Appendix

YKY56_ Notional financeability analysis appendix

Contents

1. Objective 3

2. Methodology 3

2.1 Key financial ratios to be tested 3

2.2 Determine target rating and associated targets for key metrics 4

2.3 Calculate the key financial ratios 4

2.4 Comparison of results to target 5

2.5 Financeabilty constraints and potential solutions 5

2.6 Feasibility of raising equity – Equity financeability assessment 5

2.7 Make necessary changes to plan and repeat process above 5

2.8 Consider changes to the notional structure made since PR19 5

2.9 Sensitivity analysis 6

3. Analysis – appointee level 6

3.1 Potential solutions to the identified notional financeability constraint 6

3.2 Equity financeability assessment 8

3.3 Revised financeability analysis reflecting reduced dividend yield of 3% 9

3.4 Impact of changes in notional structure 9

3.5 Sensitivity analysis 11

4. Analysis – price control level 13

4.1 Water resources 13

4.2 Water network 13

4.3 Waste water network 14

4.4 Bioresources 14

4.5 Conclusion 14

5. Conclusion 14

1. Objective

To ensure that the company is financeable on a notional basis.

We will undertake a thorough assessment to ensure financeability at an overall company level, while also ensuring each price control is financeable on a stand-alone basis. Our financeability assessment targets the maintenance of appropriate credit ratings and investor returns to enable us to finance our activities, albeit with limited headroom, in order to achieve a stretching, fair and balanced plan.

Financial resilience testing on an actual basis can be found in the Financial Resilience appendix (YKY60).

2. Methodology

A summary of our financeability assessment process is provided below:

a) Determine the key financial ratios to be tested

b) Determine the targets against which the above key ratios will be tested

c) Calculate the key financial ratios on a notional basis using Ofwat's financial model

d) Compare the calculated ratios against the target levels

e) Where a potential financeability constraint is identified, consider potential solutions

f) Where potential equity solutions are identified, consider the feasibility of raising the necessary equity

g) Make necessary amendments to plan and repeat process within steps c) and d)

h) Consider changes in notional structure from PR19 to PR24 and the impact this has on financeability analysis above

i) Run a number of sensitivities to ensure there is adequate headroom within the base plan

Further detail on each of these stages is provided below.

2.1 Key financial ratios to be tested

Within Ofwat's PR24 methodology and financial model there are a number of financial ratios and we have reported all of these within data table RR16. We have chosen to focus our notional financeability analysis on the following three key ratios:

- Adjusted cash interest cover (alternative)
- FFO / debt (alternative)
- Gearing

We have focused on these three ratios as they are the ones most commonly referenced and utiliesed by the ratings agencies. In particular, the "alternative" ratios referenced above are the ones which most closely reflect the ratios actually used by the ratings agencies, with the alternative cash interest cover (ICR) replicating the ICR calculated by Moody's and Fitch and the alternative FFO to debt replicating the calculation adopted by S&P. On this basis we believe they are the most relevant ratios when assessing our notional financeability.

2.2 Determine target rating and associated targets for key metrics

We have targeted credit ratings of Baa1/BBB+ for the notional company as this is equivalent to the A/BBB rating assumption used within the notional cost of debt assumption in Ofwat's PR24 methodology, whilst also providing the two notches of headroom recommended within Ofwat's PR24 methodology against the requirement to maintain at least an investment grade rating (minimum investment grade rating of Baa3/BBB-).

We have primarily assessed our financeability by ensuring we meet the target levels for the ICR and FFO to debt ratios identified above, as these are the key metrics utilised by the ratings agencies. Notional targets have been set based on guidance from Moody's and S&P for a standard Baa1 / BBB+ rating, as illustrated by the table below from Moody's May 2018 report – "Regulator's proposals undermine the stability and predictability of the regime".

