

# **Havant Thicket WACC: Response to Ofwat's Draft Determinations**

28 August 2024

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## Executive Summary

We have been commissioned by Portsmouth Water (PRT) to prepare a second independent report on the estimation of the cost of capital for Havant Thicket (HT) to inform PRT's response to Ofwat's PR24 draft determinations (DD). In this report we show that while we agree with Ofwat that a bespoke cost of capital for HT is warranted, Ofwat's proposed mechanisms will not allow HT to recover its efficiently incurred cost of debt.

### PR24 Cost of Debt: Ofwat's approach fails to fully compensate HT for its expected cost of debt

Table 1 summarises our weighted average cost of capital (WACC) assessment for HT in our first report, Ofwat's PR24 DD and our updated estimates. Overall, we conclude on a HT cost of capital for PR24 of 4.46 per cent, subject to a true-up on the cost of new debt, cost of embedded debt (for the final year of PR19) and the embedded:new debt share. Our estimate is 36bps higher than Ofwat's PR24 DD estimate of 4.10 per cent, as shown in Table 1.

**Table 1: We Estimate HT's Bespoke Cost of Capital for PR24 at 4.46 per cent**

Parameter	PRT Business Plan Proposal <sup>1</sup>	Ofwat PR24 DD	NERA Update	Note
PR19 cost of new debt (PR24 embedded debt)	3.12%	2.76%	3.24%	Ofwat/NERA include 30bps company specific adjustment (CSA)
PR24 cost of new debt	3.42%	3.55%	3.60%	Ofwat/NERA include 30bps CSA
Share of new debt	12%	43%	43%	Increase reflects new RCV profile
Issuance/Transaction costs	0.19%	0.20%	0.20%	Increase reflects new RCV profile
Liquidity costs	0.88%	0.34%	0.70%	
Cost of debt	4.23%	3.63%	4.29%	
Cost of equity	4.14%	4.80%	4.80%	Increase reflects industry cost of equity change
Notional gearing	55%	55%	55%	
Appointee WACC	4.19%	4.16%	4.52%	
Retail margin deduction	0.06%	0.06%	0.06%	
<b>Wholesale WACC (real, CPIH)</b>	<b>4.13%</b>	<b>4.10%</b>	<b>4.46%</b>	

Note: <sup>1</sup> Reflects estimates under a 30 September 2022 cut-off date. These estimates match the NERA first report estimates on cost of debt, but differ on cost of equity.

Source: NERA analysis and Ofwat (Jul 24), PR24 draft determinations: Aligning risk and return - Allowed return appendix, pp.9, 107 and 114.

The key differences between our estimate and Ofwat's are:

- **Cost of embedded debt:** We disagree with Ofwat's use of the industry's PR24 embedded debt allowance plus the 30bps PRT CSA; instead, we consider that the allowance should be based on an RCV weighted trailing average plus the 30bps PRT CSA. An RCV-weighted trailing average is incentive compatible – i.e. provides the correct incentive to HT to minimise debt costs – and is consistent with standard regulatory practice for assets with bespoke investment and debt issuance profiles, e.g. TTT and SHET.
- **Cost of new debt:** Ofwat sets the cost of new debt assuming HT's debt issued will be short-tenor variable debt and thus should: i) reflect iBoxx BBB 3-5Y plus the 30bps PRT CSA; and ii) be set equal to benchmark index in the respective charging year (i.e. not based on extending trailing average). In contrast we propose that the cost of new debt should reflect the fact that HT has swapped some of its RCF variable debt to provide greater cash-flow certainty and will issue some fixed debt over PR24. Therefore, we propose an allowance that reflects a 50:50 weighting between fixed and variable rate debt, each with its associated index (A/BBB 10Y+ for long-term fixed debt and BBB 3-5Y for shorter term variable debt), respective average (extending trailing average for fixed and within year average for variable) and PRT's 30bps CSA.
  - Our proposed use of these two indices increases the expected cost of new debt by only 5 bps, but provides greater likelihood that the allowance will track debt costs and therefore minimises risk.
- **Liquidity costs:** Ofwat estimates liquidity costs based on average commitment fee costs over PR24 and excluding the HoldCo RCF cost. This understates HT's liquidity costs because it fails to account for the average liquidity cost of the RCF over the facility lifetime (i.e. starting from FYE 2024) and excludes the HoldCo RCF put in place to fund HT. Ofwat should include the costs of the RCF from FYE24, as the facilities were put in place to support PR24 investment. Likewise, the HoldCo RCF supports HT investment, and it is common for regulators to recognise loans held outside the licence in such cases. Correcting for these issues increases Ofwat's estimate from 34 bps to 69bps. Our updated analysis of liquidity costs based on TTT notional approach provides an estimate of 73bps liquidity costs – this approach has the advantage that it abstracts from HT's actual costs and is therefore incentive compatible. We propose a liquidity allowance of 70bps consistent with both our adjustments to Ofwat's approach and the TTT notional approach.

