PR24 Investor Engagement Report

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Final report for Water UK

October 2024

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Executive summary

Purpose of this report

On 28 August 2024, Water UK submitted Oxera's 'Investability at PR24' report (hereafter referred to as the 'Investability report') to Ofwat as part of its response to the PR24 Draft Determinations.[1] Our Investability report considered the investability of the water sector in England and Wales in light of Ofwat's recent PR24 Draft Determinations, as well as the wider market for infrastructure investment. Our report was informed by a detailed analysis of Ofwat's proposals, as well as direct engagement with 30 major investors in the England and Wales water and infrastructure sectors, from both the listed and unlisted markets.

The table below identifies the specific investors we engaged with over the course of this exercise. We also spoke to ten further investors who have chosen to remain anonymous: these investors are invested in both listed and unlisted water companies, or similar assets. The individuals we spoke to from each of these organisations were all senior decision makers, typically with a long history of investing in the England and Wales water sector and/or other comparable sectors.

Investors in scope of Oxera's engagement

	Name of investor	Associated water company(ies), where applicable	Listed/Unlisted
1	Allianz Global Investors	Affinity Water	Unlisted
2	Arjun Infrastructure	South Staffordshire Water	Unlisted
3	Capital Global	No exposure to England and Wales water, but investors in UK energy	Listed
4	Clearbridge	Pennon Group, Severn Trent Water, United Utilities Group	Listed
5	Investcorp Corsair	Kelda Group (formerly Yorkshire Water)	Unlisted
6	CPPIB	Anglian Water	Unlisted

[1] Oxera (2024), 'Investability at PR24', 28 August. We refer to this document as the 'Investability report' throughout the remainder of this document.

	Name of investor	Associated water company(ies), where applicable	Listed/Unlisted
7	DWS Asset Management	Kelda Group (formerly Yorkshire Water)	Unlisted
8	Fidelity	Severn Trent Water	Listed
9	GIC	Kelda Group (formerly Yorkshire Water)	Unlisted
10	HICL	Affinity Water	Unlisted
11	Invesco	Pennon Group, Severn Trent Water, United Utilities Group	Listed
12	Lazard	Pennon Group, Severn Trent Water, United Utilities Group	Listed
13	M&G	United Utilities Group	Listed
14	Maple-Brown Abbott	Severn Trent Water, United Utilities Group	Listed
15	Morrison	South East Water	Unlisted
16	Pictet	Pennon Group, Severn Trent Water, United Utilities Group	Listed
17	Schroders	United Utilities Group	Listed
18	Stepstone	Kelda Group (formerly Yorkshire Water)	Unlisted
19	USS	Thames Water (part of Kemble Water Group)	Unlisted
20	Vantage	South East Water	Unlisted

Note: Oxera is grateful to all those who took time to speak to us over the course of this project. We are also particularly grateful to Dr Dominic Nash, utilities analyst at Barclays, who helped facilitate our engagement with the listed investors that we spoke with.
Source: Oxera

This report summarises the views expressed by these investors. We provide this information for purposes of transparency, given we make reference to these views in our Investability report, and to shine further light on the specific concerns investors have raised regarding Ofwat's Draft Determinations.

We have endeavoured to faithfully represent the views expressed to us in this extensive engagement exercise. **All views expressed in this report reflect the opinions gathered from interviews with market participants, and do not necessarily represent the views or opinions of Oxera Consulting LLP.**

In conducting a survey of this nature, we recognise that investors may not necessarily be unbiased and objective observers of matters that directly impact their businesses. We also recognise that investors may be incentivised to present their views more strongly in order to help shape more favourable outcomes at PR24, and that Ofwat will be aware of this incentive.

Notwithstanding these caveats, we note the commonality of views expressed across such a wide range of investors. We recommend that Ofwat considers these views alongside our main Investability report (which we summarise below), as well as other responses received to its consultation on the PR24 Draft Determinations. Ofwat may also wish to consider whether further evidence from the investment community could help inform its Final Determinations.

Recap: Oxera's Investability report

Our assessment of the investability of the water sector in England and Wales, in light of Ofwat's recent PR24 Draft Determinations, was underpinned by the following definition of investability:

For a price control to be 'investable', **it must be highly likely that the company can attract and retain the equity capital needed** to deliver desired investment.

