# Some thoughts on the role of financeability assessment

Cost of capital conference
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Trinity House, London

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(personal views)

Analysis of financial ratios used by credit rating agencies, applied to **notional efficient company**

WACC

Cost assessment

Indexation

Tax allowance

Other things

Objective that (notional efficient) company could finance its activities under proposed price control

# Financial ratios for notional company *may* indicate internal inconsistency in WACC assumptions

Notional gearing compatible with assumptions on cost of debt & cost of equity?

## Some possible responses if there is a concern

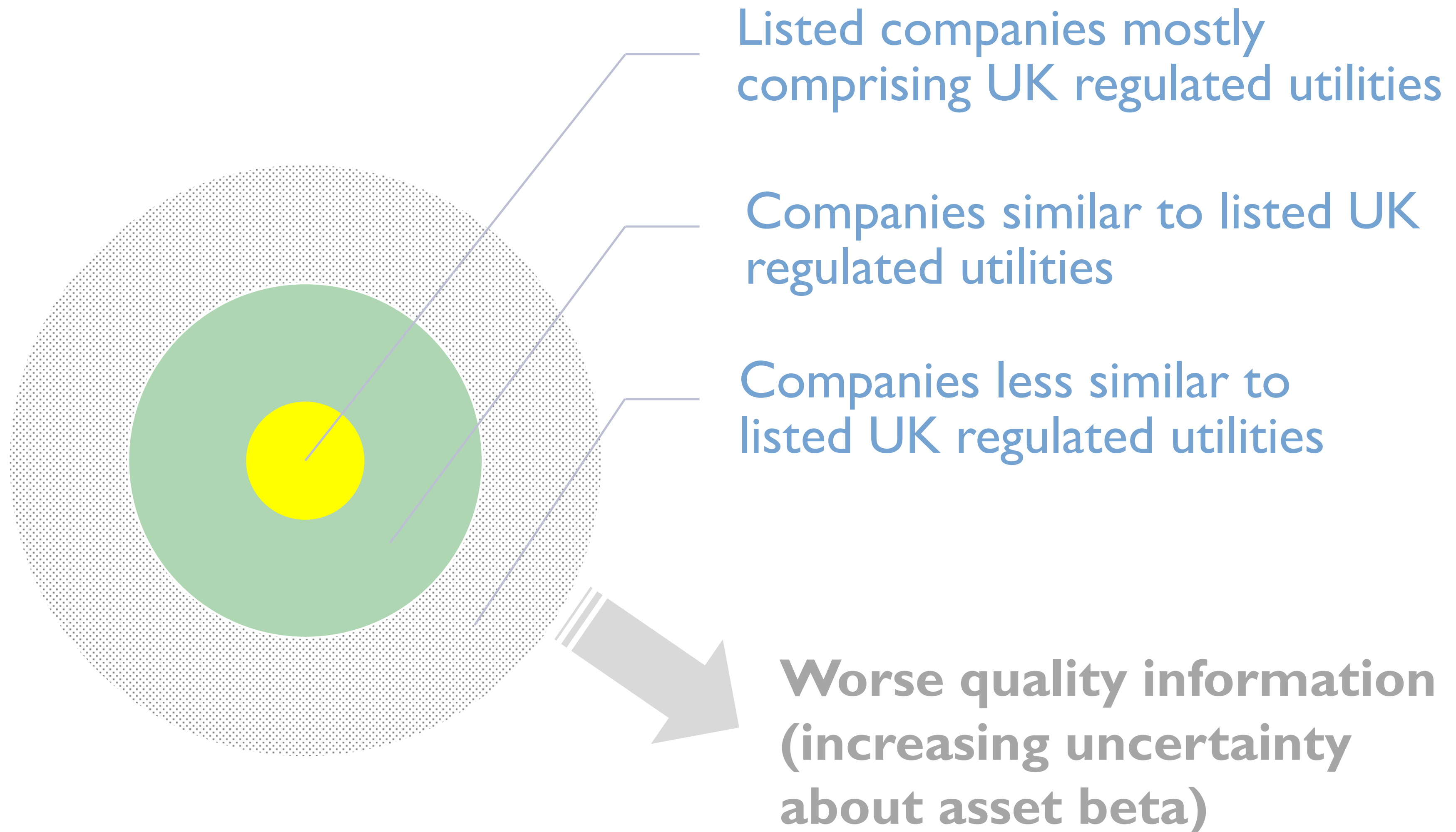
**A** Assume lower notional gearing & thereby increase WACC

