Affinity Water

AFW21- Financeability considerations

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1 Introduction

We have completed significant analysis on the financeability of the notional company and commissioned external review by Centrus. The external report is available in appendix AFW48 Centrus report. This document (AFW21) contains additional information on how we have further considered notional company financeability.

2 Our assessment of notional financeability

2.1 Approach to financeability analysis

Ofwat has a duty to secure that an efficient company can finance its functions, in other words that it is 'financeable'. From an economic and financial perspective, the 'financeability' of a regulated company like Affinity means it can access capital markets to finance its activities in a sustainable way, as well as to remain liquid, based on the revenues and regulatory mechanisms set under its regulatory framework. It is appropriate to consider if financeability under a notional structure reflects a set of achievable assumptions under which the company could reasonably finance itself at an acceptable level of financial risk.

Financeability is materially driven by the regulatory framework and regulatory decisions about the key parameters at the price review. The key aspects of the regulatory determination that affect financeability include the allowed cost of capital (WACC), cost allowances and regulatory financial mechanisms (e.g. ODIs) which determine and allocate financial risk for the notional firm.

Miscalibration of any aspect of the regulatory determination could result in a notional company which is not financeable[1]. As a result, the financeability assessment represents an overall cross-check of the business plan and the regulatory determination where all its elements are taken as a whole and considered together. The application of the financeability assessment as a cross-check on the calibration of the regulatory determination is consistent with the approaches adopted by the CMA in its PR14 and PR19 re-determinations.

The relevant financeability considerations in the assessment include ensuring appropriate financial headroom to enable companies to target a certain level of financial risk, ensuring financeability of equity as well as financeability of debt, and assessing whether companies can access financing in a sustainable way. This needs to be confirmed based on a set of clear, robust, transparent and binding financeability tests that are clearly set out, and relevant benchmarks that are supported by market evidence.

We have applied three overarching criteria for evaluating the financeability of our plan under Ofwat's PR24 Final Methodology (PR24 FM):

[1] In practice, financeability may still be preserved if the regulator 'aims up' in relation to some aspects of the FD, while exposing the regulated company to a greater challenge in other aspects of the regulatory determination, as long as the overall balance of risk and return is preserved based on reasonable assumptions, resulting in a revenue allowance or package that is financeable in the round.

- Whether a notional AFW can achieve the credit rating assumed in Ofwat's cost of debt allowance in AMP8 and beyond (considers a 25-year horizon consistent with the long-term delivery strategy).
- Whether a notional AFW has adequate financial resources to withstand plausible downside scenarios.
- Whether a notional AFW can expect to earn its required return on equity on a mean expected basis;

2.2 Assumptions underpinning financeability assessment

Our financeability analysis considers two notional base case capital structures.

- The PR24 FM base case which employs Ofwat's notional structure consistent with the requirements of the FM.
- An adjusted base case which incorporates a notional structure more consistent with PR19 whilst maintaining the same revenues as the PR24 FM base case.

The assessment of the two notional cases does not take into account the impact of legacy adjustments (post-financeability adjustments) on financial projections, as the financeability of the price control should be considered on a standalone basis and irrespective of out- or under-performance in previous control periods.

The table below sets out in greater detail the specification of each of these cases.

Table 1 Key assumptions underpinning the financeability assessment in AMP8

Assumptions	PR24 FM base case	Adjusted base case
Totex	Totex included in our plan for AMP8 is £2,013m (22/23 price base). For future controls, the average Totex profile implied by our LTDS has been used.	
PAYG	Natural rates have been assumed for cost recovery.	
Run-off		
WACC	PR24 FM estimate has been used in line with Ofwat's minimum expectations (3.23% CPIH). For simplicity, we have assumed that the WACC methodology remains unchanged in future price controls. This means that future changes in the WACC relative to AMP8 reflect (1) the interest rate path based on current market evidence and (2) the recycling of embedded debt into new debt over time.	
Gearing	Gearing is assumed to be stable at the PR24 FM estimate pf 55%[2], in line with minimum expectations.	Gearing is assumed to be stable at the alternative estimate of 60%.
ILD mix	Mix of RPI and CPIH, with new debt assumed to be CPIH	CPIH only
Equity issuance costs	PR24 FM estimate of 2%, in line with minimum expectations. There is no impact from equity issuance costs as they are assumed to be pass-through.	