We also note that, on the share of new debt, instead of fixing this proportion ex-ante, we propose that this is adjusted for outturn data at the PR24 reconciliation in order to reflect the realised/approved RCV growth in light of the expected increase in scope of HT.

### **PR24 Cost of Equity: Insufficient Relative to RIIO-3, undermining HT's ability to attract capital**

Ofwat's PR24 cost of equity for HT is in the lower half of the range calculated by Ofgem for its RIIO-3 SSMD, although there is evidence that the water sector is at least as risky as the energy sector and the risks associated with HT are even greater than the wider industry, as we have set out in our earlier report. We consider that an asset with the characteristics of HT is unlikely to have a lower equity risk than the GB energy sector and the comparison suggests that HT may have difficulty attracting equity capital unless:

- Ofwat fully compensates HT for its expected cost of debt over PR24, including liquidity costs as we summarise above, otherwise the realised equity return will be even lower than 4.80 per cent for the lower risk Appointed business, and
- Ofwat increases its Appointee cost of equity to ensure at least a comparable return to the energy sector at RIIO-3.

### **PR19 cost of debt reconciliation mechanism**

In our first report we explained that Ofwat's PR19 approach of setting HT's cost of capital at the same level as the industry and subject to the same cost of debt reconciliation was unlikely to sufficiently remunerate HT's cost of debt in light of the material increase in cost since PR19. Given HT's atypical and concentrated debt profile and the fact it issued all its debt (new debt) over PR19, we proposed an alternative mechanism for PR19 that preserves Ofwat's overall mechanism but makes the following modifications:

- New debt weight: A weight on new debt of 100 per cent (as opposed to 20 per cent) to recognise that HT issued all its debt within period, i.e. no embedded debt.
- Extending trailing average: The weights for the allowed cost of new debt trailing average based on HT's RCV growth (as opposed to equal weighting) to recognise that most of HT's RCV growth that needs to be funded occurs towards the end of PR19, where interest rates will be higher than at the start of PR19.
- Outperformance wedge: Remove Ofwat's outperformance wedge of 15bps given that Ofwat's wedge was based on industry-wide data, whereas HT's relatively small issuance size means that it is likely to underperform.

Ofwat did not comment on this proposed change to the PR19 reconciliation mechanism in its PR24 DD.

Having updated for outturn data occurring until 31 March 2024 and forecasts as of that date, our proposed mechanism would result in an expected cost of debt (real, CPIH excl. issuance and liquidity costs) over PR19 of 2.39 per cent, 24bps higher than the 2.16 per cent return under Ofwat's default mechanism. We note that both of these figures are below the fixed coupon rate on HT's CPI indexed-linked debt of 2.63 per cent real, which is the only drawn-down source of finance over PR19.

