UUWR_70

PR24 Draft Determination: UUW Representation

Area of representation: Balance of Risk and Return and Financeability

August 2024

This document outlines our representation on WACC, risk and return balance, financeability and financial resilience, equity issuance, dividends and allowed revenues and customer bills.

Reference to draft determination documents:
Aligning risk and return – Allowed return appendix
Aligning risk and return appendix
Aligning risk and return

United Utilities

Water for the North West

Executive Summary

WACC

We welcome the increase in draft determination WACC compared to the 'early view' WACC. However, the draft determination WACC remains too low to secure sector investability, as investors may choose to deploy their capital to other investments that offer a better return for a commensurate or lower risk.

Frontier Economics have updated their view on an appropriate cost of capital for the water sector, which when restated at 55% gearing, is a point estimate of 4.19% for appointee WACC and 5.65% for appointee cost of equity. These numbers are significantly higher than the draft determination 3.72% and 4.80% respectively.

Whilst we agree with Ofwat's move to select a point estimate towards the top end of the cost of equity range, the problem that we observe, is that Ofwat has not, in fact, aimed up in the way that it has intended. Having opted for the lowest admissible risk-free rate, the lowest admissible TMR and the lowest admissible beta, Ofwat's aiming up tends to act as a correction for parameter misestimation rather than deliver a heightened attractiveness into returns.

To correct this parameter misestimation, the risk-free rate should be based on a basket of proxies to avoid too much weight being placed on one specific proxy that diverges from other market evidence, the TMR should be increased at a time of higher interest rates just as it was reduced when interest rates were moving lower, beta should be increased by including Pennon data and putting more weight on shorter dated beta estimates that now exclude unusually volatile periods. On top of this, hybrid bond cross checks support retaining a point estimate at the top of this higher range.

Whilst we welcome the removal of the 15 basis point outperformance adjustment from the cost of new debt, this does not go far enough as the underlying index is significantly unachievable even for best in class companies with ratings stronger than the notional company. We strongly advocate that the underlying index used to assess the cost of new debt, the debt indexation mechanism and embedded debt cross checks should be changed to be the iBoxx GBP Utilities 10yr+ index as this is more representative of sector costs, with future index changes monitored in the run up to the final determination to determine whether an additional uplift is required. Efficient companies with credit ratings stronger than the notional company assumption should be able to at least consistently match and likely outperform the underlying index. This should benefit sector embedded debt costs in the longer term.

The cost of embedded debt should be updated to include all known sector issuance up to Q3 2024 along with a realistic projection of aggregate debt issuance in the sector up until 31 March 2025 (for both refinancing and to finance RCV growth) based on 2024 debt rates experienced across the sector as a whole. We expect this to lead to an increase in the cost of embedded debt.

Issuance and liquidity costs should be increased to 20bps by reflecting 12 months pre-funding of debt.

Overall, our view is that the final determination WACC needs to be increased from the draft determination level. This will support a convincing case, made in the round, as to why investors should choose to make investments in the water industry in England and Wales.

Risk and return balance

The draft determination risk and return balance has been set too punitively, such that companies are unlikely to be able to earn the allowed returns.

Performance commitments are too skewed to the downside and they do not meet the basic criteria of 'stretching but achievable'. Funding has not been allowed to provide the required levels of performance and when combined with significantly stronger incentive rates, relative to AMP7 levels, and the removal of risk protections such as penalty collars, this is anticipated to lead to net financial penalties with significant additional downside risk.

The overall outcome of the draft determinations reflect many individual examples where Ofwat appears to have meaningfully aimed down either when considering specific cost allowances or a modelled approach. This includes

introducing enhanced sharing mechanisms, which are welcome, but while not allowing reasonable baseline allowances for expected costs. In addition, the PCD framework is, in many cases, restrictive and inflexible, significantly undermining the efficiency benefits that have been achieved from Ofwat's totex and outcomes framework. We consider that Ofwat needs to reevaluate many of its challenges and take a reasonable, evidence-based approach, reconsidering whether its modelling evidence is genuinely reflecting a 'fair bet' or whether it results in outcomes skewed towards the downside.

The asymmetric negative skew and P50 below the base return in the draft determination implies that either the cost of equity is set too low, or the amount of risk required to be borne by investors is too high and therefore for the plan to be investable, something must change. Our representation puts forward a package with the appropriate balance between risk and return, where efficient expenditure allowances facilitate the investment required to improve services for customers and the environment, an outcomes package that is balanced and appropriately calibrated and a level of return commensurate with the risk required and most importantly, set at a level that can attract investors to the sector.

Overall, the risk and return balance needs to be recalibrated for the final determination to give companies a reasonable prospect of earning the allowed returns, without facing excessive downside risk. This is crucial in enabling companies to attract the significant amounts of investment needed for AMP8.

Financeability and financial resilience

Whilst we understand that there are many aspects of the draft determination financeability assessment that are reasonable and justified in principle, we do have concerns that the notional company financeability assessment may not actually provide comfort that efficient companies in the sector are, in fact, financeable.

Headroom against financial ratios has been set too 'close to the wire'. Moody's has already flagged that unless there are changes at the final determination, its assessment of water company business risk has increased primarily due to a likely downgrade in its assessment of the stability and predictability of the regulatory regime. As a consequence, required financial ratio thresholds would be tightened. Other rating agencies may well make similar changes ex-post of publication of the final determination. Additional headroom is also required as the gross interest impact on financial ratios has not been reflected.

Further, the notional company financial ratio output is unlikely to be achievable in the real world. Gating mechanisms result in significant levels of spend being excluded from the assessment. The 55% gearing assumption excludes realistic debt and interest costs that almost all companies in the sector will face. Asymmetrical expected performance and insufficient cost allowances that are only partially compensated by sharing mechanisms means that notional company financial ratio output is unlikely to be achieved in practice.

Further, the ratings treatment of our large PR19 DPC project, the Haweswater Aqueduct Resilience Programme, has the potential to weaken our financial resilience which would require additional equity for UUW that needs to be compensated by an additional equity return to be earned by United Utilities.

Equity issuance

Ofwat should allow 5% for equity issuance costs in line with other regulatory assessments and to cover liquidity costs of raising equity.

Allowed revenues and customer bills

Following adjustments made in Ofwat's draft determination, as modified by the proposals in this representation, the estimated average household bill is £580 per customer in 2029/30, before inflation. This remains below the upper range bill that we tested with customers as part of the affordability and acceptability testing of our business plan, where 75% of customers continued to support real bills in 2029-30 of £586 per customer. In this context, our business plan continues to reflect a sector-leading affordability support package for customers, with a total support package of £525m. £200m of this is funded directly by shareholders.

Dividends

Whilst our business plan proposed dividend policy was noted in Ofwat's draft determinations as being broadly in line with expectations, we respond in this document to several identified areas of refinement and clarification.

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1. WACC

1.1 Key points

- **We welcome the increase in WACC from the early view, but believe there is more that should be done to secure sector investability:** Frontier Economics' updated report recommends a point estimate of 4.19% appointee WACC, significantly higher than the Draft Determination 3.72%.
- **Certain cost of equity sub-elements should be adjusted:** Top end of CAPM range should be used as supported by hybrid cross checks, more weight should be put on shorter dated beta estimates as can include Pennon and now excludes unusually volatile data periods, RFR should be based on a basket of proxies and TMR should be increased further reflecting the 'higher for longer' interest rate environment.
- **We continue to be concerned about the assumption of 55% gearing:** In particular, we are concerned about the impact on the notional company financeability assessments.
- **The assumed cost of new debt is currently unachievable for almost all in sector:** We strongly advocate using the iBoxx utilities index going forward, as this index is more representative of sector costs.
- **We provide evidence that certain cost of debt sub-elements should be adjusted:** Embedded debt should be updated for issuance and projected issuance. We advocate an increase in issuance and liquidity costs to 20bps by reflecting 12m pre-funding of debt. The proportion of new versus embedded debt potentially understated due to gating mechanisms
- **Our view is that the cost of equity needs to increase to attract investment:** This is essential to help to support, in the round, a convincing case as to why investors should choose to put their money into the water industry. We do not believe that the draft determination provides sufficient positives to support such a case.

1.2 UUW's PR24 proposal

Our October business plan submission adopted Ofwat's early view CPIH real appointee WACC of 3.29%. However, in line with many companies in the sector, we highlighted that due to significant changes in market data and the macroeconomic environment we expected the WACC would need to be updated for the draft and final determination. In addition, we highlighted the need for the final determination WACC to be a fair and balanced position reflecting both quantitative and qualitative matters, such as the sector's significant capital needs and investor choices around deploying capital.

We also commissioned a report (plus a subsequent update) from Frontier Economics that set out their view of the cost of capital, which at the time of the updated report was a CPIH real appointee WACC range of 3.53% to 3.96% and a CPIH real appointee cost of equity range of 4.81% to 5.71% (at 60% gearing) using a 30 April 2023 cut-off date. In light of this, we concluded that Ofwat's "early view" cost of equity of 4.14% was especially low.

These points were set out in section 9.4.2 of Chapter 9 of our business plan submission (UUW09) and was supported by our supplementary document UUW73 Cost of Capital Considerations, which included the Frontier Economics original and updated report.

1.3 Draft determination position

The draft determination CPIH real appointee WACC has been set at 3.72%, with a CPIH real appointee cost of equity of 4.80%, as set out in the PR24 draft determinations: Aligning risk and return – Allowed return appendix.

1.4 Issues and implications

Overall, we welcome the increase in the draft determination WACC from the "early view" position. We also agree with Ofwat's move to select a point estimate towards the top end of the range. However, we consider that the 3.72% appointee WACC remains too low and risks water companies being unable to attract the necessary funding to finance their investment programmes.

We note that in the city briefing on the PR24 draft determination Ofwat commented that its allowed return on equity of 4.80% was slightly above and that its cost of debt of 2.84% was aligned with its survey of analyst expectations. However, we understand that Ofwat's survey asked for analysts' expectations "for our allowed return for Ofwat's draft determinations", i.e. what Ofwat would do as opposed to what the allowed return should be. We are concerned that the framing of survey questions may have acted to influence the responses given. To illustrate this, we refer to an investor survey with nearly 80 responses undertaken by Barclays in April 2024. In this survey, which Ofwat cited in its Risk and Return: Allowed return Appendix two of the questions asked were:

- What baseline allowed return on equity will Ofwat provide at the Draft Determination?
- What return on equity do you think a water company should earn, if it is meeting regulatory targets and at regulatory leverage (c.60%)?

We note that Barclays stated that the "*results show a strong mismatch between the RORE investors expect to be announced, and the one they deem fitting. Whilst the RORE expectation is skewed towards the 4.43-5.0% range (44% of responses)*…[i.e. aligned with the draft determination allowed cost of equity]…*most investors believe that a return either 5.01-5.4% (28% of responses) or above 5.8% is needed (31% of responses). In fact, only c.26% of the respondents expect Ofwat to announce an allowed return they see fit at the DD*".

The Barclays commentary continued to conclude that, based on the survey results: "*Returns are expected to be too low in the Draft Determination: Appropriate required baseline returns…Responses have a modal average of >5.8% real required return and a median average of 5.5-5.8%...Expectation of Draft Determination is far lower: Both the median and modal averages are between 4.43% and 5.0% real return.*"

This indicates that whilst the draft determination cost of equity was aligned with what many analysts expected from Ofwat, it doesn't necessarily follow that the analysts consider the rate is sufficient for investors.

Companies across the sector, including United Utilities, are likely to require a significant amount of new shareholder capital during the 2025-30 period to support investment and to enable the industry to spread the recovery of costs over time. Assuming that the risk and reward balance/cost allowances are appropriately calibrated, it is also important that shareholders substantially bear the risks around variations in projected costs and revenues, and step in to fund remedial action where performance is poor while reacting in a proportionate way to the rewards that the regulatory regime offers to good performers.

No one is forced to invest in the water industry in England and Wales. There are numerous other sectors and places that investors can put their money, and many of these alternative investment opportunities are currently offering historically high rates of return. In this context, water companies and their investors must see the prospect of a return that is commensurate with the returns for a similar level of risk that are available elsewhere, in order to maintain and renew investor interest in the sector.

In section 2 of this response we have highlighted concerns about Ofwat's cost allowances, performance targets and outcome delivery incentives. Together, the miscalibrations mean that efficient, strong performing companies are looking at an out-turn return that is below Ofwat's allowed return. In section 2 below we set out our expected PR24 RORE range, which shows that our view of the draft determination is an expected return (P50) below the allowed return and a negative skew on the risk range (P10/P90). Our draft determination response resets the expected (P50) return in line with allowed cost of equity although the challenges of delivery and the stretching cost delivery targets continue to result in a negative skew of P10/P90 return. But we also consider that Ofwat's allowed return has itself been set in fundamentally the wrong place owing to shortcomings in Ofwat's estimates of the cost of equity and the cost of debt.