2.3 Results of the financeability assessment

The table below sets out the results of the financeability analysis. Full analysis is provided in Annex 1.

Table 1 Summary of the results of the financeability analysis

Test	PR24 FM base case	Adjusted base case
Test 1 **AMP8** Whether a notional AFW can achieve the credit rating assumed in Ofwat's cost of debt allowance in AMP8 and beyond	• Financeable but contingent on (1) assumed changes to the notional company and (2) the assumption that the notional company can attract and retain required equity capital.	• Financeability constrained as the notional company cannot achieve the target Baa1 credit rating assumed in the WACC driven by (1) higher gearing and (2) the assumption that all ILD in CPIH which, all else equal, increases the interest cost included in the AICR calculation. • The adjusted base case also assumes the notional company

[2] We have calibrated annual gearing to targeted level (55% under base case and 60% under adjusted base case) by changing (1) dividend payments and (2) equity issuance sequentially.

		can attract and retain required equity capital.
Test 2 Whether a notional AFW has adequate financial resources to withstand plausible downside scenarios	• The notional company is financially resilient in all but Ofwat Totex scenario. • Results are contingent on Ofwat's specification of and assumed changes to the notional company.	• Financial resilience is constrained as (1) notional company cannot achieve a rating above the Baa2/BBB stable level; (2) in Ofwat prescribed Totex downside scenario, AICR is close to or below the lock-up trigger level.
Test 3 Whether a notional AFW can expect to earn its required return on equity on a mean expected basis	• AFW's ability earn its required return on equity on a mean expected basis is negatively affected by risk asymmetry which are described in AFW20, and the differences between allowed and required CoE. • We have proposed specific remedies to address some risk drivers at source. However, there is residual asymmetric risk exposure that warrants careful consideration and resolution throughout the PR24 process, for example due to PCDs, which imply material downside-only exposure based on our notional risk assessment.	

3 Annex 1: Detailed results of the financeability assessment

3.1 Financeability test 1

The overall conclusions from Test 1 are as follows:

Under notional PR24 FM base case, key projected financial metrics are consistent with the thresholds for a Baa1/BBB+ rating.

Under the adjusted base case – which does not include the positive impacts of the reduced notional gearing and the inclusion of RPI debt in the ILD mix adopted by Ofwat in its FM – the projected metrics fall short of the required thresholds for Baa1/BBB+ rating.

This implies a financeability constraint for the adjusted base case as the notional company cannot achieve the credit rating implied in the allowance in the base case and does not have sufficient headroom to absorb downside shocks. All else equal, this indicates that financeability conclusions are contingent on assumed changes to the specification of the notional company.

The table below sets out the project metrics for AMP8 under the PR24 FM base case which are consistent with stable Baa1/BBB+ rating.

Table 3 Projected financial ratios for the regulated company under the PR24 FM base case

Key metrics	FY26	FY27	FY28	FY29	FY30	AMP8 average	Threshold Baa1	Threshold Baa2
AICR	1.53x	1.58x	1.58x	1.57x	1.57x	1.57x	≥ 1.5x	≥ 1.3x
Net Debt / RCV	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	≤ 72%	≤ 80%
FFO / Net Debt	9.90%	9.95%	9.92%	9.99%	10.06%	9.97%	≥ 9%	≥ 6%
Moody's rating	Baa1	Baa1	Baa1	Baa1	Baa1	Baa1		

These results are contingent on the assumed notional financial structure (notional gearing, mix of ILD).

To show the impact of Ofwat's notional financial structure assumptions, we also assess financeability based on the adjusted notional company as follows.