In addition, we considered five key questions for determining whether the proposed regulatory settlements were investable. These questions—and our assessment of the Draft Determinations against each of these—were as follows:

1 **Are Ofwat's assumptions around how equity financing is delivered realistic**, including assumed dividend reductions and/or equity injections?

In its financeability assessment, Ofwat assumes the notional company implements 'equity solutions' to finance new investment while maintaining target levels of gearing. Specifically, Ofwat assumes the notional company is able to cut dividends in half (from 4% to 2%) while raising external equity.

Our report determined that the 'equity solutions' underpinning Ofwat's financeability assessment are not credible. Our determination was based on our analysis of European utilities, which showed these companies maintain dividends even when raising external equity. This raises significant doubts as to whether the sector will be able to raise the levels of equity financing needed to meet investment requirements in the coming years, if companies seek to finance this investment via lower dividends.[2]

2 **Is the base return set at an appropriate level**, such that the marginal investor is incentivised to commit equity capital?

[2] Oxera (2024), 'Investability at PR24', 28 August, section 4.

Our Investability report did not assess Ofwat's Cost of Equity (CoE) methodology in detail, nor did it seek to provide an 'Oxera view' of what the allowance for PR24 should be. Instead, we focused on a specific issue with Ofwat's approach to estimating the CoE allowance, which was likely to be problematic for investability. This related to Ofwat's decision to estimate the CoE allowance based on a 'through the cycle' approach, which assumes that returns to equity are broadly stable over time.

Our assessment demonstrated that while Ofwat's 'through the cycle' approach could mean investors are (other things being equal) fairly compensated over the long-run, the approach risks under-compensating investors when applied during a period of high real interest rates (as noted by both the UK Regulators Network (UKRN) and Ofgem).[3] We also concluded that—to address this issue—Ofwat should cross check its CoE estimates against other market data (e.g. the cost of new debt issuance) to ensure its allowance is adequate.[4]

3 **Does the calibration of the regulatory settlement provide a 'fair bet'** for investors, with a symmetric distribution of returns, such that the expected return equals the allowed return?

Our Investability report considered whether Ofwat's Draft Determinations would mean investors faced an equal chance of outperformance and underperformance, or whether the distribution of risk was skewed to the downside.

Our assessment concluded that, as an overall package, the downside risk to investors was greater than the upside risk. This downside skew of risk reflects cuts to companies' proposed total expenditure (TOTEX) allowances and an overly stringent performance package.[5] We therefore concluded that Ofwat's Draft Determinations were unlikely to represent a 'fair bet', such that—in practice—investors' expected return would be below the base return (of 4.80% CPIH real).[6]

4 **Is the overall risk exposure reasonable**?

Infrastructure capital has a low tolerance for risk, which is why it is prepared to accept relatively low returns. Because of this, in addition to considering whether the distribution of risk under Ofwat's Draft Determinations was skewed to the

[3] Oxera (2024), 'Investability at PR24', 28 August, pp. 63–66.
[4] Oxera (2024), 'Investability at PR24', 28 August, section 5.
[5] This included more stretching Peformance Commitment Levels (PCLs) and higher Outcome Delivery Incentive rates, increased expectations of what companies can deliver from base funding allowances and a high degree of delivery risk with scheme-level Price Control Deliverables (PCDs).
[6] Oxera (2024), 'Investability at PR24', 28 August, section 6.

downside, we also considered the overall level of risk in the proposed regulatory settlements.

Our report concluded that the water sector faces a considerably higher level of risk and uncertainty than in previous regulatory periods due to multiple factors. We also observed that the aggregate sharing mechanism (ASM) introduced by Ofwat would still leave investors exposed to a considerable degree of risk. We therefore concluded that—to ensure its determinations are investable—Ofwat should make changes to ensure that the level of risk exposure is one which the existing investor base would be willing to accept.[7]

5 **What is the equity being used to finance/fund** (e.g. creation of assets versus bill subsidies for current consumers)?

In its Draft Determinations, Ofwat reduced the RCV[8] run-off rates (which determines how quickly companies can recover the value of capital invested—as represented by the RCV—through consumer bills), for certain companies to address perceived affordability concerns. This approach implies that Ofwat is expecting companies to raise equity to subsidise bills in AMP8, at a cost to future customers.