We recognise that the draft determination provides for an increase in the costs of capital relative to 2020-25 allowances. Almost all of this increase comes from a formulaic update of previous calculations to take account of observable changes in market data. We are strongly of the view that Ofwat needs to go further than this and revisit aspects of a methodology that was forged when rates were thought to be 'lower for longer' so as to provide for an appropriate level of return now that rates look like they are, in fact, going to be 'higher for longer'.

We note that Ofwat will have heard and seen on multiple occasions that such a shift in thinking is needed:

- In its 2021 PR19 redetermination, the Competition & Markets Authority (CMA) were clear that multiple aspects of Ofwat's PR19 methodology risked deterring investors from choosing to invest in the water industry, ultimately leading the CMA to provide for a return on equity that was more than half a percentage point higher than Ofwat's PR19 return;
- Subsequently, three of Ofwat's fellow regulators – the Civil Aviation Authority, the NI Utility Regulator and Ofcom – all provided in decisions between 2021 and 2023 for returns that were materially higher than Ofwat's return;[1]
- Since 2022, water company share prices have fallen, and one of the listed companies has consistently traded at a valuation below RCV, despite overall RORE out-performance and confounding Ofwat's expectations of a sharp move up in market values;[2]
- In business plans submitted in October 2023, most companies indicated to Ofwat that they could not accept Ofwat's December 2022 'early view' methodology for estimating the cost of capital (NB: in previous price reviews, a majority of companies were able to use Ofwat's methodology without alteration); and then
- One week after Ofwat published its draft determination, Ofgem published its methodology for its RIIO-3 price reviews of energy network companies and tabled a range for the allowed return on equity that was significantly higher than Ofwat's chosen range.

Ofwat will also have observed that the proposed return for the 2025-30 regulatory period is out of line with observable market benchmarks. The 'all-in' equity return that the draft determination provides for is ~6.8% in nominal returns. As shown in Table 1 below, during the month of July 2024, investors could obtain fixed income returns with low/no risk of:

- around 4.5% by buying UK government gilts;
- just under 6% by buying investment-grade corporate bonds; and,
- between 6% and 6.4% by buying bonds issued by Severn Trent Water and South West Water (the two 'outstanding' companies in Ofwat's draft determination).

Table 1: Available fixed Income returns with low/no risk as at July 2024

Instrument	Annual yield
UK government gilts (nominal)[a]	4.53%
Investment grade corporate bonds[b]	5.92%
Severn Trent bond[c]	6.00%
South West Water bond[d]	6.38%

Source: a) Bank of England spot nominal government liability curve with 20 year maturity as at 31 July 2024, b) iBoxx BBB 10yr+ non-financials index as at 31 July 2024, c) Final terms for Severn Trent Utilities Finance Plc £350,000,000 5.875 per cent. Guaranteed notes due 2038, UUW annualisation calculation, d) Final terms for South West Water PLC £400,000,000 6.375 per cent. Guaranteed notes due August 2041

[1] On a like-for-like basis, allowing for differences in risk profiles and changes in market data: the CAA's risk-free rate and total market return were higher than Ofwat's PR19 figures; the UR provided for a higher risk-free rate; and Ofcom provided for a higher risk-free rate and a higher TMR.

[2] Jonson Cox speech to Westminster Energy, Environment and Transport Forum, 19 April 2022.

Water company equity is a significantly more risky investment option than any of the above-mentioned alternative assets. In order for equity investors to positively choose to put their money behind water companies' capital programmes, it is vital that the investor sees appropriate compensation for the equity risk that they are being asked to take on. We believe that this is not something that the draft determination delivers.

The remedies for this problem are straight-forward to identify and easy for Ofwat to implement in its final determination, not least because the vast majority of the required corrections are already well understood and have already been applied in other regulatory reviews.

WACC – Frontier Economics advise 4.19% appointee WACC and 5.65% cost of equity (55% gearing)
Alongside this response we are providing Ofwat with a report by Frontier Economics, UUWR_72 Cost of Capital for PR24: An update prepared for United Utilities August 2024[3] (the "Frontier Economics August 2024 Report").

In this report, Frontier Economics has updated its view on WACC using a 31 March 2024 cut-off date. The Frontier Economics August 2024 Report contains much of the detailed arguments and supporting data that evidences the assertions included in this document and so should be read alongside this document.

The Frontier Economics August 2024 Report (when translated into 55% gearing for comparability purposes) concludes on a 4.19% point estimate for appointee WACC and a 5.65% point estimate for cost of equity, which exceed the Draft Determination equivalents by 47 and 85 basis points respectively. This is shown in Table 2 below.

Table 2: Frontier Economics WACC point estimates

	Frontier Economics August 2024 point estimate	
	60% gearing per report	Recalculated on 55% gearing
Cost of equity	6.02%	5.65%
Cost of debt	2.99%	2.99%
Gearing	60%	55%
Appointee WACC	4.20%	4.19%

Source: Frontier Economics August 2024 Report prepared for UUW, UUW 55% gearing recalculation

The Frontier Economics August 2024 Report finds that:

- the PR24 estimate of the risk-free rate should be derived from a wider basket of proxies than just the yield on index-linked gilts;
- the TMR should not be regarded as having a fixed value – i.e. Ofwat should be allowing in PR24 for some movement up in stock market returns at a time of 'higher for longer' interest rate, just as it made downward adjustments in PR14 and PR19 when interest rates were moving successively lower; and
- Ofwat's estimate of beta needs to reflect all of the available data, including data from all three of the listed water companies, placing more weight on shorter look back periods (i.e. 2-years or shorter) given this now excludes pandemic related distortions, captures Pennon as a pure-play water company, and should encapsulate more of a forward looking view.

Frontier Economics also identify a number of adjustments that Ofwat needs to make to the allowed cost of debt. We expand on these below after first considering the detailed points on cost of equity.

Table 3 below shows that Frontier Economics' work is in line with the positions that the CMA and Ofgem have taken in their respective work:

[3] This report can be found in our draft determination response document UUWR_72 Cost of Capital

Table 3: Estimates of the cost of equity

	Ofwat PR24 DD[a]	CMA PR19 updated[b]	Ofgem RIIO-3[c]	Frontier Economics[d]
Gearing	55%	55%	55%	55%
Cost of equity	4.19% to 4.88% Point: 4.80%	5.28%	4.2% to 5.8%	5.09% to 5.65% Point: 5.65%

Source: a) Ofwat (2024), Aligning risk and return – Allowed return appendix, b) CMA PR19 redetermination updated for risk free rate March 24 data and 55% gearing, c) Ofgem RIIO-3 Sector Specific Methodology Decision updated for 55% gearing, d) Frontier Economics August 2024 report prepared for UUW updated for 55% gearing

Cost of equity: risk free rate – index linked gilts not in line with other data, basket of proxies should be used
The key question at PR24 for the risk-free rate is what is the 'best' proxy for the riskless asset. Is the current methodology sufficient or do wider readings need to be taken from several different sources?

Currently, different instruments point towards very different CPIH real risk-free rate values depending on whether the methodology starts from RPI index-linked gilt yields and converts up to a CPIH real equivalent using an estimate of the RPI/CPIH wedge or starts from nominal yields and converts down to CPIH real using a CPIH forecast. Table 4 and Table 5 below show this divergence in evidence between different risk free rate proxies and that this was also the case in March 2024 when the draft determination WACC was being set:

Table 4: Risk free rate measures, as at March 2024

	Nominal	RPI real	CPIH real
Index-linked gilts, 20Y	-	1.07%a	1.35%b
Nominal gilts, 20Y	4.47%c	-	2.48%d
AAA non-government bonds, 10+Y	4.53%e	-	2.51%f
AAA non-government bonds, 10-15Y	4.34%g	-	2.38%h

Source: a) Bank of England spot index linked government liability curve with 20 year maturity - March 2024 average, b) a as inflated by 28bps RPI CPIH wedge, c) Bank of England spot nominal government liability curve with 20 year maturity – March 2024 average, d) c as deflated by OBR CPIH forecast then 2% to maturity, e) iBoxx non-gilt AAA 10yr+ index – March 2024 average, f) e as deflated by OBR CPIH forecast then 2% to maturity, g) iBoxx non-gilt AAA 10-15yr index – March 2024 average, h) g as deflated by OBR CPIH forecast then 2% to maturity

Table 5: Risk free rate measures, as at July 2024

	Nominal	RPI real	CPIH real
Index-linked gilts, 20Y	-	1.22%[a]	1.50%[b]
Nominal gilts, 20Y	4.63%[c]	-	2.63%[d]
AAA non-government bonds, 10+Y	4.68%[e]	-	2.67%[f]
AAA non-government bonds, 10-15Y	4.51%[g]	-	2.54%[h]

Source: a) Bank of England spot index linked government liability curve with 20 year maturity – July 2024 average, b) a as inflated by 28bps RPI CPIH wedge, c) Bank of England spot nominal government liability curve with 20 year maturity – July 2024 average, d) c as deflated by OBR CPIH forecast then 2% to maturity, e) iBoxx non-gilt AAA 10yr+ index – July 2024 average, f) e as deflated by OBR CPIH forecast then 2% to maturity, g) iBoxx non-gilt AAA 10-15yr index – July 2024 average, h) g as deflated by OBR CPIH forecast then 2% to maturity

This divergence in evidence is recognized to some extent in the draft determination, but is never fully addressed as:

- First, Ofwat compares the yields on nominal AAA non-government bonds to the yield on nominal gilts, and concludes that the data shows no evidence of a so-called ‘convenience yield’. In our view, this is the wrong comparison. Ofwat’s preferred estimate of the risk-free rate is the yield on the index-linked gilts and it is the ‘specialness’ of this specific proxy for the riskless asset that is in question. Table 4 and Table 5 above confirm that there is a clear differential between the risk-free rate in the first row of the table compared to all subsequent rows.
- Second, Ofwat uses different inflation assumptions in its write-up in order to reconcile the conflicting readings. Everywhere else in the draft determination, Ofwat allows for inflation in line with the Office of Budget Responsibility’s (OBR’s) latest economic forecast together with assumptions that (i) CPIH inflation will remain at 2.0% over the long term; and (ii) RPI inflation will run at 2.9% until 2030 and then drop to 2.0% at the point where the ONS aligns the formulae for calculating RPI with CPIH. In its analysis of the risk-free rate proxies, however, Ofwat then switches to an exclusively swap-based measure of future inflation (which effectively deflates nominal risk free rate proxies to CPIH real using a c3% swap based CPIH inflation forecast as opposed to the 2% long term CPIH forecast used elsewhere) in order to show that the readings in the nominal and RPI real figures in Table 4 and Table 5 above convert to near-identical CPIH real risk-free rates. We consider that these inconsistencies in approach are surprising and would instead argue that Ofwat should use OBR forecasts in every aspect of every workstream in its draft determination.

Putting both of these things together, we are clear that Table 4 and Table 5 at the very least give pause for thought. A decision, therefore, to focus exclusively on index-linked gilt yields as the sole proxy for the riskless asset, to the exclusion of all other admissible measures, constitutes a somewhat one-dimensional approach to the cost of capital assessment.

Our view is that Ofwat should, when presented with plausible evidence of index-linked gilt ‘specialness’, construct an estimate of the risk-free rate using a basket of proxies for the riskless asset and risk-free rate of return. This could be the basket that the CMA used in its 2021 PR19 decision. Or it could be a different, perhaps broader basket, that takes in readings from nominal gilts, potentially medium- and long-dated gilts of different maturities. The key point we would make in its favour is that a basket approach would act as a safeguard against inadvertent over-reliance on a single atypical reading, thus ensuring that the risk-free rate that feeds into the PR24 cost of equity calculation is not skewed in a way that may ultimately make it difficult for companies to maintain and attract equity capital.

We also note that such an approach is explicitly permitted under the UKRN’s 2023 cost of capital guidance. The final paragraph on p.14 of the guidance states that:

“… regulators agree that nearly any risk-free proxy stripped of accurately measured risk premia should give a value close to the 'true' risk-free rate. In principle this suggests that evidence from these proxies could provide a useful sense check in times of ILG market volatility or to help define the range within which the point estimate for the risk-free rate should be drawn.”

Cost of equity: beta – Pennon should be included and more weight should be placed on spot 2 year betas

Pennon has been a pure play water company since June 2020 and therefore there is sufficient data to include Pennon in the beta assessment, particularly for the shorter-term data windows. The availability of Pennon pure play water company data will continue to increase in the run up to the Final Determination which strengthens this argument.

Ofwat’s suggestion that Pennon’s beta offers no relevant information is somewhat counter-intuitive. While pre-2021 share price data may be affected by Pennon’s waste business, the last 2-3 years of data comes from a near pure-play water company. The fact that the Pennon beta has been materially higher than the UU and SVT betas during this period has informational value which should not have been discarded. This is especially the case given the very small sample of data that Ofwat has to work with.