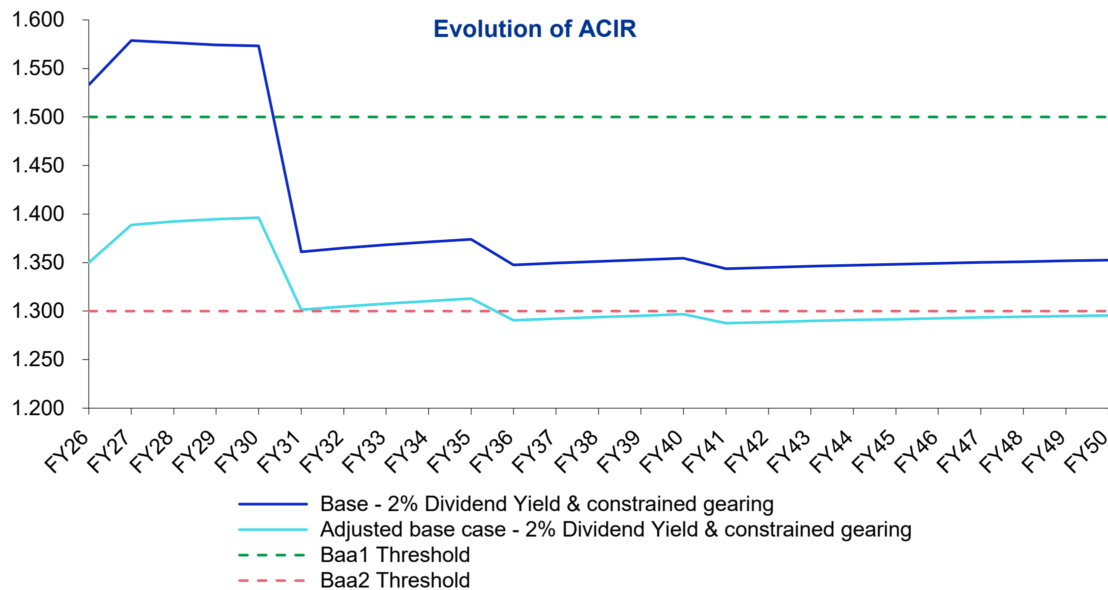
Table 4 Projected financial ratios for the regulated company under the adjusted base case

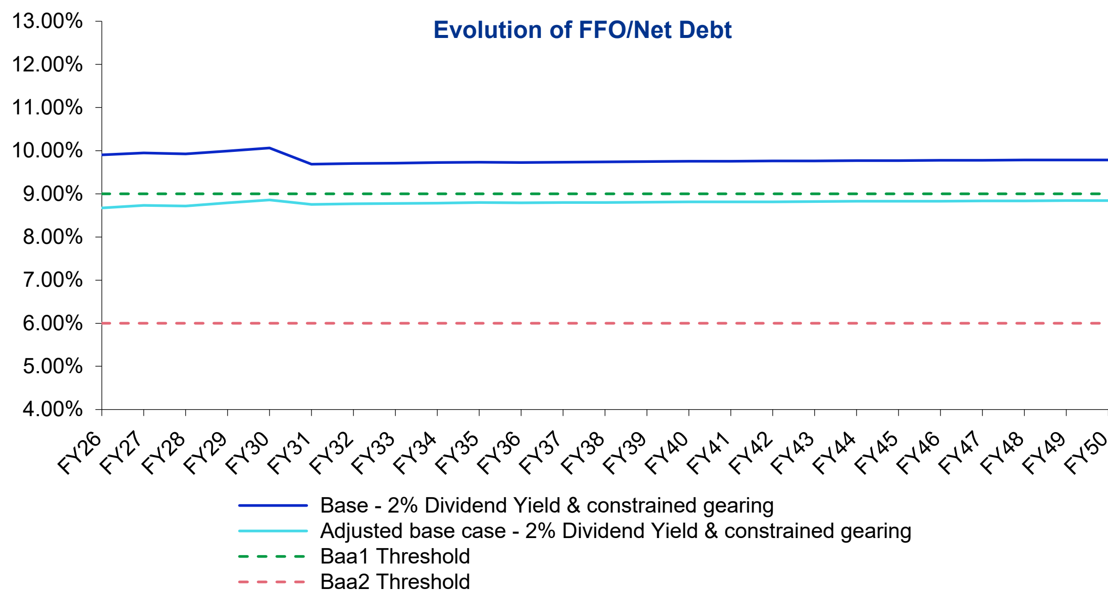
Key metrics	FY26	FY27	FY28	FY29	FY30	AMP8 average	Threshold Baa1	Threshold Baa2
AICR	1.35x	1.39x	1.39x	1.39x	1.40x	1.38x	≥ 1.5x	≥ 1.3x
Net Debt / RCV	60.00%	60.00%	60.00%	60.00%	60.00%	60.00%	≤ 72%	≤ 80%
FFO / Net Debt	8.67%	8.73%	8.72%	8.79%	8.86%	8.75%	≥ 9%	≥ 6%
Moody's rating	Baa2	Baa2	Baa2	Baa2	Baa2	Baa2		

Projected metrics deteriorate materially under the adjusted base case, with the average AMP8 AICR decreasing by c.0.20x and FFO / Net Debt by c.1.22%. The projected AICR falls short of the required threshold for Baa1/BBB+ rating and does not provide the notional company with adequate headroom to absorb downside shocks.