Our report determined that this decision by Ofwat would be likely to adversely affect investability, by signalling its willingness to use financial levers to delay cost recovery in an unpredictable manner. We also concluded that investability could be further undermined by Ofwat's suggestion that any resulting increase in AMP9 bills could be addressed via similar interventions at PR29, particularly given the expected continued need to raise new external capital beyond AMP8.[9]

Based on our findings against these five questions, our report concluded that, if implemented as proposed, Ofwat's Draft Determinations would likely result in significant investability issues for the sector as a whole. In particular, we identified a material risk—substantiated in our investor engagement—that the sector would be unable to raise the new equity investment required to finance the proposed investment programme for AMP8, as well as the high levels of expenditure expected over the coming decades.

[7] Oxera (2024), 'Investability at PR24', 28 August, section 7.
[8] RCV (or Regulatory Capital Value) is a regulatory construct used by Ofwat when setting companies' price controls. It represents the total investment made by investors which is not immediately remunerated via pay-as-you-go revenues and which is yet to be depreciated.
[9] Oxera (2024), 'Investability at PR24', 28 August, section 8.

Key findings from Oxera's investor engagement

In our engagement, we sought views from investors on three themes: i) investability; ii) returns; and iii) risk. We now summarise the main points that were raised in the discussions across each of these areas.

1 Investability

Investors consistently agreed with our definition of investability, including the five questions underpinning our assessment. Investors highlighted the areas covered by the first three questions (i.e. equity financing assumptions, adequate base returns, and the need for a 'fair bet' in the regime) as the greatest areas of concern at PR24.

Investors argued that a number of Ofwat's PR24 policies did not appropriately reflect the broader market context, making the water sector less attractive as an investment proposition. Specific concerns were raised regarding: restrictions on gearing (i.e. the level of debt financing of the RCV, and potential requirements to make major short-term changes), the approach to setting the overall risk and reward package, and the approach to dividends (particularly its assumption that the notional company could halve its payment of dividends without adversely impacting its ability to raise new equity).

Investors consistently highlighted that in order to secure sufficient financing for the extensive capital programme, Ofwat should consider the characteristics and requirements of both current and credible potential future water sector investors. Some also noted that without setting the kinds of incentives that attract investors with low and stable return requirements, there would be a risk of materially increasing the sector's long-run cost of capital, which would ultimately be reflected in higher customer bills.

Finally, there were also calls from some investors for Ofwat to offer longer-term guidance. These investors argued that given the need to increase investment over multiple control periods, Ofwat needed to move beyond focusing almost exclusively on the control period in question to one which provides confidence about the investment proposition over a longer timeframe.

2 Returns

Virtually without exception, **investors indicated that Ofwat's view of a CPIH-real CoE allowance of 4.80% was significantly below what could be considered to be an adequate level, based on market evidence**. Specific points raised included the below.

- The Draft Determination's equity allowance was more in line with the cost of raising debt under current market conditions, which would make raising equity difficult (since investors require larger risk premia to compensate for the additional risks associated with equity investments over debt).

- Ofwat's conclusion that its Draft Determinations were investable based on Market to Asset ratio (MARs[10]) evidence is inappropriate. In particular, investors argued that the conclusions drawn from this MARs evidence were considerably more optimistic than market sentiment, since this evidence:
  i. relates only to a subset of specific firms, which typically have better relative performance, and so are not representative of the broader sector; and
  ii. excludes important additional evidence from recent failed sales processes and transactions involving unlisted companies at valuations below RCV.[11]

Investor feedback also indicated that the proposed CoE allowance is unattractive compared to other investment opportunities, even after accounting for differences in risk. In particular, investors argued that Ofgem is seen as likely to offer better returns for lower risk in RIIO-3. Investors also pointed to evidence of more favourable returns on offer in other jurisdictions, including across US water utilities and German electricity networks.

Finally, **investors expressed universal concerns about the prospect for dividends, based on the Draft Determinations**. A majority argued that a dividend yield

[10] MARs represent the ratio of enterprise value (i.e. share capitalisation and net debt) to RCV. Regulators often use MARs as a 'cross check' to gauge the market's view of how the sector is likely to perform against regulatory settlements. Regulators generally interpret a MAR above one (i.e. a MAR premium above zero) as evidence that the market considers companies will outperform the regulatory settlement over a long horizon.
[11] We document three case studies in our Investability report which indicate that recent sector transactions appear to have occurred at depressed valuations. These depressed valuations could imply MARs of less than one, casting doubt over the investability of Ofwat's Draft Determinations (since this implies investors are not willing to invest £1 today for an increase in RCV of £1). See Oxera (2024), 'Investability at PR24', 28 August, pp. 69–70.

assumption of 5–6% (seen widely in the UK and European utility sectors[12]) is an inherent pre-requisite for utility sector shareholders.[13] A few investors specifically cited Pennon's experience of cutting dividends—which resulted in its share prices dropping—as evidence of the significant weight infrastructure investors place on stable cash distributions.[14]

3 Risk

Nearly every investor we interviewed indicated that risk levels in the water sector were either 'high' or 'very high'.[15] Most investors also felt that the overall risk level was markedly higher than in previous periods, including PR19, and higher than would be expected for the water sector.