Exhibit 5
Moody's ratio guidance for the UK water utilities

Issuer Rating	Maximum RCV gearing (previous)	Maximum RCV gearing (new)	Minimum AICR (previous)	Minimum AICR (new)
A2	≤ 60%	≤ 55%	≥ 1.8x	≥ 2.0x
A3	≤ 68%	≤ 65%	≥ 1.6x	≥ 1.7x
Baa1	≤ 75%	≤ 72%	≥ 1.4x	≥ 1.5x
Baa2	≤ 85%	≤ 80%	≥ 1.2x	≥ 1.3x

The table above highlights that Ofwat's notional gearing of 55% is more akin to an A2/A3 rating, rather than the Baa1/BBB+ rating targeted within the rest of the notional structure, which Moody's guidance shows would require a gearing of less than 72%.

Whilst we have utilised Ofwat's notional gearing of 55% as the opening gearing at March 2025, we have not set an explicit target for gearing each year given the differential between notional gearing and agency targets for a Baa1/BBB+ rating.

For downside sensitivities we have also considered the key metrics against the threshold for a minimum investment grade rating of Baa3 / BBB-. The relevant targets are illustrated within the table below:

Notional financeability assessment Key metric target thresholds	Base target	Sensitivity target
Adjusted interest cover (alternative)	1.50	1.10
FFO to debt (alternative)	9.0%	7.0%

2.3 Calculate the key financial ratios

Ratios have been calculated using Ofwat's PR24 financial model. We have also calculated ratios within our own financial model as a cross check.

The output between Ofwat's financial model and our own financial model is consistent apart from the calculation of interest costs. Our model calculates slightly higher cash interest costs, as it assumes a proportion of existing RPI-linked is re-financed each year into CPIH-linked debt in accordance with the notional new debt assumptions. This has no impact on the total nominal interest charge within the FFO to debt calculation, but does increase the real cash interest cost within the adjusted ICR calculation.

The overall impact of this difference is relatively immaterial, impacting average ICR by 0.02, therefore it does not impact the conclusions within this document; however we recommend Ofwat re-considers this assumption within their model.

Ofwat's financial model calculates gearing based on a year-end Index debt value and an average year Index RCV value, which slightly overstates the year end gearing; therefore we have also Included an additional gearing calculation that utilises a year-end Index RCV to ensure a consistent year-end gearing. The figures presented within the tables in this document represent our adjusted gearing figures.

2.4 Comparison of results to target

The calculated ratios are compared to the target levels identified above. The comparison is predominantly conducted on an average basis across the five years within the 2025-30 period as rating agencies typically consider metrics and trends over a number of years, rather than focussing on one year in isolation.

Whilst our analysis will primarily be focussed on average metrics across the five year period we will also consider whether there are any trends across the period and the minimum metrics within the period.

2.5 Financeabilty constraints and potential solutions

Where the analysis in 2.4 above shows that metrics are close to, or below, the target levels identified above then a potential financeability constraint exists.

If this is the case we will consider potential solutions, which could include:

- Equity solutions, such as dividend retention, where there is significant RCV growth
- The use of financial levers, such as PAYG and run-off rates
- The appropriateness of the 'early view' of the allowed return (WACC), particularly in light of recent market movements

2.6 Feasibility of raising equity – Equity financeability assessment

If equity is considered a potential solution within 2.5 above, then we will assess the feasibility of raising the appropriate equity. Our approach will primarily focus on a comparison between the proposed notional rates of equity and debt, together with any recent market evidence.

2.7 Make necessary changes to plan and repeat process above

If a financeability constraint is identified then our plan will be amended and the process above repeated to determine whether the proposed solutions are successful.

2.8 Consider changes to the notional structure made since PR19

Notional gearing has been changed from 60% at PR19 to 55% at PR24 with very little evidence being provided to support the change and despite widespread opposition across the industry. As noted above, notional gearing of 55% Is also Inconsistent with the target metrics for

a Baa1/BBB+ rated company. We will re-run our financeability analysis using PR19 notional structure assumptions to determine the impact of the change in notional structure and to consider whether the change has a material impact on our financeability assessment.