In both PR24 FM and adjusted base cases, AICR and FFO / Net Debt deteriorate in the medium-term which suggests that Ofwat's financial assumptions are not sustainable and will create financeability challenges in the future.

Figure 1 Evolutions of AICR and FFO/Net debt





3.2 Financeability test 2

The overall conclusions from Test 2 are as follows:

Under both notional cases considered Moody's AICR appears to be the most constrained metric.

Under the PR24 FM base case, the notional company can withstand the majority of Ofwat's prescribed downside scenarios without triggering a downgrade to Baa3. This dynamic is materially driven by Ofwat's specification of and assumed changes to the notional company. However, Ofwat prescribed Totex downside scenario results in ratings below the lock-up trigger level (Baa2/BBB negative).

The projected metrics are weaker under the adjusted base case, with the highest implied rating at Baa2/BBB level.

As a result, analysis of financial resilience for the notional company indicates that there is likely a misalignment between the risk for a notional company like AFW and the allowed return.

The table below sets out the impact of downside scenarios on projected financial ratios for the notional company over AMP8 for PR24 FM and adjusted base cases.

The impact of a plausible downside scenario on costs implies material financial difficulty and/or financial distress for the notional company. Under both cases, the projected AICR falls below the lock-up trigger level in Totex overspend scenarios.

Table 5 Results of downside scenario analysis

Scenario indicator	Downsides	AICR	Net Debt / RCV	FFO / Net Debt	Moody's Rating
PR24 FM case	PR24 FM case	1.57x	55.00%	9.97%	Baa1
	Ofwat: Totex	1.06x	55.00%	8.12%	Baa3
	Ofwat: ODI	1.43x	55.00%	9.49%	Baa2
	Ofwat: low inflation	1.56x	55.00%	9.95%	Baa1
	Ofwat: deflation	1.56x	55.00%	9.96%	Baa1
	Ofwat: high inflation	1.56x	55.00%	9.94%	Baa1
	Ofwat: bad debt	1.38x	55.00%	9.29%	Baa2
	Ofwat: interest rate increase	1.44x	55.00%	9.63%	Baa2
	Ofwat: financial penalty	1.45x	55.00%	9.53%	Baa2
Adjusted base case	Adjusted base case	1.38x	60.00%	8.75%	Baa2
	Ofwat: Totex	0.95x	60.00%	7.06%	Sub-investment
	Ofwat: ODI	1.28x	60.00%	8.36%	Baa3
	Ofwat: low inflation	1.38x	60.00%	8.73%	Baa2
	Ofwat: deflation	1.38x	60.00%	8.74%	Baa2
	Ofwat: high inflation	1.38x	59.91%	8.77%	Baa2
	Ofwat: bad debt	1.22x	60.00%	8.13%	Baa3
	Ofwat: interest rate increase	1.28x	60.00%	8.42%	Baa3
	Ofwat: financial penalty	1.28x	60.00%	8.36%	Baa3

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Under both notional cases, there are significant financeability constraints as the implied credit rating falls materially below Baa3 under a number of scenarios, in particular under the Ofwat Totex scenario, which suggests that the Ofwat PR24 FM allowed return is not consistent with the underlying projected risk exposure in AMP8.

This indicates a potential misalignment between the risk for a notional company like AFW and the allowed return. Such a misalignment is not consistent with corporate finance theory and market dynamics where a disconnect between risk and return would incentivise an investor to seek alternative opportunities with better risk-reward profiles.

3.3 Financeability test 3

The overall conclusion from Test 3 is that a notional AFW cannot reasonably expect, on average, to earn the required return on equity based on PR24 FM financial assumptions. This is because the PR24 FM CoE has not fully priced in the forward-looking risks – including material asymmetric risk implied by the FM – and market conditions for AMP8. This is evidenced by our risk analysis AFW20. We have proposed specific remedies to address some risk drivers at source. However, there is residual asymmetric risk exposure that warrants careful consideration and resolution throughout the PR24 process. We look forward to engaging with Ofwat in relation to the risk allocation assumed in our plan and calibration of mechanisms to address drivers of asymmetric risk exposure at source.