Many investors reflected on how, in light of the PR24 Draft Determinations, Ofwat's regime compared unfavourably to other jurisdictions in terms of the risk/return trade-off. **Nearly all investors argued that Ofgem's regime reflected better returns for lower risk**. Some investors noted that the water sector in England and Wales was among their most risky regulated investment.

Investors highlighted the following as the areas of greatest concern with respect to risk at PR24.

- **Achievability of performance targets**. Several investors indicated that performance targets were set unrealistically high, such that outperformance would be very difficult even for the best performers. Investors also highlighted additional performance risk driven by penalties for non-delivery and/or late delivery in the price control deliverables (PCD) framework.

- **Dividend and financing risk**. Many investors expressed concerns with the sectors' ability to raise the capital needed for AMP8, given the proposed CoE allowance and the recent spike in interest rates. Investors also noted that increased uncertainty around when (and if) dividends will be paid

[12] Oxera (2024), 'Investability at PR24', 28 August, pp. 52–53.
[13] In contrast, Ofwat's notional financeability assessment assumes companies will cut dividends from 4% to 2% to finance RCV growth, before seeking to raise new equity. See Oxera (2024), 'Investability at PR24', 28 August, p. 41.
[14] Shares in Pennon Group PLC were down 6% following the announcement. See Reuters (2024), 'UK's Pennon to pay 3.5 million pounds compensation for Brixham water contamination', 21 May.
[15] More specifically, we asked investors: 'How would you characterise the overall level of investor risk in the UK water sector today?', asking them to provide a rating on a scale of 1 to 5, where 1 indicates 'low risk' and 5 indicates 'very high risk'. Almost 90% of respondents indicated a rating of either 4 or 5, with the remainder providing a rating of 3. We provide more details in section 4.2 of this report.

out further complicates companies' ability to attract capital from infrastructure investors.

- **Regulatory, political and reputational risk**. This was a recurring theme in our engagement. Several investors indicated that Ofwat's regulatory environment is less supportive than in other sectors and jurisdictions, pointing to Ofwat's level of regulatory intervention as evidence of this. Some investors argued that the strict penalties and sectoral investigations for some companies created concerns of a 'contagion' effect across the sector.

- **Variability in returns**. Finally, investors also raised concerns about the variability in returns observed within the sector, and how these had increased in recent regulatory periods.[16] Investors indicated that the degree of variability observed is more consistent with a high risk regime than a low/medium risk regime expected for 'core' infrastructure investments.

[16] We highlighted the increased variability of returns in our Investability report. See Oxera (2024), 'Investability at PR24', 28 August, pp. 26.

1 Introduction

On 28 August 2024, Water UK submitted its response to Ofwat's PR24 Draft Determinations consultation. Part of the supporting documentation for its response included Oxera's report 'Investability at PR24' ('Investability report').[17] This report considered the investability of the water sector in England and Wales, in light of Ofwat's PR24 Draft Determinations and the wider market for infrastructure investment.

Our report was informed by a detailed analysis of Ofwat's proposals, as well as engagement with 30 major investors in the England and Wales water and infrastructure sectors.[18] The purpose of this supplementary report is to document the investor feedback received and highlight themes that emerged from this engagement, which informed the findings in our Investability report.

Due to the fact that this is a supplementary piece, this report is written on the basis that readers are familiar with the discussion in our main Investability report. As such, we do not provide a detailed overview of each of the arguments outlined within the main report.

The remainder of this report is structured as follows:

- **section 2** discusses investor perceptions of **investability** and their views on Oxera's investability framework as presented in the Investability report;
- **section 3** explores investor views on the rate and structure of allowed **returns** provided in Ofwat's PR24 Draft Determinations;
- **section 4** highlights investor concerns with the level, skew and specific areas of **risk** in the England and Wales water sector compared to other sectors and internationally.