We also note that with the full transition to CPIH there is now a mismatch within the key notional metrics where returns are calculated on the higher CPIH basis, but interest costs are still calculated on the lower RPI basis, which elevates metrics. Other regulators, such as Ofgem, have also ensured CPIH consistency across all metrics; therefore we have also re-run our financeability analysis to consider the impact of index-linked debt initially being 50% or 100% CPIH related, rather than RPI related.

2.9 Sensitivity analysis

As well as ensuring the base figures meet the relevant target levels it is also critical to ensure that there is appropriate headroom to absorb reasonable downside sensitivities.

We will conduct sensitivity analysis using the financial resilience sensitivities provided by Ofwat and compare the output of these to the target levels for a minimum investment grade rating of Baa3/BBB- detailed above.

3. Analysis – appointee level

Our initial assessment primarily consisted of an analysis of the key metrics at an appointee level within our base plan versus the target measures highlighted above. As noted in chapter 9 of our business plan we have Included a WACC of 3.66%, which reflects Ofwat's 'early view' of WACC updated for latest market data at July 2023. A summary of our initial analysis is presented below:

Notional financeability analysis Key metric analysis	Target	FY26	FY27	FY28	FY29	FY30	Avg
Adjusted interest cover (alternative)	1.50	1.65	1.58	1.52	1.46	1.43	1.53
FFO to debt (alternative)	9.00%	9.72%	9.21%	8.65%	8.30%	8.12%	8.80%
Gearing (regulated)		57.0%	58.6%	60.7%	62.7%	64.1%	60.6%

The analysis above shows that a debt financeability assessment based purely on metric analysis highlights financeability concerns as the FFO to debt metric is below target on an average basis and the ICR measure is only just within target. There is also a trend of deteriorating metrics across the 2025-30 period, with all metrics below target In 2029 and 2030. The targets above also reflect the rating threshold, rather than the middle of the range for that rating; therefore headroom is already limited.

Gearing increases from 55% to 64% by the end of the period, with an average gearing of over 60%. Whilst gearing levels remain within agency targets for a Baa1/BBB+ rating, the increase in gearing caused by the increase in investment expenditure is causing the deterioration in the other key metrics across the period.

Our initial analysis therefore **identifies a potential notional financeability** constraint which is examined further below.

3.1 Potential solutions to the identified notional financeability constraint

As detailed in Section 2.5 we have identified three potential solutions to a notional financeability constraint which we consider in further detail below.

1. Equity solutions such as dividend retention

   The deterioration in key metrics across the period is primarily a result of the significant increase in planned capital expenditure across the period in comparison to the current period, which is all assumed to be debt funded within the above initial assessment.

   On this basis, we agree with Ofwat that equity has a role to play in resolving the financeabilty constraint and ensuring financial resilience; however we disagree with Ofwat's baseline presumption that equity should be used to reduce gearing to the opening notional level of 55% to secure that objective. The table in Section 2.2 highlights that the Moody's gearing threshold for the Baa1 target rating is 72%; therefore we do not consider it unreasonable for gearing to be higher than the 55% notional level and increase slightly in periods of intense capital expenditure and then reduce again in later years as capital expenditure returns to more normal historic levels. Actual sector gearing has averaged c70% across a number of years, which suggests this is the most efficient level of gearing.

   We will consider the impact of reduced dividend yield, in accordance with Ofwat's PR24 methodology, but will also conduct an assessment of the credibility of raising the necessary equity, particularly in light of recent market movements since Ofwat set its 'early view' of WACC. (See section 3.2 below)

2. The use of financial levers such as PAYG and run-off rates

   We do not consider the use of financial levers, such as PAYG and run-off rates to be a financeability solution as both Moody's and Fitch back any changes from the use of financial levers out of their interest cover ratio.