The allowed rate of return should be set such that it allows an efficient regulated company to raise and remunerate capital at market cost. This principle is important because in an efficient competitive market equilibrium all of the firm's financing costs are priced in, i.e. paid by customers as part of the price for the output.

The CoE set out in the PR24 FM (1) has not been determined based on a methodology best supported by corporate finance theory and market benchmarks[3] and (2) is not reflective of the forward-looking risks and market conditions for AMP8[4]. This creates material under-provision of returns required by equity and hence a financeability constraint – particularly given the scale of required new equity capital.

The results of our risk analysis indicate the presence of material asymmetric risk which is primarily driven by:

- ODIs: a combination of (i) stretching assumed targets; and (ii) the new PR24 rates published by Ofwat that are significantly more stringent than at PR19, which are driving downside skew across the risk ranges

[3] There appears to be a disconnect between the early view cost of equity and current pricing of debt. Allowed CoE should be assumed to remain sufficiently above the current CoD to promote equity investment in the sector given that given that (1) debt and equity are both claims on the same underlying asset and (2) equity is riskier than debt. This is not the case based on the FM which incorporates a significantly lower differential between allowed CoE and cost of new debt than previous price controls as well as a reduction in the differential relative to prevailing yields on the benchmark index. This could mean that the cost of capital materially exceeds allowed returns for AMP8, making investment in PR24 less attractive compared to other opportunities with better risk-reward profiles. Investors are likely to be disincentivised to invest in water sector equity when CAPM-derived equity risk premiums, which influence allowed returns, do not align practically with the lower-risk debt pricing.

[4] AFW47 Alternative WACC

- Totex: the material increase in the scale of our capital programme and corresponding delivery risk
- PCDs: PCDs are inherently a downside-only incentive, and by design add a downside skew to the risk range. The large scale of the skew relates to the fact that the incentive is expected cover a significant proportion of industry enhancement spend (approximately 60-80%), and is exacerbated by: (i) the double count risk of penalties being incurred on both ODIs and PCDs simultaneously; and (ii) the penalty rates being based on the average unit cost, rather than the marginal cost of delivery

As a result, at this stage a notional AFW's ability earn its required return on equity on a mean expected basis is negatively affected by risk asymmetry and the differences between allowed and required CoE.

We have proposed specific remedies to address some risk drivers at source, such as a cap of -0.5% RoRE for the Per Capita Consumption Performance Commitment. However, there is residual asymmetric risk exposure which will need to be addressed to support equity financeability and ensure that equity investors are able to earn the required return on an expected basis.

Furthermore, given the fact that Ofwat could intervene in the plan at Draft and Final Determination stages, we will accordingly re-assess the impact of the calibration of cost allowances and regulatory financial mechanisms – as well as the latest view of the allowed CoE – on the ability to earn required return.

4 Annex 2: consideration of potential remedies for financeability constraints

The table below sets out our assessment of potential remedies for financeability constraints. This assessment informs which remedies we consider appropriate to take forward to address any constraints identified in our analysis.

Table 8 Assessment potential remedies for financeability constraints

Remedy	Commentary	Take forward?
Increase in allowed returns	It is necessary for the regulator to set an appropriate, evidence-based, allowance for equity returns, which is based on a balanced review of available market evidence, 'aims up' in the presence of uncertainty of the underlying CoE parameters and exposure to asymmetric risk and supports financial projections which meet financeability tests. This is essential to retain and attract investment in the sector. An increase in the cost of equity would be the most likely market outcome in case of financeability constraints. This is because in the most likely market dynamics that would result in an economically efficient outcome, the price of capital would rise, if the capital is insufficient to provide the necessary financial headroom for the assumed risks. Increasing CoE to address financeability constraints is consistent with approach adopted by the CMA at PR19.	Yes