# 1. Introduction

We have been commissioned by Portsmouth Water (PRT) to prepare a second independent report on the estimation of the cost of capital for Havant Thicket (HT) to inform PRT's response to Ofwat's PR24 draft determinations (DD). We prepared our earlier report in September 2023 submitted as part of PRT's business plan submission.<sup>1</sup>

This report is structure as follows:

- Section 2 reviews Ofwat's approach to HT's PR24 cost of debt allowance, and we identify necessary changes to ensure HT will recover its expected cost of debt.
- Section 3 compares Ofwat's proposed cost of equity for the Appointee business with Ofgem's RIIO-3 cost of equity, which suggests that the overall cost of capital for HT is insufficient relative to the higher returns in the GB energy sector.
- Section 4 sets out our proposed changes to the PR19 cost of debt reconciliation model, drawing on our earlier September 2023 report.

## 2. PR24 Cost of Debt

### 2.1. PR24 Embedded Cost of Debt Allowance

NERA 2023 report:

We proposed that the cost of new debt issued over PR19 (or PR24 Embedded cost of debt) should be based on RCV-weighted trailing average over 2020-2025 and the average of A and BBB 10Y+ rated iBoxx indices for the corresponding years. We did not propose to rely on Ofwat's cost of debt for the notional entity, as we have demonstrated that HT's cost of debt issuance is concentrated over the years since 2021, whereas Ofwat's PR24 embedded cost of debt allowance will reflect companies' debt issuance over an approximate 20-year historical period.<sup>2</sup>

Ofwat Draft Determination:

Ofwat proposes that HT's PR24 cost of embedded debt should be based on the sector embedded cost of debt plus PRT's CSA of 30bps.<sup>3</sup> Ofwat considers starting point should be whether the industry/PRT's cost of debt adequately remunerates HT, and it considers that that notional cost of embedded debt of 2.46 per cent plus CSA of 30 bps, providing an allowance of 2.76 per cent (CPIH real), should sufficiently remunerate PRT.

#### 2.1.1. Our analysis of DD proposals

We understand that Ofwat considers that the sector cost of embedded debt allowance plus CSA of 2.76 per cent is higher than the fixed coupon rate on HT's CPI indexed-linked debt of 2.63 per cent

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<sup>1</sup> NERA (September 2023) Cost of Capital for Havant Thicket.

<sup>2</sup> NERA (September 2023) Cost of Capital for Havant Thicket, p.34.

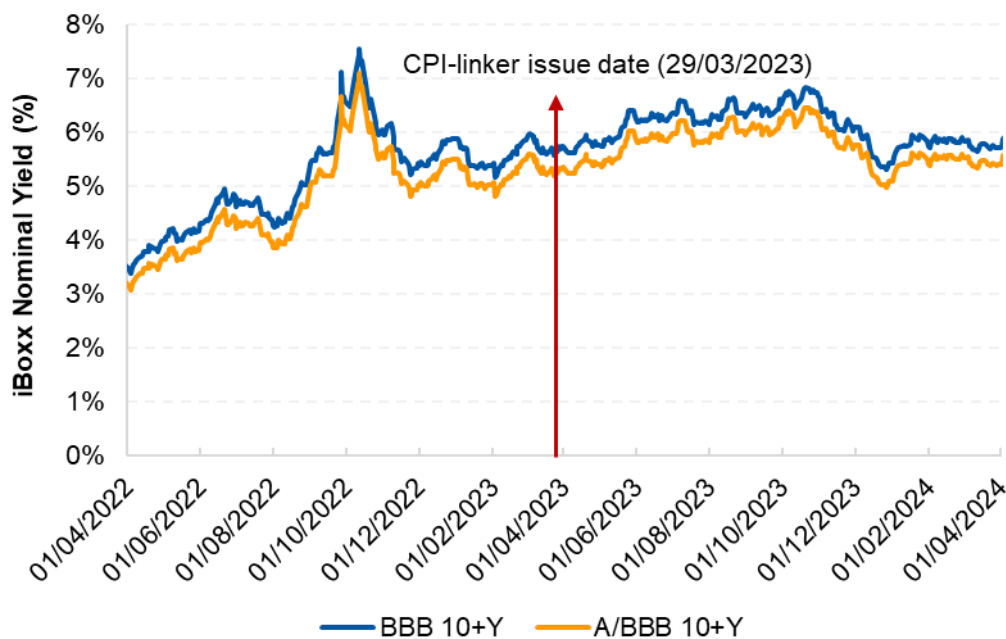
<sup>3</sup> Ofwat (July 2024) Draft Determinations, PR24 Draft determinations: Aligning risk and return: Allowed return appendix, p.111.