**B** Assume higher cost of equity / cost of debt

**C** Change time profile of revenue (e.g. via RAB/RCV)

**D** Reduce risk exposure (e.g. incentive calibration)

# Quality of available information on WACC parameters (uncertainty about "asset beta")

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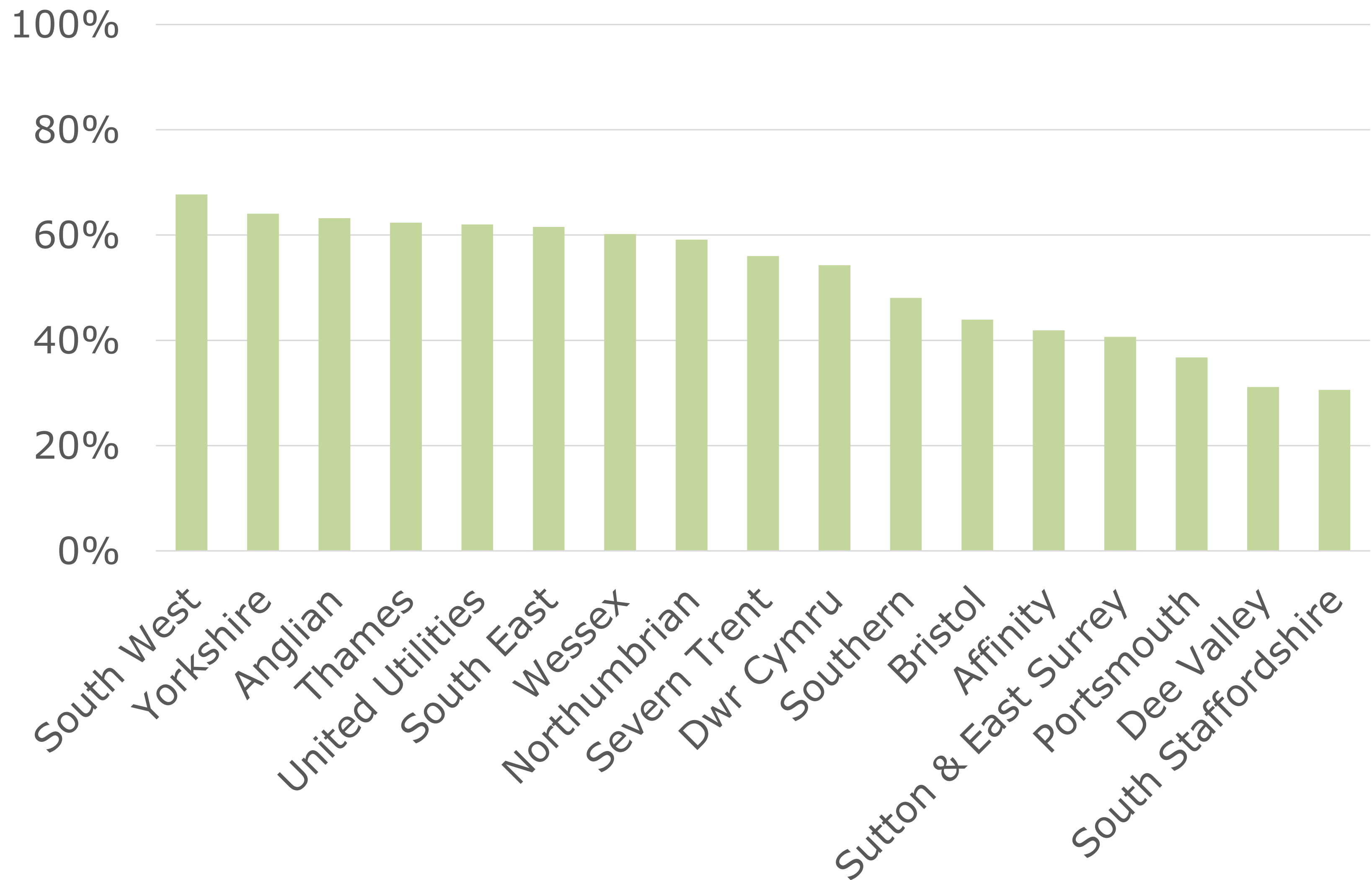
# Alternative view on notional gearing for water companies (illustrative purposes only)

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Source: illustrative calculations based on Ofwat PR14 FD data

# Alternatives to lower notional gearing assumption

**C** Change time profile of revenue

RPI indexation excessive (use CPI or RPI-1%)?

RAB/RCV depreciation too slow / too little PAYG?

**D** Reduce risk exposure

Some risk exposure not worth the financing costs (e.g. totex incentive rate of 60% plus?)

But only if these changes can be justified as reasonable from long-term customer perspective

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