Re-calibration of other price control parameters	The calibration of other regulatory mechanisms – for example, cost allowances and ODI – could contribute to financeability constraints. This is not the case for the AFW BP, which has been optimised to appropriately balance risk and return and bills but may be required following Ofwat's interventions in the plan. Where this is the case, it would be appropriate to address these drivers of financeability constraint at source i.e. by re-calibrating the cost allowances and the design of the regulatory mechanisms. Amending the calibration of cost allowances and ODI mechanisms to address financeability constraints is consistent with approach adopted by the CMA at PR19.	Yes
Changes in notional gearing	A change in the notional gearing assumption does not represent a robust solution to addressing identified financeability issues. This is because: • It cannot improve the company's overall financial position with the same level of business risk—it merely shifts risk exposure from debt to equity. • This reallocation of risk between debt and equity providers is not appropriately *price* the risks present. • The CMA did not adopt lower gearing to address financeability constraints it identified for the notional water company. • Reductions in notional gearing are not consistent with the observed trends in actual company leverage (RCV-based)	No
Additional equity investment	As noted above, it is not unreasonable to assume investment of equity (new or via dividends) in case of financeability constraints which arise solely from significant RCV growth. However, this investment is contingent on: • The CoE allowance being (1) determined on the basis best supported by corporate finance theory and (2) reflective of the forward-looking risks and market conditions for AMP8. • Appropriately pricing in the impact on CoE of lengthening the duration of equity cash flows.	Yes – but noting that this remedy is contingent on appropriate CoE pricing and appropriate only to alleviate pressure on cashflows arising from high growth
Specific cash flow adjustments to recognise the impact of the capital programmes	• The step change in the scale of capital programmes can create a funding challenge as a result of the gap between the required capex spend and the depreciation included in the revenues. This is because there is a time lag between when companies start incurring increased spend and when it gets reflected in revenue build blocks. • In the PR04 FD Ofwat noted that "*a consequence of requiring companies to undertake large capital programmes is persistent negative cashflow, ie companies spend more than they receive. This can lead to a deterioration in credit quality which could restrict companies' access to capital markets or significantly increase the cost of finance*". • Ofwat provided a revenue adjustment of 1.0% in 2007-08 to maintain financeability, rising to around 1.3% by 2009-10.	No

	• Ofwat considered that it would not be appropriate to focus on keeping bills lower in the short term if it would increase the risks faced by companies and thus potentially constrain their access to capital markets. The regulator argued that this would not be in consumers' interests. • However, PR19 CMA states that shifting cash flow is not considered an appropriate remedy as it doesn't mitigate the underlying risk of the business and credit positive. The CMA noted that *"Our approach to assessing whether the Disputing Companies' determinations are financeable is more consistent with the approach taken by the rating agencies. We were concerned that Ofwat's approach would increase bills in the current price control without any confidence that it will in practice improve the creditworthiness of the companies or, indeed, that on the contrary it might adversely affect financial resilience in the future which could result in higher costs for the companies and their customers."*	
Changes in proportion of ILD	• First, we note that for internal consistency of the notional structure and to avoid risks arising from asset-liability mismatch, all ILD should be assumed to be CPIH-linked from the inception of the price control. This is not the case. • An increase in the proportion of ILD, where the debt portfolio includes a mix of RPI and CPIH debt, effectively means that the notional company would issue additional RPI debt despite the reduction in the proportion of RCV linked to RPI. This does not appear to be a reasonable assumption. • Increases in proportion of ILD are not consistent with the observed trends in the sector • The CMA did not increase the proportion of ILD to address financeability constraints it identified for the notional water company. • Increases in the proportion of IL debt would require recognition of associated swap costs in order to fully reflect the all-in costs of obtaining IL finance – otherwise the approach would be selective where the benefits are adopted into the structure, but costs are not. • We note that Ofwat has not proposed an increase in the proportion of ILD as the proportion of ILD issued by the sector director (i.e. not via swaps) is close to the notional assumption.	No
Acceleration of cash flows through adjusting regulatory levers such as PAYG and run-off rates to address debt financeability constraints	• These adjustments provide time-limited cash flow/liquidity benefits without addressing underlying issues and shift the problem into the future; • Regulatory levers cannot effectively address financeability issues as they fail market-based tests – rating agencies continue to 'look through' PAYG and run-off adjustments; • Acceleration of cash flows from future periods is not an efficient market outcome which is regulation is meant to proxy; and	No

	• The mismatch between cost recovery and benefit realisation translates into inequitable allocation of costs to current customers and intergenerational issues.	

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