   This view was also adopted by the CMA within the PR19 appeal.

   On this basis we have not proposed any amendments to the 'natural' PAYG and run-off rates detailed within our plan.

3. The appropriateness of Ofwat's methodology for determining WACC

   As noted by the CMA as part of the PR19 appeal within para 10.72: "*Our starting point is that the WACC is the primary factor in the redetermination ensuring that an efficient firm can finance its functions. If the WACC is set at a level which properly reflects the cost of debt and cost of equity for the investors in the sector, both debt and equity investors will earn sufficient returns to cover the costs of financing, and therefore the companies will be financeable*."

   We agree with the CMA that WACC is a primary factor within any financeabilty assessment and if a financeability constraint is identified then we need to consider whether that constraint has arisen because the WACC has been set too low.

   As discussed within Section 9.5 of our plan and Appendix: WACC Assessment there have been material movements in the market since Ofwat set their 'early view' of WACC at 3.29% based on market data up to September 2022. We expect Ofwat to revisit their WACC estimate at both draft and final determinations and we have Included an updated WACC of 3.66% within our plan to reflect market movements to July 2023; however the cost of equity within this updated WACC is only 4.55% in comparison to the range provided by our three independent experts of 4.39% to 5.71%. As detailed in Section 9.5 of our plan and accompanying Appendix: WACC Assessment we encourage Ofwat to revisit some of the assumptions within their methodology when re-assessing WACC.

3.2 Equity financeability assessment

A fair and balanced plan should provide a fair return to equity investors, taking account of the risks they face. To ensure that we can retain and attract sufficient equity investment to finance our plan and ensure that debt investors, customers and other stakeholders can be confident that there will be a functioning equity 'buffer' and hence the business is financially resilient we need to ensure that the business can earn a sufficient return and that the returns we pay to our equity investors are sustainable.

In order to assume equity solutions within our plan it is critical that equity investors are adequately remunerated. Delivering sufficient and sustainable equity returns is essential to maintaining the confidence of equity investors in a world where capital is easily re-deployed. We note that commentary from equity analysts has turned decidedly negative in recent months and one of the three listed water companies, Pennon Group, has seen its market-to-asset ratio fall very close to 1, despite Pennon benefiting from a very low embedded cost of debt, which essentially guarantees financing outperformance. On this basis a harsh cost of equity settlement could increase the risk that equity investors lose confidence in the water sector and withdraw support.

In order for gearing to remain constant across the 2025-30 period at the opening notional gearing level of 55% there would need to be equity contributions across the period of £1.075bn. This is a very material sum which we do not consider realistic to attain, nor do we consider it necessary to ensure notional gearing remains at 55% every year given this is not consistent with the target gearing of a Baa1/BBB+ rated company.

In order to determine whether equity is a credible solution to the financeability constraint identified above, we need to assess whether equity investors will be appropriately remunerated. One way of looking at this is to consider how the cost of debt compares to the cost of equity, as investors will not invest in riskier equity if they can earn a comparable return on lower risk investment grade debt.

Recent increases in the market mean that the yield on BBB debt (based on Ofwat's chosen index) has averaged 6.33% across July 2023 in comparison to a proposed cost of equity of 6.64% within our July 2023 market update of Ofwat's 'early view' of WACC. It is likely the current high inflation is elevating the BBB debt yields slightly; however it is clear that the yield on investment grade debt is now very close to Ofwat's 'early view' of the return on equity. On this basis we see little reason why a rational investor would choose to invest equity in water companies rather than buy investment grade corporate debt.