Ofwat's PR24 beta is lower than Ofwat's PR19 beta (on a like-for-like basis, allowing for the change in Ofwat's notional gearing assumption).

The sole reason for this downward movement is a small change in empirical readings of the SVT and UU betas since 2019. During this time period there has been unusually high volatility caused by the Covid pandemic and the initial market impact of the Russo-Ukraine war along with the subsequent period of high inflation, which has acted to supress water company betas. In addition, it is well known that statistical estimates of beta are inherently imprecise, and the change that Ofwat identifies falls well short of constituting a clear structural break. It would have been more logical, therefore, for Ofwat to attribute movement in the data to noise rather than to draw the conclusion that there has been a downward drift in required returns. This is especially the case when the latest spot estimates point, if anything, to a small upward movement in betas to above PR19 levels during late 2023 and 2024.

Finally, it is important to be clear that empirical estimates of beta are unavoidably backward-looking measures of the correlation that water company share prices have historically exhibited to wider stock market movements. Water companies today are very different from the water companies of the early 2010s (which is when Ofwat's preferred measure of beta starts). We now face different types of cost risks, owing to a large step up in capital investment requirements, and investors more generally view risks in the sector in their totality through a very different lens compared to the viewpoint that they had just a few years ago.

In these circumstances, we believe the question Ofwat should consider is: Do we think that water companies' shares have become less risky or more risky propositions in the eyes of equity investors since PR19? It is difficult to conceive that the answer to this question could be "less risky." And there are numerous reasons why a rational investor could reasonably see more risk now than they would have seen in the past. It is not, therefore, a huge surprise to us that the Barclays survey that Ofwat cites in the draft determination document found that investors rated water the riskiest utility sector and the UK the riskiest European country[4].

Further, Moody's has recently stated that *"…the DD increases the sector's business risk, a credit negative. A change in our view of the stability and supportiveness of the regime or companies' ability to recover costs and earn a return could lead us to adjust our ratio guidance."*[5]

We therefore very clearly see the direction of travel on beta at PR24 as being up not down. As Frontier Economics explains, Ofwat can capture this change in perceptions by giving more weight in its final determination to beta estimates constructed from recent share price data, including Pennon share price data. More recent share price data also has the benefit of excluding periods of higher than usual volatility caused by the Covid pandemic and the initial market impact of the Russo-Ukraine war along with the subsequent period of high inflation, in addition to the more up to date evidence on sector risk perceptions.

However, more generally, Ofwat needs to demonstrate that its final PR24 beta comes out in a logical place, having regard to the overall return that the combination of its risk-free rate, TMR and beta produces versus the benchmarks that we described earlier in this chapter.

In this regard, we especially ask Ofwat to place weight on the comparison that investors will inevitably make to Ofgem's beta for energy network businesses, as companies that have broadly the same underlying characteristics and risk profiles. There is no logical reason why the PR24 beta should be lower than the RIIO-3 beta. Indeed, the Barclays survey response on relative risks and Moody's comments on reassessing the business risk of the UK water sector set out above could justify the PR24 beta being higher than the RIIO-3 beta, and so any discrepancy in allowed returns will necessarily raise questions about the fairness and predictability of the regulatory regime going forward.

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[4] Ofwat (2024), Aligning risk and return – Allowed return appendix

[5] Moody's Sector In-Depth: Regulated Water Utilities – United Kingdom. Regulator's draft determination increases sector risk 14 Aug 2024 (https://www.moodys.com/research/doc--PBC_1417545)

Cost of equity: TMR – should be set higher than regulatory precedent TMR from times of low interest rates
The second reference point that Ofwat uses when triangulating water companies' required return is the level of return that investors are currently expecting from stock markets generally.

A huge amount has been written on this subject in recent years. Ofwat's draft determination provides for a small increase in its preferred TMR value following an update to previous analysis of historical return data. However, it is noticeable that the draft determination range of 6.29-6.87% centres below the CMA's preferred value of 6.81% and below Ofgem's RIIO-3 range of 6.5-7.0%.

An arguably bigger problem with Ofwat's analysis is that there is limited consideration of the interest rate cycle and the sense that Ofwat will be making its final determination at a point in time when interest rates will be 'higher for longer'. This ought to be a key consideration for PR24, in that a conscious decision to set the allowed rate of return in line with long-term average market rates risks leaving water company returns out of line with other investments and handicapping water companies when they compete for capital in today's market.

Frontier Economics discusses this omission from Ofwat's considerations in its report. As demonstrated in Figure 1 below, they observe that regulators, including Ofwat, have in the past been able to marry a regulatory approach in which the TMR is viewed as more stable than the risk-free rate with discernible movements in the precise value of the TMR from one price review to the next to reflect prevailing market conditions. In Ofwat's case, this entailed moving the TMR down from a value of 7.4% RPI real in PR09 to a figure of 6.5% CPIH real in PR19, i.e. a relative drop of c2% on a nominal basis.

Figure 1: Long run TMR as estimated by DMS, Regulatory decisions on TMR and yields on 20 year ILGs.

Source: Frontier Economics August 2024 report prepared for UUW

It is only logical that Ofwat should provide for a discernible move back in the opposite direction now that long-term interest rates have reverted to pre-2008 levels. Contrary to what Ofwat says in the draft determination, this would not be a "violation of the 'fair bet' principle". Rather, it would represent a consistent application of Ofwat policy across successive reviews, given clear evidence that Ofwat squeezed down in multiple aspects of its cost of capital analysis when interest rates were looking like they were going to be 'lower for longer'.

We note that a degree of upward movement on the TMR to reflect current market conditions is explicitly permitted under the UKRN's 2023 cost of capital guidance. The penultimate paragraph on p.19 of the guidance states that the UKRN's recommended approach to the TMR:

"… does not imply that regulators should simply pick the same fixed value for the TMR in each decision for all time, but that the TMR would be relatively less variable than the underlying RFR."

Overall, it is appropriate that TMR is moved up and that a figure from the top of Frontier Economics' TMR range is appropriate, i.e. 7.1%.

Cost of equity: point estimate - should be set at the top of the CAPM range
We welcome Ofwat's draft determination decision to aim up in the range and provide for a rate of return that lies above the mid-point cost of capital estimate.

We very strongly endorse the logic behind this decision. The scale of the additional financing that the sector requires ahead of and during the 2025-2030 regulatory period is of a different order of magnitude to anything that water industry investors have seen previously. A price review which requires equity formation rather than merely servicing existing equity capital, in particular, makes it vital that companies are able to make a positive investment case to markets. The offer of an attractive and competitive rate of return is a key component in this story.

The problem that we see, however, is that Ofwat has not, in fact, aimed up in the way that it has intended. Having opted for the lowest admissible risk-free rate, the lowest admissible TMR and the lowest admissible beta, Ofwat's aiming up tends to serve as a correction for parameter misestimation rather than deliver a heightened attractiveness into returns.

It follows that Ofwat needs to make the corrections listed under the three previous headings and then aim up in order to achieve the outcome that it has rightly targeted.

In addition, as set out more fully in the Frontier Economics August 2024 Report, hybrid debt cross checks give directly observable (with an appropriate assumption on the proportion of equity like features of the hybrid bond) implied expected return on equity. This cross check provides a range of 5.8% to 8.4% with a point estimate of 6.6% for the cost of equity, giving strong evidence that the very top of the CAPM range should be used.

Gearing – we continue to disagree with move to 55%, with the key issue being impact on financeability testing
We continue to disagree with the reduction in notional gearing from 60% at PR19 to 55% at PR24. As demonstrated in the Frontier Economics August 2024 Report, this diverges from the actual gearing of almost all companies in the sector and also diverges from regulatory treatment in other high investment sectors such as Ofgem RIIO-ED2, CAA H7 and Ofgem RIIO-3 (GD) SSMD.

Our main concern is that the 55% gearing assumption results in notional company financial ratios that are more comfortably placed than that which almost all companies in the sector could reasonably achieve. Because of this 55% gearing assumption the notional company financeability testing no longer represents a reasonable test that an efficient water company is financeable.

Cost of debt
Setting an allowance to cover the industry's cost of debt ought, in principle, to be rather more straight-forward than the process of setting an appropriate return on equity, given that companies' interest costs are observable quantities. We broadly agree with Ofwat's overall cost of debt methodology. But we consider that there are some omissions and errors in Ofwat's numerical analysis.

Cost of new debt – strongly advocate change of iBoxx index to Utilities index
Whilst we welcome the removal of the 15 basis point outperformance adjustment from the cost of new debt, this does not go far enough, as the composite A/BBB corporate index used by Ofwat is now significantly unachievable even for the best in class companies in the sector.

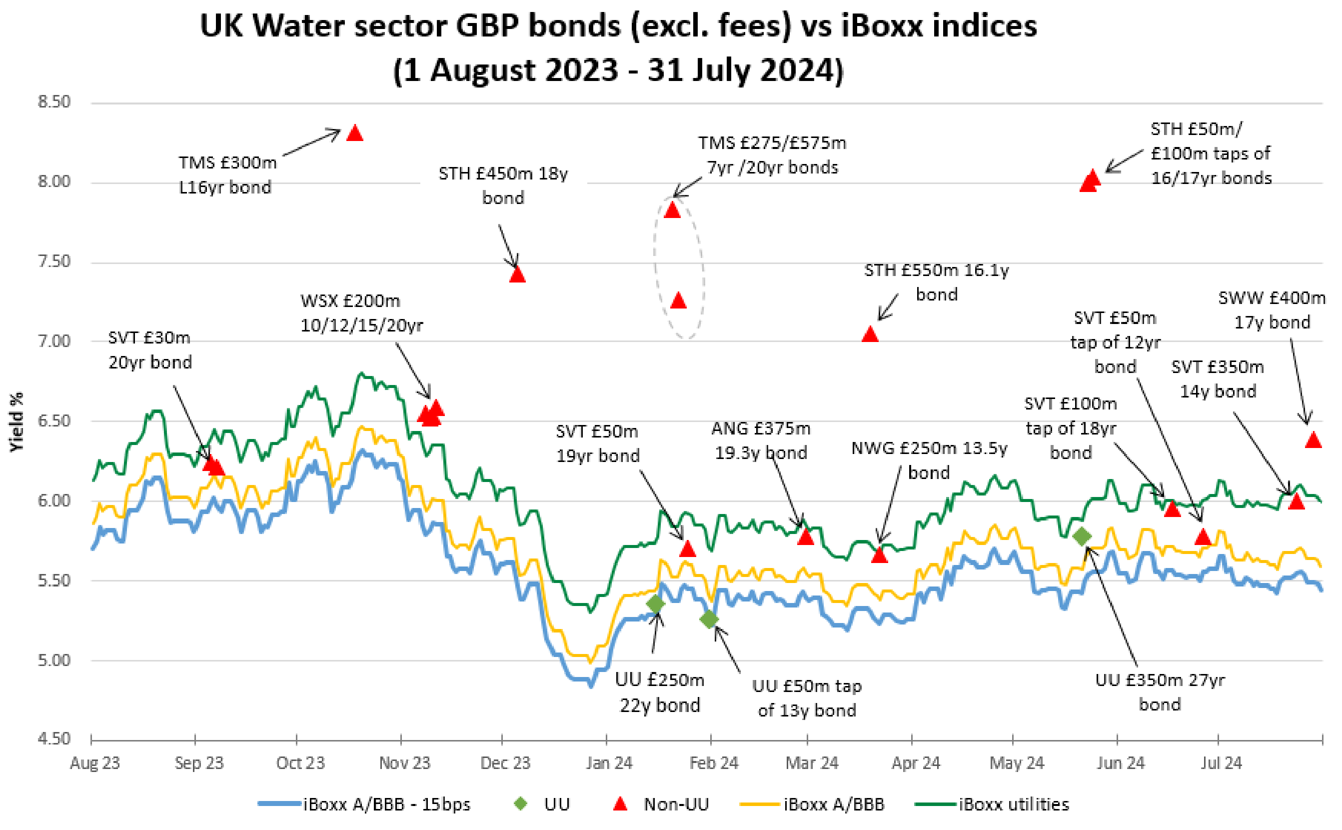
We strongly advocate that the reference index for the cost of new debt, the debt indexation mechanism and also the cross checks for embedded debt should all be changed to reference the iBoxx GBP Utilities 10yr+ index as this

is more representative of sector costs. This is also supported by Frontier Economics in the Frontier Economics August 2024 Report and is the index used by Ofgem at RIIO-2 and indicated will be used for RIIO-3.

However, Ofwat should reassess market data closer to the Final Determination and should also consider whether there needs to be an upwards adjustment to the Utilities index reflecting the decrease in index levels from the end of July 2024 resulting from the removal of Thames's high yielding bonds.