real. Ofwat’s assessment is based on notional financing requirements given the RCV profile in Ofwat’s DD (i.e. CAM1: Actual/reforecast).

By contrast, our updated analysis shows that an embedded cost of debt allowance based on RCV weighted trailing average would provide an allowance of 2.94 per cent or 3.24 per cent including the CSA. This is higher than Ofwat’s proposed allowance yet lower than our estimate in our 2023 report of 3.41 per cent<sup>4</sup>, reflecting the updated expenditure profile and iBoxx benchmark rates.

The main reason that our approach provides a slightly higher allowance than the coupon cost associated with CPI ILD is that our approach abstracts from the timing of HT’s debt cost and instead uses RCV growth as a proxy for debt issuance. Our approach is incentive compatible – i.e. ensures that HT has the incentive to minimise costs – and consistent with standard regulatory practice for assets with bespoke investment and debt issuance profiles. In effect, Ofwat’s approach fails to recognise that HT issued debt in a period of relatively low market rate, and deprives HT all of the benefits of debt market timing, as set out in the Figure below.

**Figure 2.1: HT issued its CPI ILD at a period of relatively low debt market rates; Ofwat’s approach to cost of embedded debt deprives HT of any benefit of market timing**



Source: NERA analysis.

In summary, we consider that Ofwat’s proposed approach is wrong in principle in that:

- By focusing on HT’s CPI coupon cost it does not provide incentives for efficient debt issuance.
- It is inconsistent with Ofwat’s proposal for HT’s cost of new debt where it proposes to recognise HT specific notional debt issuance profile (in terms of the balance of embedded and new debt) and rating.

<sup>4</sup> NERA (September 2023) Cost of Capital for Havant Thicket, p.41.



## 2.2. PR24 Cost of New Debt

### NERA 2023 report:

We proposed that the PR24 cost of new debt should be based on extended trailing average of the average of A and BBB rated iBoxx 10 year+ indices, where the weights are based on RCV growth as per our approach for the cost of PR24 embedded debt.<sup>5</sup>

### Ofwat Draft Determination:

Ofwat has proposed to set the PR24 cost of new debt based on iBoxx BBB 3-5Y plus the CSA of 30bps. Ofwat believe that the approach is more aligned with shorter tenor of the floating rate facilities supplying majority of new debt for project (£250m out of £325m). According to Ofwat, average years to maturity of the index is approximately 4 years, aligning with the average tenor of facilities of around 3.5 years for a 6 year facility, assuming straight-line drawdown.<sup>6</sup>

Ofwat does not propose to set the allowance based on a trailing average and instead set the allowance equal to benchmark index in the respective charging year, as Ofwat considers that most debt is floating.<sup>7</sup>

### 2.2.1. Our analysis of DD proposals

Ofwat assumes that all debt is variable rate debt whereas in fact most debt will effectively be fixed rate debt:

