ability to raise finance on reasonable terms. In practice, this is interpreted as retaining a solid investment grade credit rating.

In its assessment Ofwat uses an assumed split of debt and equity, not the actual gearing level. If a company fails, on this notional basis, to satisfy the metrics consistent with a solid credit rating then this indicates a concern with financeability.

This approach is in line with regulatory precedent. Both Ofwat and the CMA have restated in previous decisions that financeability should be assessed on the basis of a notionally efficient company. However, the way regulators approach financeability assessments raises a number of important issues.

Lack of consideration of equity metrics

In evaluating financeability Ofwat focuses solely on debt finance and does not take account of metrics of interest to equity investors. This is potentially a concern, since the "mitigation" methods suggested in the event of financeability difficulties involve some additional investment from existing and/or new equity investors.

Ofwat sets out three potential responses to a notional financeability problem:

- Bring forward regulatory revenue through adjusting the pay-as-you-go (PAYG) or RCV depreciation;
- Assume a reduction in dividend yield below the notional benchmark; and/or
- Assume an injection of new equity.

Two of the three courses of action thus have a direct impact on equity investors. Recourse to additional equity (whether through lower dividends or a fresh equity injection) is in line with regulatory practice. The CMA has accepted in recent regulatory cases that it is reasonable to assume extra equity if the purpose is to support RCV (or regulated asset base, RAB) growth.

At the same time, it is legitimate to question whether the scale of the equity contribution is reasonable and how the regulator has assessed the availability of new equity and its potential cost. For example, the cost of equity in the WACC calculation is consistent with a sector that is perceived to be low-risk and generates a steady dividend stream. If the dividend reductions assumed by the regulator are material and persistent, is this consistent with the assumed cost of equity in the WACC calculation? Furthermore, if the regulator is assuming an injection of new equity to address financeability in the notional structure, it would be reasonable to include an allowance for the associated costs.

Therefore, as far as the WACC estimate is concerned, the financeability assessment may provide additional support for the ability of the company to raise debt finance but not to access equity markets.

Consistency with credit rating agency definitions

In its draft determinations for PR19, Ofwat has applied its own definitions of AICR and the flow of funds of operations (FFO) to net debt. These definitions differ from those of Moody's in the case of AICR and Standard & Poor's in respect of FFO/Debt. One particular difference is that Moody's strips out any adjustments to the PAYG rate compared to the natural rate based on the split of operating expenditure (opex) to total expenditure (totex).

Ultimately, what matters for the ability to raise finance on reasonable terms is the views of investors, not the rating agencies. However, we are not aware of evidence to support using different definitions. At the very least, one would expect Ofwat to consider the rating agency metrics alongside its own definition of those metrics, and to attach material weight to them in its assessment. When the CMA considered this issue in Bristol Water (2015), it stated that actual rating agency metrics should be used and adjusted Ofwat's calculations accordingly.

Consistency with the cost of debt

Ofwat's methodology for estimating the cost of debt is based on the iBoxx indices of A-rated and BBB-rated corporate bonds (A and Baa in Moody's terminology). Research published by Anglian Water in its business plan estimated that the weighted average rating of the bonds in the iBoxx indices was A-.[1] In contrast, Ofwat's financeability assessment is based on a rating of Baa1 and in practice is more compatible with Baa2. Therefore to be consistent, either:

- the cost of debt in the WACC allowance should be based on a Baa1 (Baa2) rating; or
- the financeability assessment should be tested against metrics that are consistent with a rating of A- or higher.

Long-term financial resilience

As highlighted above, Ofwat interprets its resilience duty to include financial resilience. It describes this as a company's ability to avoid, cope with and recover from disruption to its finances and considers that an efficiently structured and operated firm should be financially resilient over the longer term.

In assessing financial resilience it is important to understand not just the degree of financial headroom in the base case outlook but also the sensitivity of financial metrics and credit ratings to potential downside scenarios. The capacity to access equity markets during times of shock is another critical element of financial resilience.

In implementing its resilience duty Ofwat appears to have delegated much of the responsibility to companies, relying on the long-term viability statement (LTVS) process and assurances of financeability contained in firms' business plan submissions. It raises the question whether Ofwat has done enough to evaluate the resilience of its own determinations. The CMA Bristol Water (2015) decision stated that:

[1] Anglian Water, 15B Target credit ratings for water companies at PR19, February 2018.

> *"We consider it good regulatory practice to consider the impact of downside shock on financial ratios."*

In assessing financeability and financial resilience as part of its draft determinations, Ofwat has not analysed downside scenarios or carried out stress tests. Yet, at a point where the regulator is applying more stringent methods for setting targets than previously, analysing vulnerability to shocks is more important than ever in understanding the underlying financial position of the companies it oversees.

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