Supporting evidence:
Figure 2 below shows the GBP public nominal issuance across the sector over the past 12 months from the large WaSCs, with the blue line being the iBoxx A/BBB indices less 15bps, the yellow line being the iBoxx A/BBB indices with no adjustment and the green line being the iBoxx Utilities index:

Figure 2: UK Water sector (large WaSCs) GBP bonds (excl. fees vs iBoxx indices)



Source: UUW calculations using publicly available yield data from new issuance Final Terms, iBoxx yields from S&P Global Market Intelligence

Table 6: Performance of UK Water sector (large WaSCs) GBP public bonds (excl. fees) versus iBoxx indices over the 12 months to 31 July 2024

	Performance vs iBoxx A/BBB index		Performance vs iBoxx Utilities index	
	All WaSCs	Excl. TMS/STH	All WaSCs	Excl. TMS/STH
Best	15.9bps o/p	15.9bps o/p	46.4bps o/p	46.4bps o/p
Worst	233.5bps u/p	73.9bps u/p	202.0bps u/p	34.4bps u/p
Weighted average	106.1bps u/p	30.5bps u/p	74.3bps u/p	2.5bps o/p
Median	58.0bps u/p	23.8bps u/p	23.0bps u/p	7.1bps o/p

Source: : UUW calculations using publicly available yield data from new issuance Final Terms, iBoxx yields from S&P Global Market Intelligence

As can be seen from the above graph, of the £4.835 billion of GBP public nominal bonds issued by the UK water sector (large WaSCs) in the past 12 months only £300m of bonds (or c6%) issued by United Utilities managed to achieve yields at least in line with the unadjusted iBoxx A/BBB index (yellow line on graph), which is the index used in setting the draft determination allowed cost of new debt. Table 6 above shows that the sector weighted average performance against that index over the past 12 months was over 100 basis points of underperformance.

Even removing issuance by Thames and Southern, Table 6 above shows the weighted average performance was c30bps of underperformance, and this is with a 67% weighting to perceived 'best in class' issuers United Utilities, Severn Trent and South West Water, some of which are rated more strongly than the notional company and so should be able to consistently outperform the index.

This clearly demonstrates that use of the iBoxx A/BBB index is inappropriately tough and should be replaced by the iBoxx Utilities index (potentially with a positive adjustment as per the below point on the future evolution of iBoxx rates), which is the green line on the graph and better reflects the issuance yields of the sector. Alternatively, if the iBoxx A/BBB index is retained a significantly positive adjustment (of at least 30bps) would need to be added on to the yield. Even then, if ratings agencies change their key credit ratio thresholds in response to the final determination, then that adjustment might also be insufficient to reflect any subsequent ratings actions.

The weighted average performance versus the iBoxx Utilities index over the past 12 months was c74bps underperformance. Excluding issuance by Thames and Southern, the weighted average performance was c2.5bps outperformance, again this is with a 67% weighting to perceived 'best in class' issuers United Utilities, Severn Trent and South West Water, some of which are rated more strongly than the notional company and so should be able to consistently outperform the index. Because of this we view the weighted average performance of c2.5bps outperformance as being somewhat lower than what should reasonably be expected.

In addition, due to its downgrade below investment grade, Thames's bonds were removed from the iBoxx BBB and Utilities indices at the end of July. The exclusion of these high yielding bonds will result in a material drop in the yield on those iBoxx indices going forward, resulting in an additional challenge for water company debt issuance to perform against the iBoxx indices. As shown in table 7 below, we estimate this impact as reducing iBoxx indices by 8[6] to 19 bps, and in itself warrants an upwards adjustment to the iBoxx utilities index of c15bps. This is something that should be monitored closer to the Final Determination especially if Southern, which is on review for downgrade, were to lose its investment grade ratings and also be removed from the iBoxx indices.

Table 7: Analysis of impact of Thames Water exiting the key corporate bond indices

	Annual yield to maturity			
	31 July 2024	**1 August 2024**	**Change**	**Thames impact only**
iBoxx A index (no Thames impact)	5.27%	5.21%	(0.06)%	Nil
iBoxx BBB index (Thames impact)	5.92%	5.70%	(0.22)%	(0.22)%-(0.06)% = (0.16)%
iBoxx Utilities index (Thames impact)	6.00%	5.75%	(0.25)%	(0.25)%-(0.06)% = (0.19)%

Source: S&P Global Market Intelligence, UUW calculations

Issuance and liquidity costs – advocate increase to 20bps by reflecting 12m pre-funding of debt
Whilst we welcome the increase in allowed issuance and liquidity costs by 5bps to 15bps at draft determination, we advocate that this should be increased further to 20bps at final determination.

At the draft determination, 6-7bps of the 15bps allowed issuance and liquidity costs was attributed to raising debt on average 6 months ahead of deployment of funds. As efficient companies need to have liquidity of at least 12

[6] As the A and BBB indices are averaged.

months on a rolling basis, this calculation should be updated to reflect companies raising debt on average 12 months ahead of deployment of funds, which would increase the costs of this element to 12-14bps.

The need for over 12 months' liquidity on a continual basis was demonstrated very clearly in S&P's 31 July 2024 downgrade of Thames[7] which was predicated by S&P's expectation that Thames would not *"have a remedy plan to cover its liquidity needs by 1.1x for the next 12 months before the autumn of 2024"* and *"We assess Thames Water's liquidity position as less than adequate, reflecting our view that the company's liquidity resources will not cover its funding needs by at least 1.1x in the 12 months from June 30, 2024."*

This requirement for 1.1x liquidity needs for the next 12 months is not specific to Thames but is a standard threshold for corporates to be assessed as having an 'adequate' liquidity position.

Increased issuance and liquidity costs at 20bps would be more in line with precedents elsewhere:

- In their report for UU, Frontier Economics calculates 22bps for similar additional borrowing costs
- Ofgem allowed 25bps for similar additional borrowing costs at both RIIO-2 and RIIO-3 SSMD

Proportion of new debt – potentially understated due to gating mechanisms
In the draft determination there has been significant use of gated mechanisms for spend that has regulatory requirements and therefore is expected to be spent. The exclusion of this spend has potentially resulted in an under assessment of the proportion of new debt across the sector and therefore the ratio of embedded to new debt. The assessment of the proportion of embedded to new debt should include consideration of gated spend.

Cost of embedded debt – needs to include debt to be raised before 31 March 2025 to fund RCV growth
Ofwat states in its draft determination document that its allowance for embedded debt costs does not yet take into account the cost of debt that companies have raised or will raise between 1 April 2023 and 31 March 2025 to finance RCV growth. Ofwat has also not had time to factor in the debt costs reported in companies 2024 annual performance reports.

Both items lead to an under-estimation of the allowed cost of debt at the draft determination. We expect the final determination cost of embedded debt to factor in the cost of all known debt in issue up to at least Q3 2024 (irrespective of whether reported via the APR) and make a realistic projection of aggregate debt issuance in the sector up until 31 March 2025 based on 2024 debt rates experienced across the sector as a whole.

Investability considerations – need a persuasive story why investors should put money into the water industry
The allowed cost of equity needs to demonstrably attract equity to the sector in a time of very high investment needs, very high competition for investment from other sectors (such as electricity and gas) and the noticeable change in risk perception for the water sector.

We identified at the start of this chapter that provision by Ofwat of a competitive base level of return is a necessary, but not sufficient, condition for maintaining and attracting new equity interest in the sector. As a conclusion to this section, it is important to be clear that our investors will look beyond the headline cost of capital number and form a view about investment in the water sector in rounded way and taking into account a number of additional factors.

A key question that shareholders and potential equity investors will ask is how readily the returns built into the regulatory regime will translate into earnings and actual tangible cash payments up from the company to equity owners. There are a number of factors that come into play here:

1. The sizeable upswing in the industry's capital programme creates a possibility that companies will need to go to shareholders for repeated injections of new capital over a protracted period of time;
2. Ofwat's draft determination downsizes the sector's base dividend yield to just 2% per annum where there are financeability constraints;
3. Companies may not be able to earn allowed returns in practice due to asymmetrical expected performance on totex, ODIs, etc. and inappropriate cost assessments that are only partially compensated for by sharing mechanisms (see next section for more detail);

[7] https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/3223673

4. Current accounting standards significantly distort companies' reported earnings, making companies appear to earn returns that are significantly lower than the industry cost of capital; while
5. Following changes to Ofgem's RIIO-3 methodology, water companies will be providing lower upfront cash returns than energy networks even irrespective of whether or not the differentials in TMR, beta, etc. identified in earlier sections of this paper persist when Ofwat publishes its final determination; and
6. There is a real risk that Ofwat's proposed modifications to licences in relation to financial resilience could be perceived as 'trapping' equity in a penal environment. This could damage the ability to attract new equity.

All of these things would tend to make water companies, and especially listed water companies, less attractive to investors than the textbook utility business of years gone by. Ofwat will have observed what happened to National Grid's share price in May 2024 when the company announced a step up in its capital programme, a rights issues and a cut in its dividend yield. It is in everyone's interests that the water industry avoids similar turbulence and value destruction following the finalisation of the PR24 determination.

We do not propose any fundamental changes at this stage in response to the penultimate matter identified above, and the fourth factor is not something that lies within Ofwat's or companies' control. However, we do question the rationale for rebasing to such a low dividend yield. While growth stocks typically have high reinvestment rates, and therefore low dividend payouts, regulated infrastructure is a unique asset class which attracts a very specific investor with well-established investment criteria. Without a doubt, investors in companies which invest and own regulated utility assets place materially greater emphasis on dividend yield. The dividend yield is intrinsically linked to the strength and stability of asset cash flows. While there are instances of companies lowering payout ratios, this would be considered highly unusual for the asset class. In Europe, companies with low payout ratios typically carry significantly higher risk than pure play regulated utilities – for instance high growth renewable companies like Orsted. While these companies are considered utility peers, they are treated differently to European regulated utilities which is a subset of the European utility peer group

In our October 2023 business plan, we proposed that the base level of dividends during the 2025-30 regulatory period should be set one percentage point below the real CPIH-stripped cost of equity. After making our proposed correction to Ofwat's calculations, this would be equivalent to a dividend yield of around 4% per annum, which we regard as an appropriate level of actual payments to investors in light of the returns that investors can get from competing assets with similar characteristics. A dividend yield of just 2%, by contrast, risks causing significant disquiet to investors and making water companies a much less 'investable' proposition than they ought to be.

The broader point here, however, is that both companies and Ofwat need to be demonstrate a convincing case about why it is that investors should choose to put their money into the water industry. We are concerned that the draft determination does not provide a convincing case and that a key priority for Ofwat ahead of the Final Determination will be to develop an overall narrative that corrects this skew and makes the PR24 price controls a strongly competitive 'investable' proposition.

1.5 Approach for final determination

Whilst we have used Ofwat's draft determination WACC for the tables we have submitted as part of our draft determination response, this has been done for consistency and comparability purposes and we continue to believe that certain changes should be made for the final determination approach.

As described in more detail above, the final determination WACC should be set at a level higher than the draft determination WACC and should be set at a level that demonstrably attracts equity to the sector in a time of very high investment needs, very high competition for investment from other sectors (such as electricity and gas) and the noticeable change in risk perception for the water sector.

For the cost of equity, beta should increase once Pennon data is included and more weight is put on shorter term estimates, TMR should increase in the current higher interest rate environment to reverse previous regulatory precedent decreasing TMR in low interest rate environments and to reduce weight on subjective ex-ante assessments, the risk free rate should increase by taking account of a basket of proxies and the point estimate should be set at the top of the CAPM range as supported by hybrid debt cross checks.

For the cost of debt, the iBoxx utilities index should be adopted for the cost of new debt, the AMP8 debt indexation mechanism and index cross checks. Sector issuance data should be observed in the run up to the final determination to determine whether an upward adjustment is also needed to the iBoxx utilities index following the end of July removal of Thames yield data from the indices. Embedded debt rates should be increased to reflect actual sector issuance to Q3 2024 along with a realistic projection of aggregate debt issuance in the sector up until 31 March 2025 (for both refinancing and to finance RCV growth). Issuance and liquidity costs should be increased from 15bps to 20bps and the proportion of embedded to new debt should reflect expected spend under gated mechanisms to ensure this is not understated in practice.

2. Risk and return balance

2.1 Key points

- **The draft determination risk and return balance has been set too punitively:** Companies are unlikely to be able to earn the allowed returns.
- **Performance commitments are too skewed to the downside:** Expected financial penalties result in allowed returns not being earned with significant additional downside risk.
- **There are numerous examples of "aiming down" which combined undermine sense of a "fair bet":** A reasonable, evidence-based approach would be preferable to subjective challenge.
- **Bioresources sharing mechanisms are welcome:** However, additional clarity and potential reinstatement of the RCV guarantee are still needed.
- **Our view of the DD RORE range is an expected return (P50) below the allowed return and a negative skew on the risk range (P10/P90).** Our representation puts forward a package with the appropriate balance between risk and return, where efficient expenditure allowances facilitate the investment required to improve services for customers and the environment, an outcomes package that is balanced and appropriately calibrated and a level of return commensurate with the risk required and most importantly, set at a level that can attract investors to the sector.
- **Final determination risk and return balance needs recalibrating:** Companies need reasonable prospects of earning allowed returns, without excessive downside risk, to attract necessary investment.