- While existing debt facilities are RCF which are ostensibly floating rate, we understand that PRT has adopted an interest management strategy that seeks to minimise cash-flow volatility through floating-to-fixed swaps and has swaps in place to fix around 50 per cent of the floating debt. To be clear, we would not propose that Ofwat recognises the cost of the derivative positions, as this is not Ofwat's practice. Rather, we would propose that Ofwat assumes that a proportion of new debt is issued at a fixed rate.
- In addition to the RCFs, we understand PRT also expects to issue fixed rate debt. In particular, we understand from PRT that, as a result of the likely increase in scope of HT, it plans to bring forward refinancing of the RCF facilities and to seek to refinance these based on fixed rate debt issuance. Under the totex forecasts Ofwat relies on, the fixed portion of new debt (after accounting for c.50 per cent hedging of floating facilities) would be 50 per cent over PR24, aside from the last year where it increases to close to 90 per cent. However, based on PRT's latest forecasts of totex, which account for the increase in scope of HT, the fixed portion of new debt increases to around 90 per cent from FYE 28 onwards.
  - Overall, our analysis suggests the proportion of fixed:floating debt will be approximately 50 per cent over the PR24 regulatory period.

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<sup>5</sup> NERA (September 2023) Cost of Capital for Havant Thicket, p.34.

<sup>6</sup> Ofwat (July 2024) Draft Determinations, PR24 Draft determinations: Aligning risk and return: Allowed return appendix, pp.111-112.

<sup>7</sup> Ofwat (July 2024) Draft Determinations, PR24 Draft determinations: Aligning risk and return: Allowed return appendix, pp.111-112.

- Ofwat's proposal to treat all new debt as variable rate is also inconsistent with Ofwat's expectation for future price reviews (which will cover the post-construction period). Ofwat explains that HT should be integrated into its sector framework for setting allowed returns as early as reasonably practicable, and that PRT should have due regard to this consideration in its future financing decisions concerning Havant Thicket.<sup>8</sup>

To reflect the balance of expected variable and fixed rate debt, we propose an allowance based on:

- A 50 per cent weighting on iBoxx BBB 3-5Y index to reflect the use of RCFs during the construction phase which is shorter-term variable debt and not only partially fixed through derivatives. Debt issued under the "variable" portion would have a return based on the average yield of the index for the charging year in question, i.e. consistent with Ofwat's proposal of variable debt not relying on an extending trailing average.
- A 50 per cent weighting on iBoxx A/BBB 10 year plus index to reflect the expected portion of debt that will be fixed and longer term, consistent with the sector cost of debt approach and the eventual transition for HT to be incorporated within the sector wide approach. Contrary to the variable portion, the fixed portion return would be based on an extending trailing average reflecting RCV-based debt issuance (notional issuance), consistent with the proposal in our first report.

Based on our/Ofwat's forecasts of iBoxx, our proposed approach would result in a cost of new debt allowance over PR24 of 3.60 per cent, including PRT CSA of 30 bps, as per Ofwat's approach. This is only 5bps higher than Ofwat's 3.55 per cent in expectations, and could be lower than Ofwat's proposed approach ex post. Importantly the use of the two indices reflecting fixed and floating rate portions should ensure that debt costs track the allowance, minimising risk for both customers and HT.

### **2.3. Balance of Embedded and New Debt**

In our earlier report, we proposed 12 per cent new debt based on ratio of closing 2020-25 notional debt (embedded) and new debt based on totex. Ofwat has adopted our approach but has used more up to date totex profile, so new debt is now 43 per cent.<sup>9</sup>

We consider that that the approach needs to be future proof to allow for the expected increase in the scope of HT, with increased expenditure implying a greater weight on the new cost of debt. We recommend that this is achieved through a true-up mechanism on the embedded: new debt ratio through the use of the existing reconciliation model. Specifically, this would be based on the actual HT RCV recognised throughout PR24 and the associated notional debt issued based on 55 per cent gearing.

### **2.4. PR24 Issuance/Transaction Costs and Liquidity Costs**

NERA 2023 report:

<sup>8</sup> Ofwat (July 2024) Draft Determinations, PR24 Draft determinations: Aligning risk and return: Allowed return appendix, p.109.

<sup>9</sup> Ofwat (July 2024) Draft Determinations, PR24 Draft determinations: Aligning risk and return: Allowed return appendix, p.112.