In addition, we note the comparison of risk premia on equity and debt analysis conducted by Oxera which looks at the differential between the asset risk premium (ARP) and debt risk premium (DRP). (Further details can be found within Oxera's report included within Appendix: WACC Assessment). The analysis highlights an ARP-DRP differential within our July 2023 market update of Ofwat's 'early view' of WACC of only 0.67%, versus an equivalent differential at PR19 of 1.70% (Ofwat FD) and 1.75% (CMA FD). As this difference is primarily a consequence of the increase in interest rates, it is also beneficial to consider the differential at PR09 (0.95%) which was a period with similar market rates.

Concern with the proposed cost of equity Is further highlighted by the range of cost of equity provided by three independent experts, as detailed In Appendix: WACC Assessment. Reports provided by Oxera, First Economics and KPMG suggest a cost of equity ranging from 4.39% to 5.71%. Our July 2023 market update of Ofwat's 'early view' of WACC contains a cost of equity of 4.55%, which sits right at the bottom of the range provided by our experts.

Based on the above evidence we conclude that within Ofwat's current methodology for calculating WACC there is an insufficient premium within the proposed equity yield over current investment grade debt yields for a rational investor to choose to invest equity rather than debt.

On this basis we do not believe it credible to assume that new equity will provide a solution to the financeability constraint identified above as it will not be available at the return to equity based on Ofwat's early view methodology of WACC. We have, however, reduced the base dividend yield down from 4.0% to 3.0% to support financeability and financial resilience which is an equity contribution of £253m.

Our investors have also agreed to introduce £940m of capital between 2023 and 2027, via repayment of inter-company loans and a reasonable dividend yield is critical to their support for that. On this basis we do not believe it credible to assume any further reduction in yield.

We have repeated our financeability analysis reflecting the reduced dividend yield below.

3.3 Revised financeability analysis reflecting reduced dividend yield of 3%

Our revised assessment consists of an analysis of the key metrics within our updated plan versus the target measures highlighted above. A summary of our updated analysis reflecting the change to dividend yield is presented below:

Notional financeability analysis Key metric analysis	Target	FY26	FY27	FY28	FY29	FY30	Avg
Adjusted interest cover (alternative)	1.50	1.66	1.60	1.55	1.50	1.48	1.56
FFO to debt (alternative)	9.00%	9.82%	9.41%	8.93%	8.66%	8.56%	9.07%
Gearing (regulated)		56.5%	57.7%	59.4%	61.0%	61.9%	59.3%

The analysis above shows that the reduced dividend yield results in an improvement in core metrics, with both core metrics now above target on an average basis; Adjusted ICR metrics have also improved such that FY30 metrics are now only just below target levels. FFO to debt remains below target across FY28 to FY30; however the gap is now reduced.

Gearing increases across the period, but remains within agency targets for our target rating of Baa1/BBB+ and also remains within the PR19 benchmark gearing of 60% on an average basis. At its maximum level of 61.9% in FY30, notional gearing remains below Moody's gearing threshold for an A3 rating of 65%.

Based on an 'In the round' assessment we consider the above metrics to be the minimum level at which our plan could be considered notionally financeable, subject to sensitivity analysis.

We now consider the other elements of our financeabilty analysis.

3.4 Impact of changes in notional structure

As noted above, notional gearing has been changed by Ofwat from 60% at PR19 to 55% at PR24 with very little evidence being provided to support the change and despite widespread opposition across the industry.

In order to consider the impact of the change in notional gearing we have re-run the financeability analysis above reflecting an initial gearing of 60% rather than 55%, with a summary of the results included within the table below:

Notional financeability analysis PR19 notional structure	Target	FY26	FY27	FY28	FY29	FY30	Avg
Adjusted interest cover (alternative)	1.50	1.52	1.48	1.44	1.41	1.39	1.45
FFO to debt (alternative)	9.00%	8.67%	8.37%	8.00%	7.81%	7.76%	8.12%
Gearing (regulated)		61.3%	62.2%	63.6%	65.0%	65.8%	63.6%

The analysis above highlights that if the PR19 notional structure had remained it is unlikely that the notional company could be considered financeable as both the ICR and FFO to debt key metrics are below the target level on an average basis and remain below the target threshold for four years within the period.