2.2 UUW's PR24 proposal

Our October business plan submission proposed a RoRE range of -6.28% to 4.43% around the base allowed return. We highlighted that this broadly downward skewed risk profile reflected the stretching costs and performance targets that we had set in our plan, but with clear opportunities for rewards in the event of exceptional performance and clear (and significant) penalty consequences in the event of underperformance. These points were set out in section 9.3 of Chapter 9 of our business plan submission (UUW09).

2.3 Draft determination position

The draft determination risk and return package proposed a number of targeted amendments compared with the arrangements at PR19. These included:

- strong financial incentives on performance, with performance commitment levels reflective of sector median forecasts rather the upper quartile targets;
- increased protection for real price effects through the indexation of energy costs, materials, plant and equipment costs, in addition to labour costs;
- recalibration of retail and wholesale cost allowances, taking account of the effect of inflation;
- the extension of the DPC regime;
- the introduction of formal gated allowances for larger complex investments projects;
- the introduction of standard cost sharing to the bioresources control, and a reduction to cost sharing rates that apply across other wholesale controls;
- the lowering of cost sharing rates for enhancement costs;
- the introduction of enhanced cost sharing rates for investments associated with the Industrial Emissions Directive and large schemes that are not provided with a formal gated allowance, and reducing the sharing rate for business rates;

- the introduction of a separate aggregate sharing mechanism for outcomes and costs,
- a proposal to apply the RCV reconciliation adjustments to the RCV on 31 March 2025;
- a proposal to cap the PR19 cost sharing rate that applies for 2024-25 to 60%;
- the option for companies to accept QAA and ODI adjustments as adjustments to the RCV rather than revenue; and
- to consult on an option to commit to fund the efficient costs of water companies establishing and raising new equity via an exchange listing.

These amendments were stated to be aimed at supporting companies to deliver the step increase in investment while protecting customers from miscalibration of the price determination package.

2.4 Issues and implications

Overall, we welcome the targeted amendments to the PR24 risk and return package that have been introduced at the draft determination. However, for many of these amendments, whilst the principles are sound, the detailed implementation is problematic.

Performance commitments are too skewed to the downside, especially on wastewater
As can be seen from the RORE ranges presented in Figure 3 below, based on the draft determination we expect to incur penalties as a base case with a significant downside skew to the range of likely outcomes, which will significantly challenge our ability to earn the allowed returns in practice.

This is especially the case on wastewater, and as an example we highlight our internal sewer flooding metric.

As discussed more in our DD representation document *UUWR_12 Internal Sewer Flooding*, Ofwat has not taken account of the compelling evidence presented in our October 2023 Business Plan document[8]. We put forward an ambitious target of a 32% reduction in AMP8, reflecting a 55% reduction since AMP6 in line with the two-AMP strategy we outlined at PR19. Opposite this, Ofwat has proposed a target that would represent a c70% reduction of incidents in two years (2025/26 compared with 2023/24). This change to target has been combined with tripling the incentive rate, relative to AMP7 levels, and removal of the penalty collar.

This PCL does not meet the basic criteria of “stretching but achievable.” UUW has never been funded to provide this level of performance, and there is clear evidence from previous determinations that such investment would have been rejected as not being cost beneficial. Funding for that level of performance would be prohibitive given that urban runoff and combined sewers are such clear drivers of incidents – 1% of days account for 29% of incidents. It would not be cost effective to weatherproof the system.

We reiterate that common performance targets are not appropriate for this metric. It results in targets that suit some company circumstances and they will find easy to meet, leaving customers overpaying for service. Meanwhile, it leaves other companies with no chance of meeting the target, resulting in guaranteed financial penalties. Our estimate is that on a P50 basis we can expect a £23m penalty each year, as the metric is currently construed. On a P10 basis – with rainfall broadly equivalent to 2023/24 then this would be a £63m penalty each year. If Ofwat will not set company specific targets (as it has done for many other metrics, including external sewer flooding) then we ask that it reconsiders the target, the incentive rate and the collar. This is a major contributor to our overall estimate that P50 performance on performance commitments (excluding MEX) as constructed in the DD leads to a typical penalty of £36m per annum and P10 performance a £177m per annum penalty.

In its recently published sector report[9] Moody’s also highlights the likelihood of significant penalties associated with performance commitments across the sector in AMP8, stating: “*Ofwat has set more demanding operational performance targets and strengthened incentive rates. Based on the draft determination and if companies*

[8] UUW30 – Performance commitments technical document - PR24_ISF_Internal Sewer Flooding

[9] Moody’s Sector In-Depth: Regulated Water Utilities – United Kingdom. Regulator’s draft determination increases sector risk 14 Aug 2024 (https://www.moodys.com/research/doc--PBC_1417545)

perform in line with their business plan assumptions, we estimate that most companies are likely to incur net penalties over the next five years, in aggregate amounting to around £2 billion across the sector."

We consider that the power of performance commitment incentives needs to be reduced overall, but particularly in respect of wastewater.

There are numerous examples of "aiming down" which combined undermine any sense of a "fair bet"
The overall outcome of the draft determinations reflect many individual examples where Ofwat has meaningfully aimed down either when considering specific cost allowances or a modelled approach.

Examples include business rates, where inevitable revaluations (which simply mechanistically roll forward the tax base) have been disregarded, leading to a c£206m shortfall in AMP8. Whilst the 90% sharing mechanism is appropriate and welcome, its focus should be to cover the likely, but unquantified risk from potential increases in the tax rate, and it does not obviate the need for the baseline allowance to reflect best available estimates.

This point is acknowledged by Moody's, who commented in a 29 July 2024 credit opinion on Thames[10] that:

"…energy costs and business rates, which will be subject to ex-post inflation adjustments and enhanced cost sharing. However, initial cost allowances may not reflect current cost expectations and any true-up will only be applied at the end of the AMP8 period. This means that companies will have to fund any interim increase in costs, which would weaken in-period financial metrics."

Likewise, it is confounding that Ofwat does not recognise that the implications of the Balmforth review and the EA's reassessment of flood risk areas mean that interventions for reservoir safety will be more extensive and expensive in future than they have been in the past. Meanwhile, the PCD framework tends to lead to restrictive and inflexible outcomes, significantly undermining the efficiency benefits that have been achieved from Ofwat's totex and outcomes framework in the past. We understand and support the need to increase accountability for outputs, but do not believe this should come at the expense of innovation, efficiency and affordability. The current PCD approach ties companies too closely to outputs rather than outcomes, with sometimes severe limits on flexibility. This is a particular problem given that in many cases the specific outputs required cannot be delivered for the assumed cost allowances.

In addition, there are several true-up mechanisms (e.g. gating mechanisms) that do not currently allow real-time recovery/remuneration of financing costs associated with the eligible spend through AMP8. Given the large amount of spend that the draft determination has going through such mechanisms, companies will need to bear significant interim increased costs until the end of AMP true-up, which will impact financeability, given this has been set with no headroom. This places additional negative skew on the overall AMP8 risk and return balance.

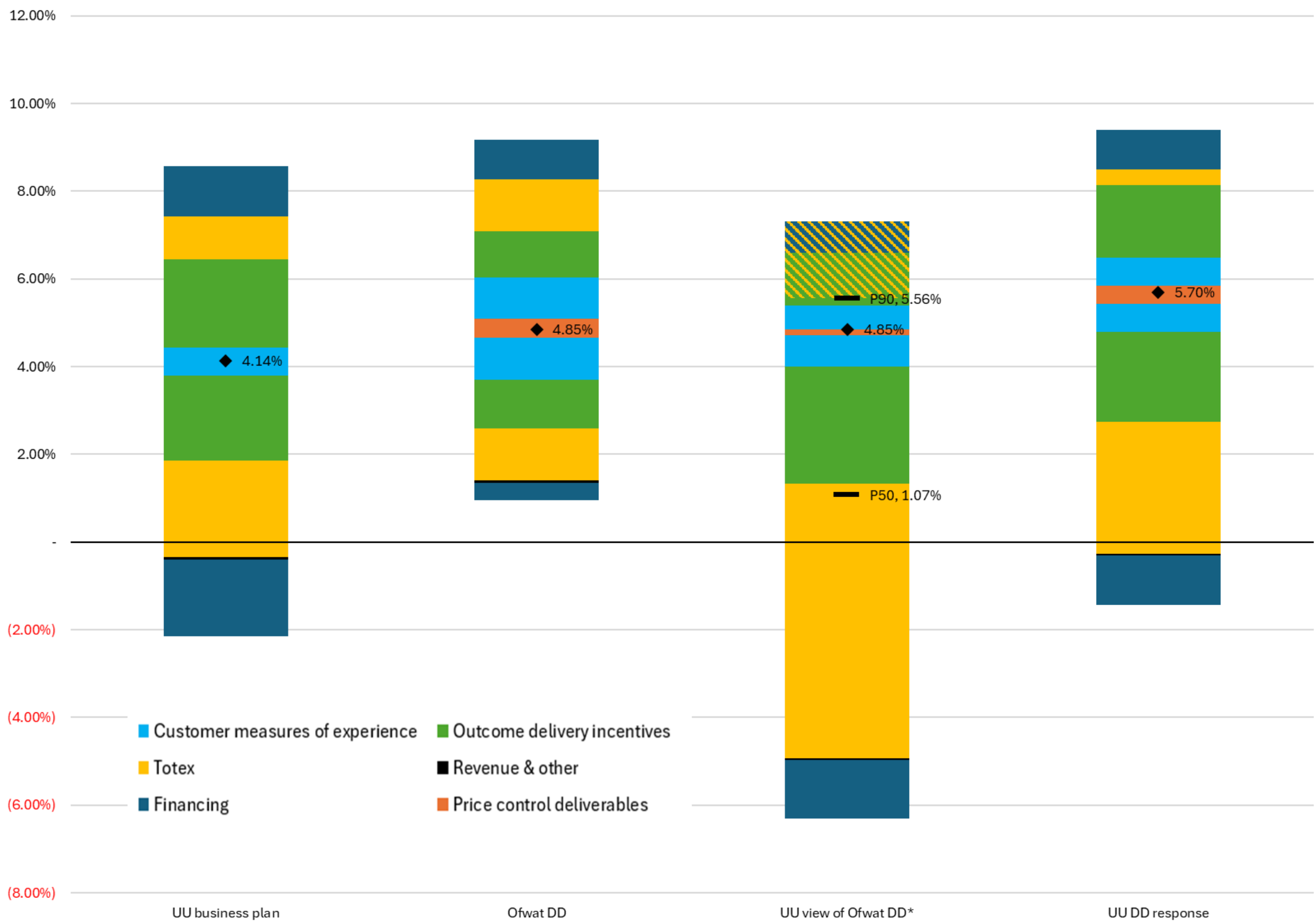
We consider that Ofwat needs to reevaluate many of its challenges and take a reasonable, evidence-based approach in areas such as reservoir safety and business rates. It should also reconsider whether its modelling evidence is genuinely reflecting a "fair bet" or whether it results in outcomes that are biased towards the downside.

Bio-resources cost sharing mechanisms are welcome but need clarity – RCV guarantee should be reinstated if Ofwat makes RCV adjustments due to cost sharing.
We fully support Ofwat's proposal to reinstate cost sharing in Bioresources, particularly given the ongoing uncertainty facing Bioresources. However, in order for the proposed cost sharing to be legitimate, it is important that Ofwat explains how that cost sharing will be executed, given (for example) its current position on the RCV "guarantee" for Bioresources. In other areas of cost sharing, the value of any reconciliation adjustment is shared between an RCV adjustment and a revenue adjustment. Assuming Ofwat proposes a similar approach to Bioresources, this should necessitate a reinstatement of the RCV guarantee, to ensure that any reconciliation values assigned to the Bioresources RCV are actually passed onto customers in future. We recognise that other options are available (such as putting 100% of any reconciliation adjustments to revenue in the next AMP), but what is most important is that Ofwat is clear how that cost sharing mechanism will work, and whether that should change the status of the Bioresources RCV.