In our earlier report, we estimated liquidity costs of 88bps based on the Thames Tideway Tunnel (TTT's) liquidity building block. Under the TTT approach, the IP is allowed to earn 12 months of pre-financing costs on expected new expenditure at the cost of capital. In practice, the liquidity building block is calculated based on the expected RCV growth over the next year, multiplied by the cost of capital.<sup>10</sup>

We also estimated issuance/transaction costs of 19bps based on a weighted average annualised issuance cost for drawdown instruments, with weights provided by average drawdown for each instrument. These were higher than the notional allowance to reflect HT's debt short-tenor, relative to the wider industry of around 20 years.

#### Ofwat Draft Determination:

On liquidity costs, Ofwat determined an allowance of 34 bps based on the commitment fee charge over 2025-30 for the project's non-holdco RCFs, expressed as a percentage of drawn borrowings. Ofwat excludes HoldCo RCF on the basis that "*Holdco financing is outside the regulatory ringfence and so bears a component of equity risk which is compensated for in the allowed return on equity.*"<sup>11</sup> Ofwat did not consider the TTT approach was appropriate because "*As a project with significant excess capacity in its arranged RCFs, we considered it more logical that the relevant allowed return for liquidity purposes should be an RCF commitment fee rather than the sector WACC, as used by NERA.*"<sup>12</sup>

On issuance/transaction costs, Ofwat agreed with NERA's approach and updated the calculation to reflect the latest RCV profile. We note we identified some potential inconsistencies in Ofwat's calculations, but once corrected we calculate the same 20bps allowance for issuance costs.

### **2.4.1. Our analysis of DD proposals**

We consider that there are two possible approaches to estimating HT's liquidity costs: a theoretical/notional approach (e.g. TTT approach) or reflect the actual liquidity costs incurred by HT. Ofwat rejected the TTT notional approach and instead focused only on the actual liquidity costs. We disagree with Ofwat's rejection of the notional approach and find that both approaches result in similar HT liquidity costs when estimated correctly.

Under the TTT notional approach, we note that:

- Ofwat's principal objection appears to be that HT has a substantive RCF and therefore this should form the basis for the allowance. However, TTT also has an RCF, which is a common approach to project financing during the construction phase. However, for TTT, Ofwat did not draw on TTT's RCF.
- The TTT approach draws on established precedent by using RCV growth as a proxy for the requirement for liquidity and the associated costs, which provides incentives for HT to minimise

<sup>10</sup> In particular,  $Liquidity\ block_t = [Forecast\ Avg\ RCV_{t+1} - Forecast\ Avg\ RCV_t] * BWACC * Change\ in\ RPI_t$ . See Ofwat (Aug 15), Project Licence – Bazalgette Tunnel Limited, Part A: Construction Revenue, Section 4, pp.69-71.

<sup>11</sup> Ofwat (July 2024) Draft Determinations, PR24 Draft determinations: Aligning risk and return: Allowed return appendix, p.112.

<sup>12</sup> Ofwat (July 2024) Draft Determinations, PR24 Draft determinations: Aligning risk and return: Allowed return appendix, p.113.

such costs. By contrast, Ofwat's reliance on actual commitment costs on undrawn facilities is not incentive compatible.

- Related to the above, we draw on HT WACC as the cost of providing liquidity consistent with TTT. The marginal cost of capital is the WACC<sup>13</sup>; the marginal cost is not the cost of RCF debt which Ofwat uses in its calculation.
- Our approach also means that we do not need to draw distinctions between liquidity facilities that are held at the OpCo and the HoldCo level.
- The TTT approach focusses on the average costs over the entire construction period (PR19 and PR24), as the liquidity facilities span more than a single AMP and consistent with the 10-year Havant Thicket price control. By contrast, Ofwat has only examined the liquidity facilities arising from midnight at PR24.