This report does not attribute particular views to any specific investor. However, we have identified the list of investors whom Oxera interviewed that agreed to disclose their names in the executive summary. We also spoke with a further ten

[17] Oxera (2024), 'Investability at PR24', 28 August.
[18] We conducted one-to-one interviews over the period 19 August 2024 to 12 September 2024. All investors interviewed were provided a list of questions in advance of the interviews. Of the 30 interviews, 19 were carried out prior to the publication of the Investability report on 28 August 2024. Further interviews were undertaken following publication to allow views of those institutions not available over the summer period. Views of the groups of investors interviewed before and after publication of the Investability report were comparable, and subsequent interviews have not given us reason to alter the findings of our Investability report.

investors that have chosen to remain anonymous, representing a combination of listed and unlisted funds.

2 Investability

2.1 Background

Our Investability report demonstrated how the water sector is expected to deliver significantly and consistently higher levels of investment across future AMPs than has been seen in the past. This highlighted the importance of ensuring that the PR24 package is investable.[19]

To inform our assessment of the investability of Ofwat's Draft Determinations, we proposed the following definition of investability:

For a price control to be 'investable', it must be highly likely that the company can attract and retain the equity capital needed to deliver desired investment.[20]

Moreover, our report identified five questions which we consider any assessment of investability should take into account. This framework provides insight into: i) the extent to which investors can expect to recover their capital plus a fair return on investment, and ii) the market's willingness to accept the investment proposition that is on offer. The five questions are:

1. are Ofwat's assumptions around how equity financing is delivered realistic, including assumed dividend reductions and/or equity injections?
2. is the base return set at an appropriate level, such that the marginal investor is incentivised to commit equity capital?
3. does the calibration of the regulatory settlement provide a 'fair bet' for investors, with a symmetric distribution of returns, such that the expected return equals the allowed return?
4. is the overall risk exposure reasonable?
5. what is the equity being used to finance/fund (e.g. creation of assets versus bill subsidies for current consumers)?

During our engagement, we tested this framework and our overall definition of investability with investors. We also sought views on what they considered

[19] Although the word 'investability' does not directly appear in Ofwat's 'aligning risk and return' documents, the regulator has referred to the concept in its investor communications. See: Ofwat (2024), 'PR24 Draft Determinations: City briefing—transcript', July, p. 4.
[20] Oxera (2024), 'Investability at PR24', 28 August, p.5.

'investability' looked like in practice, and recommendations on how Ofwat should consider the instability of its proposed price controls.

2.2 Investor feedback on the definition of investability

The investors we spoke to consistently agreed with our definition of investability. There was also consistent agreement on the need for Ofwat to clarify its own view of investability, both to inform its PR24 determinations and to promote long-term regulatory consistency.

Investors also agreed with the five questions we proposed should underline the assessment of investability. Interestingly however, they also assigned different degrees of concern across each of these five areas. Specifically:

- **Qs 1, 2 and 3 (i.e. equity financing assumptions, adequate base returns, and the need for a 'fair bet' in the regime)**—most investors highlighted these as critical aspects of investability, and identified these as the greatest areas of concern at PR24.

- **Q4 (i.e. overall level of risk)**—was generally considered to be of 'moderate' to 'high' levels of concern to investors, with some stating that the level of risk was less concerning relative to other issues, subject to the distribution of risk being symmetrical.

- **Q5 (i.e. use of proceeds)**—was seen as being of 'moderate' concern.

We also asked investors if they would propose alternative definitions of investability, and/or whether they identified additional questions beyond the five captured in our framework.

One investor argued that the definition of investability should be even stronger, stating that 'the price control *must* create the conditions for the company to attract the necessary capital as a certainty'. The justification given was that investors are not captive and are operating in a competitive market.

Other investors also argued investability should take into account investors' opportunity cost and the competition for capital in the infrastructure sectors, as described in section 2 of our Investability report.[21] These investors considered that the definition of investability should explicitly account for the risk/return package proposed by regulators in other sectors and jurisdictions. The challenge for Ofwat, they argued, is to make the case for why investment in the sector is

[21] Oxera (2024), 'Investability at PR24', 28 August, p. 17.

competitive relative to other infrastructure options both within and outside the UK.