[10] https://www.moodys.com/research/doc--PBC_1415589

RORE range significant negative skew – not expected to earn allowed return with significant downside risk
Although there have been positive (yet insufficient) adjustments to calculating the allowed cost of equity since the PR24 final methodology, we do not agree with Ofwat's view that the balance of risk faced by equity in the draft determinations is commensurate with an allowed (real) return of 4.80%. Not only do we think that risk ranges for some components have been understated, but Ofwat has made several significant interventions to company business plans that will result in additional downside risk to be managed for a company to simply earn the base allowed return, with very little potential for upside and a significant risk of earning a return below the cost of equity if the additional these risks materialise. Risk and return principles dictate that the allowed cost of equity must appropriately remunerate investors for the risk it bears. Asking investors to bear more risk is not an unreasonable ask (if that is what is desired and who is best placed to manage the risk), but it must be reflected in the rate of return that is on offer. If the return is set too low in relation to the level of risk borne, a rational investor will have no incentive to invest as less risky alternative investments will be available for the same level of return. Our view is that the net impact of the methodology and interventions made by Ofwat in its draft determination result in a significant increase and downward skew to the risks faced by investors. However, as is apparent from Ofwat's view of the RoRE range being symmetrical (indeed slightly positive) these additional risks have clearly not been reflected in the calibrations of the draft determination allowed cost of equity. This means that the draft determination cost of equity is not a reasonable level of return to remunerate investors for the actual risks faced (i.e. it is not a 'fair bet'). To attract investors to the sector, companies must be able to offer a level of return commensurate to the risk faced and the draft determination, as a package, has not struck the right balance between risk and return.

Figure 3: UUW notional company RORE ranges



Source: UUW analysis

2.5 Approach for final determination

We strongly believe that the risk and return balance needs to be recalibrated for the final determination to enable companies to have reasonable prospects of earning allowed returns without excessive downside risk, in order to be able to attract necessary investment. There should be clear opportunities for rewards in the event of exceptional performance and clear (and significant but not excessive) penalty consequences in the event of underperformance.

The asymmetric negative skew and P50 below the base return in the draft determination implies that either the cost of equity is set too low, or the amount of risk required to be borne by investors is too high and therefore for the plan to be investable, something must change. There are many examples of 'aiming down' which combined undermine any sense of a 'fair bet'. Our representation puts forward a package with the appropriate balance between risk and return, where efficient expenditure allowances facilitate the investment required to improve services for customers and the environment, an outcomes package that is balanced and appropriately calibrated and a level of return commensurate with the risk required and most importantly, set at a level that can attract investors to the sector.

3. Financeability and financial resilience

3.1 Key points

- **We have some concerns with the notional company financeability assessment:** Whilst many aspects of the draft determination financeability assessment are reasonable and justified in principle, we do have concerns that the notional company financeability assessment may not actually provide comfort that efficient companies in the sector are, in fact, financeable.
- **Equity financeability should be assessed by an allowed cost of equity that demonstrably attracts equity to the sector:** In the draft determination the allowed cost of equity is currently too low.
- **Headroom has been set too 'close to the wire':** Additional headroom is needed as financial ratio thresholds are likely to tighten with increased business risk as flagged by Moody's, to cover the absence of gross interest impact on the financial ratios, and to minimise years where financial ratios are significantly under threshold due to profile/trend which remains important.
- **Notional company financeability assessment may not be achievable in the real world:** Gating mechanisms exclude significant costs, 55% gearing assumption excludes realistic debt and interest costs, asymmetrical expected performance on totex, ODIs, etc. and insufficient cost assessments that are only partially compensated for by sharing mechanisms means notional company financial ratio output is unlikely to be achieved in practice.
- **HARP DPC ratings treatment:** We observe the potential for this to weaken UUW's financial resilience which would require additional equity for UUW that would need to earn a return on equity

3.2 UUW's PR24 proposal

Our October business plan submission set out the details of our financeability assessment in section 9.6 of Chapter 9. This was supported by our supplementary document UUW69: Evidence of financeability. Our evidence supporting financial ratio calculations and how to deal with missing elements of the calculations (for instance to correct for the use of net versus gross interest) through amended thresholds was discussed at points 4.3.24 to the end of section 4.3 of UUW69.

3.3 Draft determination position

We consider that Ofwat's financeability assessment as set out in section 5 of PR24 draft determinations: Aligning risk and return – risk and return appendix has been based on the following features:

- Target credit ratings for the notional company of Baa1/BBB+
- The key ratios and thresholds considered in the assessment were:
  - RCV gearing threshold of c57.5%
  - AICR threshold of 1.5x
  - FFO to debt (non-alternative version) threshold of 10%
- Levers used are firstly restrict dividends to 2%, then assume equity issuance, and for certain companies but not UUW amend PAYG/RCV run off

3.4 Issues and implications

In general, we agree with many aspects of the approach taken by Ofwat in the draft determination in relation to financeability, for example the target credit ratings, the ratios to be assessed, etc. However, we have concerns that the financeability assessment has been set too 'close to the wire' with no headroom available, and that the financial ratio output shows a more flattering position than is actually achievable for efficient companies in the

sector, which if properly reflected would result in Ofwat's own financeability assessment not being met. These points are covered in more detail below.

In addition, equity financeability is most reasonably assessed by making sure that allowed cost of equity can demonstrably attract equity to the sector in a time of very high investment needs, very high competition for investment from other sectors (such as electricity and gas) and the noticeable change in risk perception for the water sector. The Draft Determination allowed cost of equity is currently too low to demonstrably attract equity to the sector. This point is covered in Section 1 above on WACC. We would also observe that restricting dividends (e.g. the 2% dividend yield to solve debt financeability constraints) could also have a detrimental effect on the attractiveness of the sector from an equity investability perspective.

Reasons why the notional company financial ratio output is not achievable:
The notional company gearing has been reduced to 55% at PR24. However, as demonstrated in the Frontier Economics August 2024 Report, this diverges from the actual gearing of almost all companies in the sector. This gearing assumption leads to lower levels of debt and financing costs and therefore more comfortably placed financial ratios for the notional company than those that can be realistically achieved by efficient companies in the sector.

There have been a number of gating mechanisms introduced at the draft determination covering significant amounts of spend, most of which are associated with regulatory requirements and therefore are expected to be spent. The result of which is that the modelled spend, and hence debt and interest costs, that is shown in the financial ratio output is understated, flattering ratios and making the notional company appear financeable when this may not be the case once the gated spend is included. In addition, the gated mechanisms reduce the amount of equity issuance required and therefore reduces the amount of allowed equity issuance costs.

As discussed in Section 2 in more detail, companies may not be able to achieve the allowed returns in practice due to asymmetrical expected performance on totex, ODIs, etc. and insufficient cost assessments that are only partially compensated for by sharing.

Certain financial ratios used in the financeability testing do not fully reflect rating agency methodology. Moody's will reverse revenue profiling adjustments in its adjusted interest cover ratio. Both Moody's and S&P use gross interest amounts for their ratios, which is materially different to net interest, due to high investment resulting in high cash balances and higher interest rates resulting in higher interest receivable. This is not reflected in the financial model and therefore the FFO to debt (alternative) and adjusted interest cover ratios are overstated. If the financial ratios continue to exclude gross interest costs based on significant cash balances, then the headroom above financial ratio thresholds should be increased. In our business plan submission response[11] we calculated this as 0.2% for FFO to debt (alternative) and 0.1x for adjusted interest cover.

For these reasons, we consider that the notional company financeability testing included in the draft determination shows an overly flattered position. This results in the notional company financeability testing as no longer representing a reasonable test that an efficient water company is financeable and so gives false comfort.

Reasons why additional headroom should be given above thresholds:
The level of headroom above required rating thresholds has been set too low in the draft determination, with the average AMP8 ratio being set to only just achieve the minimum threshold with minimal regard to profile or trend. There are many years where ratios are significantly below required thresholds and setting the average ratio outcome to only just equal the minimum required threshold does not give sufficient comfort that the target credit rating will be achieved. Profiling and trend remains important to rating agencies, with Moody's removing bill profiling adjustments in their adjusted interest cover ratios, which has not been reflected in the draft determination.

There has been a step change in business risk perception for the sector. As business risk increases, to achieve target ratings the financial ratio requirements will tighten. Moody's has flagged in its recently published sector

[11] UUW October 2023 business plan submission document 'UUW69 – Evidence of financeability'

report[12] that it expects to tighten financial ratio threshold guidance due to an increase in risk stating: *"the draft determinations create a less supportive framework for the water companies and constrains their ability to earn the allowed return. The regulatory regime's stability and supportiveness, as well as companies' ability to earn a fair return, are key factors under our rating methodology for regulated water utilities. If the draft framework is confirmed at FD, business risk would increase for the sector and we would consider revising our score for either or both of these factors when assessing companies' credit quality. Against this background, companies would need to strengthen their credit metrics to maintain their current credit quality."*

Whilst Moody's has not yet published the expected impact this may have on their ratio guidance for the sector, it does reference the tightening in gearing and adjusted interest cover ratio thresholds that took place in 2018 following Moody's downgrade of the stability and predictability of the regulatory regime from Aaa (in line with GB energy networks) to Aa in 2018 following publication of Ofwat's PR19 methodology, which is shown in table 9 below:

Table 8: Moody's ratio guidance for the UK water utilities

Moody's ratio guidance for the UK water utilities

Rating	Guidance pre-2018 (Stability & Predictability = Aaa)		Guidance post-2018 (Stability & Predictability = Aa)	
	AICR	Gearing	AICR	Gearing
A2	≥1.8x	≤60%	≥2.0x	≤55%
A3	≥1.6x	≤68%	≥1.7x	≤65%
Baa1	≥1.4x	≤75%	≥1.5x	≤72%
Baa2	≥1.2x	≤85%	≥1.3x	≤80%

Source: Moody's Ratings

Implied from the above is that Moody's are minded to tighten the gearing threshold for a given rating by c3-5% and increase required interest cover by 0.1x. We think there is a significant risk that other rating agencies could amend their thresholds in similar ways, although that is unlikely to be known until after publication of the final determination. Such changes in view from rating agencies would need an increase in headroom above existing financeability testing levels.

There has been no consideration or headroom allowed to deal with the impact of DPC projects on financeability. In 3.6 below we set out how DPC projects are expected to impact incumbent company financial ratios based on our interaction with rating agencies. Once the HARP DPC lease liability is recognised on UUW's balance sheet, we expect Moody's to include an adverse gearing impact of c.3 to 5% and whilst S&P will likely treat the DPC project as 'off-balance sheet' there are trigger events where this could be included. This has the potential to weaken UUW's financial resilience which would require additional equity for UUW that would need to earn a return on equity to give additional headroom (as distinct from other financeability levers such as revenue advancement).

Draft determination revenue profiling specifically exacerbates trend problems with financial ratios:
As flagged above, profile and trend of financial ratios are still important and Moody's will remove bill profiling adjustments in their adjusted interest cover ratio. This is why in our business plan submission we smoothed AMP7 reconciliation revenue adjustments over each year in AMP8 and therefore did not include any bill profiling.

In contrast, in the draft determination, the AMP7 reconciliation revenue adjustments were applied to just years 1 and 2 of AMP8 and then bill profiling adjustments were used to smooth the AMP8 profile. In practice, this would result in Moody's reversing the bill profiling adjustments but not the AMP7 reconciliation revenue adjustments, which would introduce a significant profile into our adjusted interest cover ratios causing certain years to be significantly under threshold.

We ask that our AMP7 reconciliation revenue adjustments are applied smoothed over each year in AMP8 to avoid this impact. This point is discussed in more detail in our answer to the proforma question "Do you agree with the

[12] Moody's Sector In-Depth: Regulated Water Utilities – United Kingdom. Regulator's draft determination increases sector risk 14 Aug 2024 (https://www.moodys.com/research/doc--PBC_1417545)

proposed approach to profiling revenue? If not please provide evidence in support of your response?" which can be found in document UUWR_71 Balance of Risk and Return and Financeability – Consultation responses.

Ofwat financeability assessment: recommend 1.6x AICR threshold to accommodate Fitch, 10% FFO to debt threshold actually applied for all

The draft determination risk and return appendix confirmed that the draft determination financeability assessment "*considered an AICR threshold of 1.5x and an FFO/net debt threshold of 10%*", further it was confirmed that *"Where average financial ratios are below defined thresholds, we compare them to the financial ratios used by each company to support their Board assurance that business plans are financeable on the basis of the notional company. Where the ratios are at least as strong as per the business plan, we may assess the draft determinations as financeable"*

We represent that the relevant AICR threshold should actually be 1.6x, although we note that for the vast majority of companies that the draft determination AMP8 average AICR was above this level. There are two reasons for this:

- Firstly, this is in line with the increase in the threshold needed to accommodate the impact of gross interest (see above);
- But also, this would accommodate the Fitch 1.6x post maintenance interest cover ratio threshold for a BBB+ IDR, as this ratio is very similar to AICR.

We also represent that in relation to the AICR and FFO to debt thresholds, Ofwat should put all companies on a level playing field and allow the minimum threshold for all companies irrespective of the level included in their business plan submission.

3.5 Approach for final determination

We have followed Ofwat's draft determination financeability methodology for the submitted tables, providing consistency and comparability. However, we continue to believe that certain changes should be made for the final determination approach.

As described in more detail above, the final determination allowed cost of equity should be increased to a level that can demonstrably attract equity to the sector to ensure equity financeability.