We have updated our approach based on the TTT for the latest CAM expenditure (CAM1: Actual/forecast used by Ofwat). We estimate a liquidity cost across the entire construction period (i.e. the average liquidity cost in each year of construction divided by average notional PR24 debt) of 73bps.<sup>14</sup>

Under an "actual" approach, we agree with Ofwat's reliance on commitment fees reflecting HT's actual borrowings. However, we consider that Ofwat's calculations are understated for two reasons:

- Ofwat fails to recognise Holdco RCF is used for HT: Ofwat does not include the commitment fee associated with the HoldCo RCF. However:
  - We understand from PRT that the HoldCo RCF was put in place specifically for HT funding, which has far greater uncertainty in the timing of expenditure relative to the Appointed business. We also understand that the holding company facility is designed to provide additional resilience against key credit rating and covenant metrics and ensure capital is immediately available in the event of emerging risks during construction.
  - Ofwat is wrong to state that parent company support is remunerated via allowed equity returns.<sup>15</sup> The HoldCo RCF costs reflect additional liquidity costs over and above the cost of equity return provided on the regulated equity portion of the RCV, in the same way that Ofwat recognises the cost of the OpCo level RCF. There is no reason to treat HoldCo and OpCo RCF costs differently. Indeed, we note that Ofgem has taken into account liquidity costs held at the group level in determining liquidity/cost-of-carry allowances for energy networks.<sup>16</sup>

<sup>13</sup> See for example: Bigel (2023), Corporate Finance, Ch 3.9 Marginal Cost of Capital and Bracker, Lin and Pursley. Business Finance Essentials, Chapter 6 Marginal Cost of Capital, p.161.

<sup>14</sup> We note this reflects a change relative to our first report approach where we divided the average liquidity cost by average notional PR19 and PR24 debt. We consider this approach better reflects the fact that HT will recover these costs over PR24 and thus based on PR24's notional debt.

<sup>15</sup> Ofwat (July 2024) Draft Determinations, PR24 Draft determinations: Aligning risk and return: Allowed return appendix, p.113.

<sup>16</sup> Ofgem (Feb 21), RIIO-2 Final Determinations – Finance Annex (REVISED), p.13.

- Including HoldCo RCF costs, Ofwat’s estimate of liquidity costs would increase from 34bps to 64bps (keeping all other assumptions unchanged).
- Ofwat fails to recognise costs over the facilities’ lifetime: Ofwat approach recognises only the commitment fees over the PR24 period. But the facilities had to be put in place prior to PR24 start even if they are only drawn on during PR24. Therefore, Ofwat should recognise the liquidity costs of the facility taking into account the costs over the facility lifetime, i.e. from FYE 2024 onwards. Including the cost of the facilities over their entire lifetime, we estimate an increase in liquidity costs would from 34bps to 38bps (keeping all other assumptions unchanged).

Correcting for the two issues above, we estimate liquidity costs under Ofwat’s actual liquidity costs approach of 69bps.

Overall, we propose a liquidity cost allowance of 70bps which is supported by both a TTT notional approach (73bps), our preferred approach given that it is incentive compatible, and consistent with necessary adjustments to Ofwat’s actual liquidity costs approach (69bps).

### 3. PR24 Cost of Equity

On HT’s cost of equity, Ofwat adopted the industry-wide allowed return on equity of 4.8 per cent (real, CPIH, before retail margin deduction).<sup>17</sup> To assess the reasonability of this estimate, we compared Ofwat’s draft determination with Ofgem’s recent RIIO-3 Sector Specific Methodology Decision (SSMD), as shown in Table 3.1.