With the full transition to CPIH there is also now a mismatch within the key notional metrics where returns are calculated on the higher CPIH-stripped basis, but interest costs are still calculated on the lower RPI-stripped basis, which elevates metrics. Other regulators, such as Ofgem, have also ensured CPIH consistency across all metrics; therefore within the analysis below we have also considered the impact of index-linked debt initially being 50% or 100% CPIH related, rather than RPI related.

Notional financeability analysis 50% existing CPIH debt	Target	FY26	FY27	FY28	FY29	FY30	Avg
Adjusted interest cover (alternative)	1.50	1.59	1.54	1.50	1.46	1.43	1.50
FFO to debt (alternative)	9.00%	9.81%	9.39%	8.96%	8.68%	8.58%	9.09%
Gearing (regulated)		56.5%	57.7%	59.4%	60.9%	61.8%	59.3%

Notional financeability analysis 100% existing CPIH debt	Target	FY26	FY27	FY28	FY29	FY30	Avg
Adjusted interest cover (alternative)	1.50	1.53	1.48	1.45	1.41	1.39	1.45
FFO to debt (alternative)	9.00%	9.80%	9.38%	9.00%	8.71%	8.59%	9.10%
Gearing (regulated)		56.5%	57.7%	59.4%	60.9%	61.8%	59.3%

The analysis above shows that the inconsistency in debt treatment impacts ICR, but does not impact FFO to debt or gearing, which already reflect nominal figures. ICR falls below target when the proportion of CPIH debt is increased above 50%.

Combining both a notional gearing of 60% and fully CPIH related debt, as Ofgem assumed within their RIIO2 notional structure would result in the following key metrics:

Notional financeability analysis Ofgem notional structure	Target	FY26	FY27	FY28	FY29	FY30	Avg
Adjusted interest cover (alternative)	1.50	1.41	1.37	1.35	1.32	1.31	1.35
FFO to debt (alternative)	9.00%	8.66%	8.34%	8.07%	7.86%	7.79%	8.14%
Gearing (regulated)		61.3%	62.2%	63.6%	64.9%	65.7%	63.5%

The data within the table above highlights that under Ofgem's RIIO2 notional structure our plan could not be considered financeable, as both core metrics are considerably below target on an average basis.

All of the analysis above confirms that given our plan is on the margin of being financeable, the choice of notional structure is critical to the final financeability assessment - With Ofwat's proposed PR24 notional structure our plan appears financeable; however under the PR19 notional structure, or Ofgem's RIIO 2 notional structure, or a notional structure more consistent with the target Baa1/BBB+ rating it is likely that our plan would no longer be considered financeable.

This is particularly concerning given our reservations behind the reasoning and evidence supporting Ofwat's proposed changes in notional structure.

This issue arises primarily due to our concerns around the level of cost of equity within WACC. As detailed in Section 9.5 of our plan and accompanying Appendix: WACC Assessment we encourage Ofwat to revisit some of the assumptions within their methodology when re-assessing WACC.

3.5 Sensitivity analysis

We applied a range of sensitivities to our plan to ensure that there is an adequate level of headroom within our plan to absorb any severe, but plausible scenarios.

We applied the following sensitivities, which are broadly the sensitivities requested by Ofwat as part of the financial resilience testing. We have added an additional ODI sensitivity and omitted the bad debt sensitivity as this is covered by the totex sensitivity:

1) ODI underperformance payment (1% of RORE) over 5 years
2) ODI underperformance payment (3% of RORE) in one year applied in year 3
3) Totex underperformance (10% of totex) over 5 years
4) Inflation 2% below the base case forecast in each year of the period
5) Deflation of -1% for two years followed by return to base case forecast
6) Inflation spike of 10% in year 1, then 5% for two years
7) 2% increase in interest rates
8) Financial penalty equivalent to 6% of turnover in year 5