The final determination financeability assessment should increase the headroom above minimum thresholds through use of financeability levers, most specifically to cover the expected Moody's (and other agency) ratio threshold tightening, but also to cover the absence of gross interest impact on the financial ratios and to minimise years where financial ratios are significantly under threshold due to profile/trend.

Further, to offset the adverse financial resilience impact of the HARP DPC project, additional equity might be required for UUW that would need to earn a return on equity (as distinct from other financeability levers such as revenue advancement).

To ensure that companies are able to achieve the notional financeability assessment calculated financial ratios in practice, gated spend needs to be included in the underlying financial ratios (or projects taken out of gated assessments), cost allowances set at sufficient levels to enable companies to deliver their statutory environmental obligations that also recognise the increase to future business rates liabilities and an outcomes package that is balanced and appropriately calibrated with a level of return commensurate with the risk required and most importantly, set at a level that can attract investors to the sector. This will help ensure that financeability assessments more accurately reflect expected spend and that associated allowed equity issuance costs are correctly calculated.

Finally, we ask that AMP7 ODI revenue adjustments are applied smoothly to each year in AMP8 to avoid introducing significant profile and trend into key financial ratios and that for final determination financeability assessments that an AICR threshold of 1.6x is used and that the AICR and FFO to debt thresholds are applied consistently to all companies irrespective of levels included in business plan submissions.

3.6 Financial resilience impact of DPC projects: HARP

In 2021, UUW procured an independent ratings assessment on the fledgling HARP DPC project to assess the impact of the project on UUW's financial standing. Both Moody's and Standard & Poor's (S&P) undertook those assessments which concluded that HARP delivered as a DPC may have a material impact on the financial position of UUW and weaken UUW's underlying credit metrics.

Such a conclusion was predicated on the potential recognition of the project lease liability in UUW's net debt position and associated impact on UUW's key credit metrics. Moody's indicated that it will partially mitigate this impact by adding the corresponding lease liability/asset onto UUW's RCV, which would likely increase UUW's debt:RCV gearing by around 3-5 per cent, thus materially reducing UUW's financial headroom and adversely impacting its financial resilience.

Since that initial assessment, Moody's continues to maintain this position in respect of its proposed treatment of the HARP DPC project (see Moody's United Utilities Credit Opinion published 14 June 2024[13]).

S&P had commented that it will assess what adjustments it might apply nearer the time of completion of the project and recognition of the project lease liability, thus leaving uncertainty as to whether S&P's adjustments will provide adequate mitigation.

Since then, in a report titled "UK Water Utilities and Projects: The New DPC Investment Model in Focus" dated 16 May 2024[14], S&P has indicated that for an Appointee Company it would likely consider any DPC project to be a contingent liability, which implies that HARP DPC will be treated as 'off-balance sheet' for UUW's S&P ratings assessment. However, this does open the prospect of future events acting as potential unspecified triggers for the crystallisation of such a contingent liability to subsequently be recognised on UUW's balance sheet at some future point in time.

Fitch has not yet published a view on how DPC will be treated in the Appointee Company's ratings assessment, although it is noted that Fitch has published on DPC in respect of CAP treatment and is engaged with the market.

It is possible that, in time, the agencies may form a different view about either the way in which DPC impacts UUW's credit risk profile and/or how the HARP DPC project should be reflected in UUW's ratings assessments. However, such assessments might not be understood until much later and potentially not until the asset is taken into operational use (when the lease liability will be recognised). UUW will continue to engage with all three agencies with the objective of trying to remove recognition of the HARP DPC lease liability in its net debt position and/or to neutralise any detrimental treatment.

However, if the current proposed treatment by Moody's remains unchanged, then under DPC delivery, there would also likely be a need for UUW to raise additional equity to maintain gearing levels, credit ratings and financing headroom at the pre-HARP lease recognition level, in order to maintain an adequate level of financial resilience.

It is also recognised that if the HARP project were to be delivered by UUW as 'BAU' and added to UUW's RCV, then that delivery route would also likely necessitate UUW raising additional equity to maintain gearing levels, credit ratings and financing headroom at around the pre-project level, in order to maintain an adequate level of financial resilience. This would be supported by the existing regulatory mechanisms to remunerate investment, to incentivise such additional equity, including the setting of an appropriate cost of capital and recognition of the project in UUW's RCV.

However, under DPC, there would be no such in-built regulatory mechanisms to support UUW's equity position following a negative impact on UUW's credit quality driven by the applicable ratings agency's treatment of the DPC lease liability. Where the final ratings position confirms that headroom against credit metrics will be eroded

[13] https://www.moodys.com/research/doc--PBC_1410062

[14] https://www.spglobal.com/ratings/en/research/articles/240516-u-k-water-utilities-and-projects-the-new-dpc-investment-model-in-focus-13103691

by recognition of DPC lease liability in UUW's net debt position, restoring this headroom would not be remunerated through the existing regulatory mechanisms.

This would therefore put UUW in the position of having impaired financial resilience, as a result of the ratings treatment of HARP DPC, without the natural remedial mechanisms and incentives available under delivery by UUW - e.g. by raising an appropriate level of equity and debt to finance the project, which is supported by the addition of the asset to UUW's RCV and earning the associated WACC return on such investment.

Further, while there is a risk to credit quality if the asset were to be delivered by UUW, this arises from the risk of under-performance when delivering the project. However, this risk is somewhat symmetrical, insofar as UUW also has the opportunity to outperform, which would improve credit quality and our underlying financial metrics.

In turn, we consider that we have the ability to mitigate the risk of under-performance within the portfolio of projects being undertaken, and/or through any resultant impact on inflation and/or through other regulatory mechanisms. In contrast, under DPC any impact assessment by the ratings agencies will be imposed onto the company with certainty, without the equivalent opportunity for mitigation.

We understand that Ofwat neither agrees with Moody's proposed treatment of DPC in respect of Appointee Companies, nor believes, at this stage, that DPC would confer any significant risk transfer to the detriment of UUW. We have undergone an exchange of letters that has sought to agree and establish that Ofwat would review the case for any necessary action if the final credit ratings assessment position is proven to be detrimental to the financial resilience of UUW, consistent with its role and duties as a regulator.

In the meantime, UUW will continue to seek to secure the most benign treatment of the HARP DPC lease liability with the ratings agencies, particularly recognising that at the time that the lease liability is recognised, the asset will have been taken into operational use, which should be the point in time when the vast majority of the project construction related risks will have been retired.

4. Equity Issuance

4.1 Key points

- **Ofwat should allow 5% equity issuance costs at the final determination**: This would be in line with the evidence submitted as part of the Frontier Economics report submitted in our business plan (UUW73).
- **Our modelling of the draft determination gives rise to an equity requirement of £1,079m on a notional company basis:** We consider that this should be reflected in the final determination

4.2 UUW's PR24 proposal

Whilst in our business plan financial modelling we followed Ofwat's guidance and used 2% for equity issuance costs for the notional company, the Frontier Economics report submitted as part of our document UUW73 Cost of Capital Considerations, set out that equity issuance costs should be set at 5%.

4.3 Draft determination position

In the draft determination Ofwat has allowed 2% for equity issuance costs and has modelled equity requirements based on the notional company after restricting dividends to a 2% yield. On Ofwat's draft determination modelling this implied no new equity requirements for UUW.

4.4 Issues and implications

Our modelling of the draft determination (including the delivery of projects currently earmarked for the gated mechanism) implies a new equity requirement for UUW of £1,079 million on a notional company basis.

Whilst our arguments are unchanged from our business plan submission, we note that subsequent to our business plan submission that Ofgem has proposed that it will continue to allows 5% equity issuance costs as part of its RIIO-3 SSMD, reflecting amongst other things the cost of carry on equity raises, as the listed equity market is generally not a 'little and often' market to raise new capital.

In addition, the Frontier Economics August 2024 Report (included in DD representation document UUWR_72 Cost of Capital) continues to view 5% equity issuance costs as appropriate.

4.5 Approach for final determination

Our modelling of the draft determination implies a new equity requirement for UUW of £1,079 million on a notional company basis, which we would expect to be recognised in the final determination.

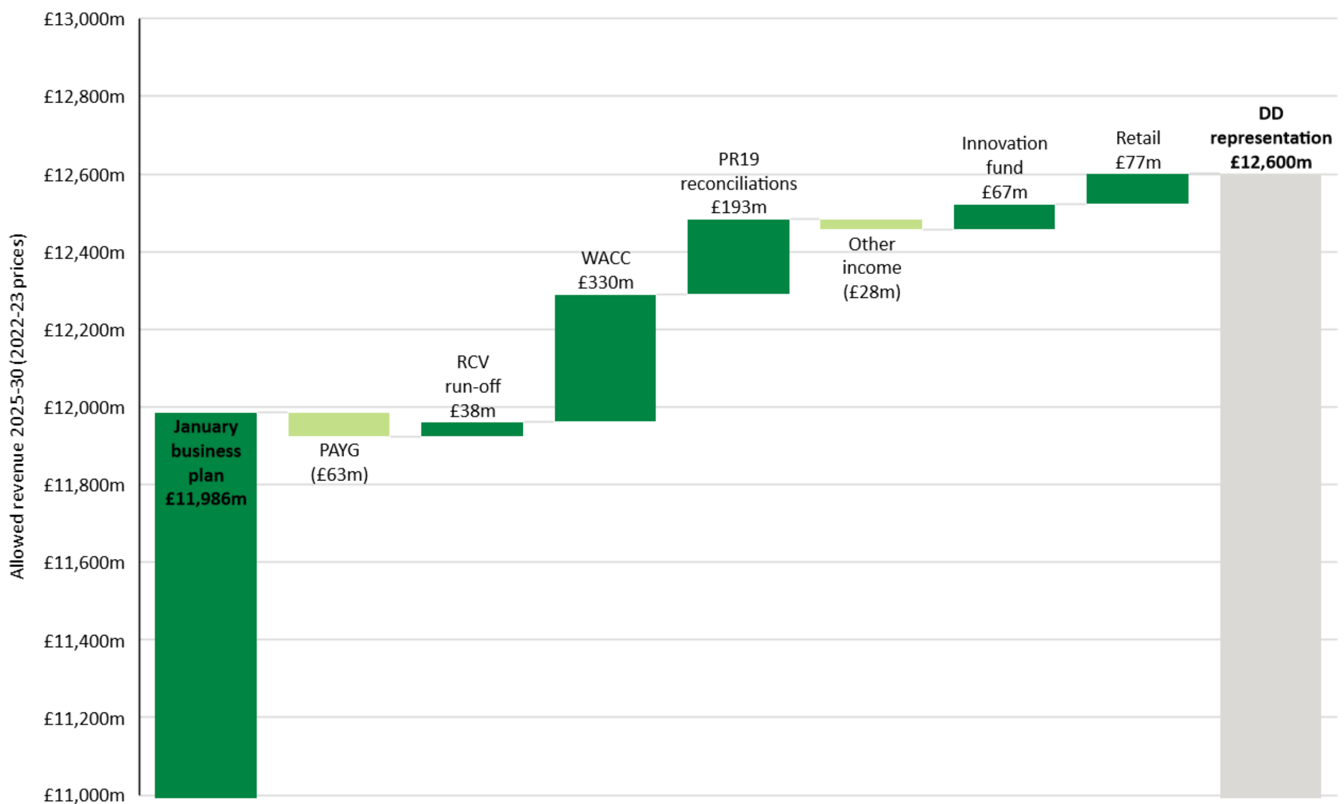
Whilst we have followed Ofwat's draft determination approach and included 2% equity issuance costs in relation to any equity issued by the notional company, this has been done for consistency and comparability purposes and we continue to advocate that 5% should be allowed for equity issuance costs.

5. Allowed revenues and customer bills

- **Manageable impact on customer bills:** Following adjustments made in Ofwat's draft determination, as modified by the proposals in this representation, the estimated average household bill is £580 per customer in 2029/30, before inflation. This remains below the upper range bill that we tested with customers as part of the affordability and acceptability testing of our business plan, where 75% of customers continued to support real bills in 2029-30 of £586 per customer. In this context, our business plan continues to reflect a sector-leading affordability support package for customers, with a total support package of £525m. £200m of this is funded directly by shareholders.

Allowed revenues have increased by approximately 5% versus our January business plan in our draft determination representation, with most increases being attributed to factors that are not associated with changes to our totex proposals. Figure 4 below illustrates the movements in the key revenue building blocks over AMP8 between our January business plan and our draft determination representations.