**Table 3.1: Cost of Equity under Ofwat’s PR24 DD and Ofgem’s RIIO-3 SSMD**

	Ofgem RIIO-3 SSMD (@55% Notional Gearing and same RfR as Ofwat)		Ofwat PR24 DD (Appointee)
	Low	High	Point Estimate
Notional gearing	55%	55%	55%
Risk-free rate	1.43%	1.43%	1.43%
TMR	6.50%	7.00%	6.58%
Asset beta	0.30	0.40	0.33
Debt beta	0.075	0.075	0.10
Equity beta	0.58	0.80	0.60
Allowed return on equity (pre-uplift)	4.35%	5.87%	4.52%
Equity uplift	n.a.	n.a.	0.28%
<b>Allowed return on equity (post-uplift)</b>	<b>4.35%</b>	<b>5.87%</b>	<b>4.80%</b>

*Note: Ofgem’s equity beta calculated assuming 55 per cent notional gearing for comparability with Ofwat’s PR24 draft determination. Ofgem’s risk-free rate also set at the same level as Ofwat’s for comparability.*

<sup>17</sup> Ofwat (July 2024) Draft Determinations, PR24 Draft determinations: Aligning risk and return: Allowed return appendix, p.8.

Source: NERA analysis, Ofgem RIIO-3 SSMD Allowed Return on Equity Early View Summary Calculations and Ofwat PR24 DD Allowed Return Model.

As shown above, Ofwat's PR24 cost of equity for HT is in the lower half of the range calculated by Ofgem for its RIIO-3 SSMD, although there is survey evidence that suggests the water sector is at least as risky as the energy sector<sup>18</sup> and the risks associated with HT are even greater than the wider industry, as we have set out in our earlier report.<sup>19</sup> We consider that an asset with the characteristics of HT is unlikely to have a lower equity risk than the GB energy sector and the comparison suggests that HT may have difficulty attracting equity capital unless:

- Ofwat fully compensates HT for its expected cost of debt over PR24, including liquidity costs, otherwise the realised equity return will be even lower than 4.80 per cent for the lower risk Appointed business, and
- Ofwat increases its Appointee cost of equity to ensure at least a comparable return to the energy sector at RIIO-3.

## 4. PR19 Cost of Debt Reconciliation

In our first report we explained that Ofwat's PR19 approach of setting HT's cost of capital at the same level as the industry and subject to the same cost of debt reconciliation was unlikely to sufficiently remunerate HT's cost of debt in light of the material increase in cost since PR19. Ofwat's PR19 cost of debt indexation mechanism is designed for a notional company with a relatively uniform debt issuance. Given HT's atypical and concentrated debt profile and the fact it issued all its debt (new debt) over PR19, we proposed an alternative mechanism for PR19 that preserves Ofwat's overall mechanism but makes the following modifications:

- New debt weight: A weight on new debt of 100 per cent (as opposed to 20 per cent) to recognise that HT issued all its debt within period, i.e. no embedded debt.
- Extending trailing average: The weights for the allowed cost of new debt trailing average based on HT's RCV growth (as opposed to equal weighting) to recognise that most of HT's RCV growth that needs to be funded occurs towards the end of PR19, where interest rates will be higher than at the start of PR19. Our approach to weight years by RCV growth, as a proxy for expected debt issuance, is consistent with Ofgem's approach for SHET, a Scottish TO, at recent reviews.
- Outperformance wedge: Remove Ofwat's outperformance wedge of 15bps given that Ofwat's wedge was based on industry-wide data, whereas HT's relatively small issuance size means that it is likely to underperform. In addition, HT's debt is likely to be more expensive relative to the rest of the industry because of construction related credit risk, making it more difficult for HT to achieve industry-wide notional rating.

Ofwat did not comment on this proposed change to the PR19 reconciliation mechanism in its PR24 DD.

<sup>18</sup> See for example Ofwat (July 2024), PR24 draft determinations: City Briefing – transcript, p.18.

<sup>19</sup> NERA (September 2023) Cost of capital for Havant Thicket, Section 4.2.2.

Having updated for outturn data occurring until 31 March 2024 and forecasts as of that date, our proposed mechanism would result in an expected cost of debt (real, CPIH excl. issuance and liquidity costs) over PR19 of 2.39 per cent, 24bps higher than the 2.16 per cent return under Ofwat's default mechanism. We note that both of these figures are below the fixed coupon rate on HT's CPI indexed-linked debt of 2.63 per cent real, which is the only drawn-down source of finance over PR19.



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