Within the sensitivity analysis we have compared the sensitised results to the targets for a minimum investment grade (Baa3/BBB-) rating as set out earlier. The table below sets out a summary of the sensitivity analysis on an average AMP basis:

AMP8 Notional company Average	Gearing (Cov)	Adjusted ICR (Alt)	FFO / Net debt (Alt)
Sensitivity trigger		1.10	7.0%
Base	59.5%	1.54	9.0%
1% ODI (All yr)	60.1%	1.39	8.4%
3% ODI (1 yr)	60.1%	1.39	8.4%
10% totex (All yr)	64.1%	1.20	7.2%
Low inflation	62.2%	1.49	9.1%
Deflation	62.0%	1.49	9.0%
High inflation	55.5%	1.61	8.7%
Interest +2%	60.1%	1.40	8.6%
Fin pen (6% 1 yr)	59.5%	1.54	9.0%

The analysis above shows that on an average basis all metrics remain above target under all sensitivities, therefore we would expect to maintain an investment grade rating, without taking into account the impact of any mitigating actions.

The table below sets out a summary of the sensitivity analysis based on the worst case year within the five year period:

AMP8 Notional Company Min yr	Gearing (Cov)	Adjusted ICR (Alt)	FFO / Net debt (Alt)
Sensitivity trigger		1.10	7.0%
Base	62.0%	1.44	8.5%
1% ODI (All yr)	63.7%	1.19	7.3%
3% ODI (1 yr)	63.7%	0.81	5.9%
10% totex (All yr)	69.5%	1.08	6.3%
Low inflation	66.9%	1.37	8.4%
Deflation	65.1%	1.41	8.1%
High inflation	57.1%	1.49	7.5%
Interest +2%	63.1%	1.26	7.9%
Fin pen (6% 1 yr)	62.0%	1.44	8.5%

The analysis above shows that under the 3% ODI and 10% totex sensitivities key metrics in certain years go below target levels; however as shown by the prior table, on average metrics remain above target and the figures above are all before any mitigations are applied.

Further details on these two sensitivities are as follows:

- 3% ODI sensitivity – Metrics are only below target in the year in which the penalty is paid (FY29). Ofwat's PR19 reconciliation rulebook notes that where ODI adjustments exceed +/- 1% of RORE, companies can ask to defer the excess to a subsequent year to mitigate extreme cash flow. The impact of this would be to reduce the impact of the sensitivity down to the 1% ODI scenario, which remains above target in all years.

- 10% totex sensitivity – ICR falls below target in FY30, whilst FFO to debt falls below target in FY29 and FY30 after four consecutive years of the sensitivity being applied. In the event that such a sensitivity occurred in one year then we would put in place mitigations and revised processes to reduce the chance of the event happening again, or reduce the potential impact of any future events. If the impact of the sensitivity is reduced in later years then metrics are not breached.

Therefore once potential mitigations are reflected we believe there would be adequate headroom. Further detail on the mitigations available is provided in Appendix: Financial resilience.

Based on the above analysis we conclude that there is adequate headroom within our plan to absorb severe but plausible sensitivities.

4. Analysis – price control level

We have assessed notional financeability primarily at the appointee level, as providers of finance will primarily be concerned with the sufficiency and sustainability of financial metrics at that level. Performing a full financeability assessment across each of the individual price controls would be very challenging as allocating the existing debt and associated interest charge across the individual price controls is a key issue.

We can, however, take some assurance that the individual price controls can stand alone as each control has revenue designed to cover:

- Overall totex for wholesale and cost to serve for retail.
- On-going day-to-day expenditure through the pay-as-you-go (PAYG) rate.
- Longer term expenditure through RCV run-off.
- A consistent cost of capital applied across each control with separate margins for retail.