Figure 4: Movements in allowed revenue between January and DD representation 2024 (RR10, 2022-23 prices)



Source: UUW analysis

The main changes in the building block components are as follows:

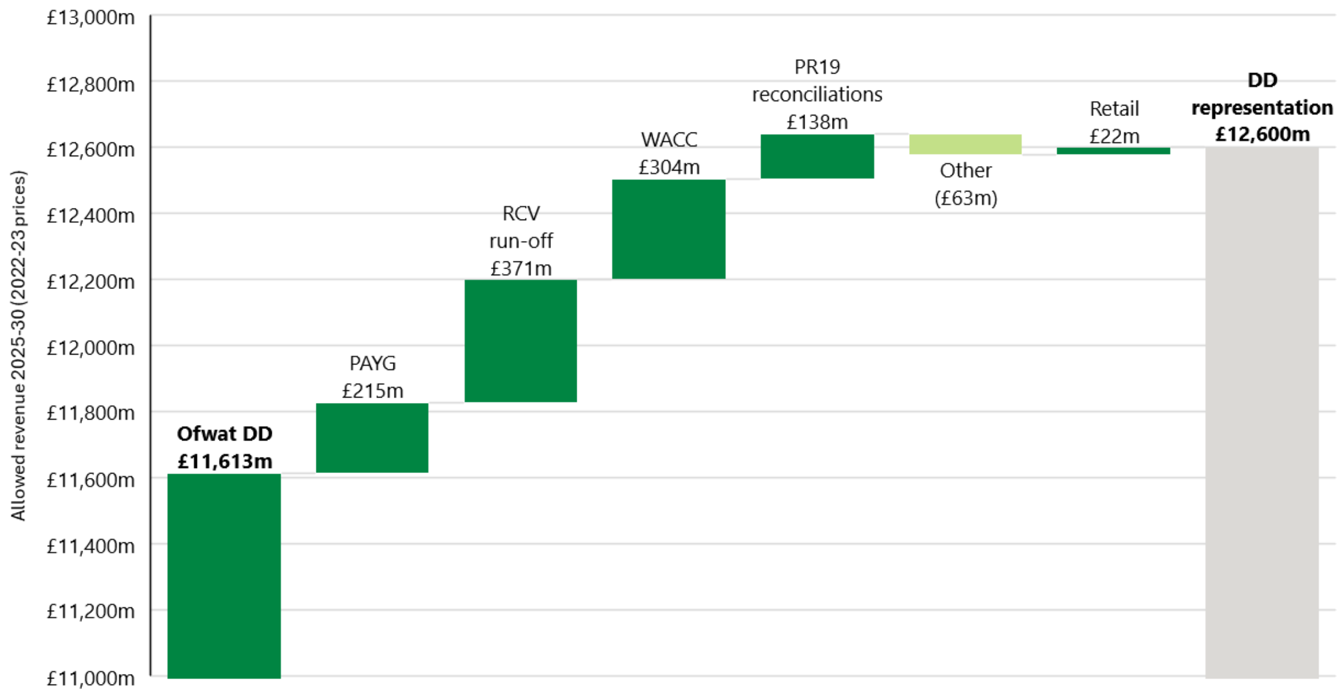
- **PAYG & RCV run-off:** Despite the addition of a further £339m of totex for additional environmental requirements, we have managed to reduce the direct impact of our investment programme on required revenues by £25m over the AMP.
- **WACC:** We have updated the allowed return calculations to use the draft determination WACC (3.72%) for the purposes of calculating allowed revenues, this is done to ensure consistency and comparability purposes,
- **PR19 reconciliations:** We have updated the PR19 reconciliation models to reflect our current expectations of revenue and RCV adjustments required having updated FY24 and FY25 projections.
- **Innovation fund:** Ofwat now requires companies to include the Innovation fund and the Water Efficiency funds within their plans. We have aligned this to Ofwat's draft determination position.

- **Residential retail:** We have included an additional £77m of totex within our Retail business plan to align to Ofwat's higher draft determination cost allowance and then uplifted this for the expected increase in allowance once the higher bills are recognised in the final determination modelling.

Allowed revenues have increased by approximately 9% versus Ofwat's draft determination in our draft determination representation, with increases being attributed primarily to differences in totex.

Figure 5 illustrates the movements in the key revenue building blocks over AMP8 between our January business plan and our draft determination representations.

Figure 5: Movements in allowed revenue between Ofwat DD and DD representation 2024 (RR10, 2022-23 prices)



Source: UUW analysis

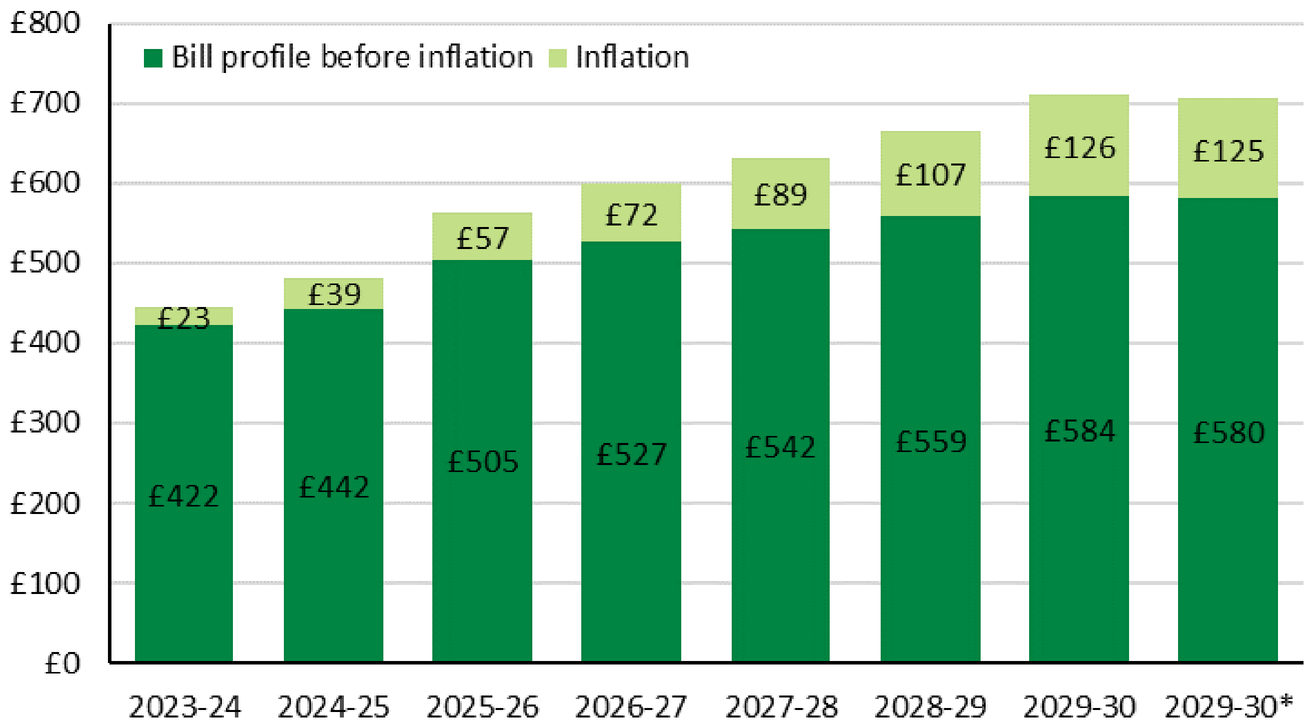
The main changes in the building block components are as follows:

- **PAYG & RCV run-off:** We continue to use the natural PAYG and RCV run-off rates for the proposed totex, this increases revenues by £586m reflecting the differences in allowed totex at the DD and our representation. Ofwat's draft determination also excluded totex associated with the large scheme gated process mechanism, which has been included in our plan.
- **WACC:** Both the Ofwat DD and our representation use the same WACC (3.72%) for consistency, therefore differences in allowed revenues reflect the differences in RCV resulting from the increased totex in our representation.
- **PR19 reconciliations:** We have updated the PR19 reconciliation models to reflect our current expectations of revenue and RCV adjustments required having updated FY24 and FY25 projections, the difference is smaller than our business plan variance due to the treatment of tax.
- **Other:** This comprises small changes to grants & contributions and tax allowances as well as removing the revenue reprofiling from the DD.
- **Residential retail:** We have included an additional £22m of totex within our Retail business plan to reflect the expected increase in Ofwat's allowance once the higher bills are recognised in the final determination modelling.

These increases to the allowed revenues translate to average customer bill that is approximately £30 higher by 2030 compared to the average bills calculated in January. However, these bills are still below the higher level that

we tested with customers as part of the affordability and acceptability testing of our business plan, where 75% of customers continued to support real bills in 2029-30 of £586 per customer[15]. Figure 6 shows the projected average household bill between 2024-25 and 2029-30 before and after the inclusion of inflation.

Figure 6: Proposed annual average customer bill before and after inflation (20232-23 prices, RR14)



Source: UUW analysis

In line with Ofwat's prescribed approach to populating the cost data tables (query response #108), the full expenditure requirements for the proposed large scheme gated mechanism projects are included within the forecast expenditure for AMP8. Therefore, the revenues and household bill presented includes the full impact of our proposals even though under its draft determination approach, Ofwat will not make an ex-ante allowance for these in its final determination. Additionally, our proposed £250m top-down efficiency adjustment relating to storm overflows that has been included within the least cost plan (CWW14) has not been included within the core plan or resulting bills. We expect that the bill impact of these two exclusions would reduce the 2029-30 real bill by roughly £4/customer below the amount presented in RR14 as shown by the 2029-30* bill within Figure 6.

[15] This is the average bill of £545 updated for current inflation assumptions and presented in FYA rather than prior year November prices, in line with the approach previously set out in UUW03.

6. Dividends

6.1 Key points

- **UUW's business plan proposed dividend policy was noted as being broadly in line with expectations:** We respond here to several identified areas of refinement and clarification.

6.2 UUW's PR24 proposal

Our October business plan submission proposed a refinement to our comprehensive AMP7 approach to gearing, dividends and benefit sharing for AMP8. For AMP8 we revisited our principles with the aim to make them clearer to understand and offer more explicit alignment with the licence changes introduced by Ofwat. These points were set out in section 9.3.5 of Chapter 9 of our business plan submission.

6.3 Draft determination position

As set out in *PR24 draft determinations: United Utilities - Quality and ambition assessment appendix,* UUW's proposed dividend policy is noted as being broadly in line with Ofwat's expectations and dividend guidance. However, several areas of refinement and clarification were identified to which we respond below.

6.4 Issues and implications

We are pleased that Ofwat assessed the dividend policy reflected in our 2025-2030 business plan as meeting Ofwat's minimum expectations. We provide some further commentary below, addressing points raised in Ofwat's quality and ambition assessment.

For the avoidance of doubt our dividend policy applies to the payment of any dividend regardless of the purpose of that dividend or the position of the company. As stated in UUW 9.3.5 'Responsible Stewardship' "*Before declaring any dividend (including the base dividend) the company will take into account the full range of factors described above*".(Emphasis added.) These factors, described at the start of section 9.3.5, include stating that

"the Board will:

- *Take account of a full range of matters including service delivery for customers and the environment;*
- *Consider company performance in the round and over time, encompassing all aspects of delivery against its licence, including delivery against performance commitments, investment plans, cost efficiency and other areas of its operations;*
- *Give consideration to the company's current and future investment needs and financial resilience over the short and longer term; and,*
- *Have due regard to whether the dividend rewards efficiency and the effective management of the business, including performance across a number of periods."*

Our dividend policy allows for the option of distribution of outperformance dividends when the company is performing well and reflecting demonstrable current or past outperformance (usually derived through the delivery of cost efficiencies, strong ODI performance, financing outperformance or a combination of these). Conversely, whilst a one-off or isolated example of poor performance wouldn't necessarily trigger a base dividends reduction, were the company to show sustained underperformance and non-delivery for customers and the environment, then a reduction in base dividends could be in the long term best interests of the company and its stakeholders and would be given serious consideration by the Board. This would especially be the case if underperformance was broadly demonstrated over a number of years, and where a reduction in dividend appeared prudent and/or necessary in ensuring that restoration or recovery from service failure could be delivered.

With regards to specific environmental factors we will consider over time, this includes our delivery against performance commitment levels and our performance for the environment in the round, as demonstrated in current dividend policy disclosures for AMP7. As evidenced in our current dividend policy disclosure in our 2023/24 APR, we will also consider the Environment Agency's Annual Performance Assessment, which assesses performance across a broad range of water and wastewater environmental measures, as an important indicator of environmental performance.

Our 2025-30 dividend policy recognised that it is prudent for a regulated business with real RCV growth to retain some of its returns. Balancing the recognition of likely growth in real RCV, with consideration of expected AMP8 investment requirements, versus being able to attract equity investment, we proposed retaining an equity return of one percent. Should there be material changes in expected investment levels, particularly if this is likely to be sustained over multiple years, we would review the proposed base dividend level and consider whether it remained appropriate.

6.5 Approach for final determination

UUW's AMP8 dividend policy within our business plan submission already met Ofwat's minimum expectation. Our response to Ofwat's specific points raised provides further details and clarity on our dividend policy which we hope will further enhance Ofwat's view of our proposed dividend policy.