This building block method, consistent with the PR24 methodology and Ofwat's financial model, and run in parallel with our own internal model, gives us assurance that each price control has the correct revenue requirement to cover its day-to-day expenditure, longer term expenditure needs and the return needed to cover past and future borrowing requirements.

We have included analysis below of the financial ratios for each of the wholesale price controls, which adopts the assumption within Ofwat's financial model that the total appointed debt is allocated to each price control in proportion to the RCV.

4.1 Water resources

Notional financeability analysis Water resources	Target	FY26	FY27	FY28	FY29	FY30	Avg
Adjusted interest cover (alternative)	1.50	1.63	1.63	1.62	1.63	1.68	1.64
FFO to debt (alternative)	9.00%	9.85%	9.73%	9.61%	9.84%	10.30%	9.87%
Gearing (regulated)		54.8%	55.0%	55.5%	55.1%	53.7%	54.8%

Both key metrics remain above target in all years. Metrics are better than overall appointee metrics above, as minimal change in totex within water resources.

4.2 Water network

Notional financeability analysis Water network	Target	FY26	FY27	FY28	FY29	FY30	Avg
Adjusted interest cover (alternative)	1.50	1.59	1.56	1.52	1.49	1.46	1.52
FFO to debt (alternative)	9.00%	9.32%	9.07%	8.68%	8.50%	8.38%	8.79%
Gearing (regulated)		56.3%	57.6%	59.0%	60.1%	60.9%	58.8%

Metrics are broadly aligned with overall appointee metrics, given that the majority of expenditure is included within the water network and wastewater network price controls.

4.3 Waste water network

Notional financeability analysis Wastewater network	Target	FY26	FY27	FY28	FY29	FY30	Avg
Adjusted interest cover (alternative)	1.50	1.60	1.55	1.50	1.45	1.42	1.50
FFO to debt (alternative)	9.00%	9.43%	9.01%	8.46%	8.12%	8.02%	8.61%
Gearing (regulated)		56.4%	57.6%	59.7%	61.6%	62.7%	59.6%

Metrics are broadly aligned with overall appointee metrics, given that the majority of expenditure is included within the water network and wastewater network price controls.

4.4 Bioresources

Notional financeability analysis Bioresources	Target	FY26	FY27	FY28	FY29	FY30	Avg
Adjusted interest cover (alternative)	1.50	1.61	1.58	1.54	1.49	1.46	1.54
FFO to debt (alternative)	9.00%	16.11%	15.44%	14.56%	14.08%	14.10%	14.86%
Gearing (regulated)		55.4%	57.1%	59.6%	61.7%	62.6%	59.3%

Both key metrics remain above target in all years. Metrics are better than overall appointee metrics above, as minimal change in totex within bioresources.

4.5 Conclusion

Metrics within the two larger price controls are broadly aligned with the metrics discussed above for the appointee, whilst metrics are improved within the two smaller price controls. On this basis we can conclude that each individual price control is financeable on a notional basis.

5. Conclusion

We expect Ofwat to revisit their WACC estimate to reflect latest market data at both draft and final determination. The expert opinion we have received suggests a revision based on current market data to July 2023 could result in an increase in WACC to 3.66%, which we have included within our plan.

Reflecting all of the above analysis, we consider our plan to be financeable on a notional basis reflecting Ofwat's notional structure; however this assessment is marginal and dependent on the overall risk and return package set out in our plan and the assumption that Ofwat will revisit its WACC assumptions based on the latest market data.

As detailed further in section 3.5 of our plan and Appendix: WACC Assessment we believe that when Ofwat reassesses its WACC it will be critical for them to cross check their cost of equity versus current BBB debt yields and the ARP-DRP framework explained within Oxera's report in Appendix: WACC Assessment to ensure there is an

adequate incentive for a rational investor to choose to invest equity in water companies rather than just buy investment-grade debt.

In the event that Ofwat does not ultimately update WACC in line with the view provided by our experts then we would no longer consider our plan to be financeable.