One investor argued that where Oxera's definition of investability refers to the need to 'attract and retain the equity capital needed', we should include the text 'at valuations at least equal to RCV or above'.[22]

2.3 Changes in regulatory approach

As noted in our Investability report, while investors understood why Ofwat might look to mitigate bill increases, there were widespread perceptions that—historically—a preference for keeping bills low over consecutive control periods had significantly contributed to a shortfall in investment levels, resilience and quality issues.[23]

In addition, **the decision to reduce RCV run-off rates to address perceived affordability concerns was seen as arbitrary**, with this decision insufficiently motivated and explained, particularly as it applies to some companies but not others. This raised concerns among some investors that Ofwat may take similar steps in future, reducing the attractiveness of investing in the sector today given greater uncertainty around future dividends.[24] Although investors ranked this issue below the other four areas in our investability framework, investors sighted it as evidence of inconsistency in Ofwat's regulatory approach.

Many investors raised issues with specific aspects of the regulatory regime. Specific concerns included:

- the proposed gearing cap[25] (i.e. a cap on the level of debt financing of the RCV), and the resulting need for some companies to make major changes to capital structures in the short-term;
- the approach to setting the overall risk and reward package, including the large penalties companies would incur if their operational performance was in line with their business plans; and,

[22] Oxera restated its view on the interpretation of MAR evidence in the Investability report, and highlighted that Ofwat needs to exercise caution in making positive conclusions on sector investability from recent capital raises at MAR valuations that may in fact have required discounts to RCV. (See Oxera (2024), 'Investability at PR24', 28 August, section 5.4.1.)
[23] This perception amongst investors (of Ofwat prioritising bill reductions over other priorities) is likely to be driven by multiple factors. We note in this respect Ofwat's statement in 2017 that water customers could be at the start of 'the decade of falling bills'. See Ofwat (2024), 'PN 17/17: Ofwat boss talks of the 'decade of falling bills', 13 October.
[24] As noted in our Investability report, in its Draft Determinations Ofwat explicitly states that it may implement similar measures to address any affordability concerns at PR29. See Oxera (2024), 'Investability at PR24', 28 August, section 8.
[25] Ofwat (2024), 'PR24 draft determinations: Aligning risk and return appendix', 11 July, p. 69.

- Ofwat's consideration of dividends, particularly its assumption that companies should reduce dividends to finance investment, and that this would not have a negative effect on their ability to raise new equity.

Investors argued that these policies did not appropriately reflect the broader market context.[26]

Finally, there were also calls from some investors for Ofwat to offer longer-term guidance. These investors argued that given the need to increase investment over multiple control periods, Ofwat needed to move beyond focusing almost exclusively on the control period in question to one which provides confidence about the investment proposition over a longer timeframe.

2.4 Current and potential water sector investors

In section 4 of our Investability report, we noted that investors in the England and Wales water sector accept below market average returns in exchange for a lower operating risk profile, more cash-flow and greater payout certainty.[27] Many investors we spoke to argued that—at least in theory—the sector should benefit in turn from investors who take a longer-term view and are therefore more willing to inject capital as required to fund improved services and environmental outcomes.

However, contrary to the logic outlined above, investors repeatedly raised concerns that this type of 'low risk/low return' package was not on offer under the Draft Determinations, with some warning about the risk of 'scaring off' low cost capital providers.

More specifically, investors highlighted how the proposed terms of PR24 would likely mean that investors would have to accept lower dividend yields. This, they argued, could mean that income funds and institutional capital—which tend to value stable, longer-term returns—may limit further investment in the sector or exit the sector altogether.[28]

Investors also indicated that if exiting investors are forced to sell (due to the unattractive profile of risk on offer), new buyers will likely be investors with

[26] We provide more details on these views in sections 3 and 4 of this report.
[27] This is typical of the type of income funds and institutional investor that favours 'core infrastructure'. Core infrastructure typically refers to little-to-no risk operational assets in developed countries, often with long-term government contracts providing stable cash flows. See Goldman Sachs (2023), 'Infrastructure: an Evolving Asset Class', accessed 1 August 2024.
[28] We note Affinity Water's Draft Determination response, which confirmed that its shareholders have withdrawn their business plan commitment to invest £150m of further equity capital 'as a consequence of the draft Determination'. See Affinity Water (2024), 'Planning our future together: Affinity Water PR24 Draft Determination Representation', para. 8.12.

higher return requirements. These investors indicated that such buyers would tend to be exit-driven and—in the words of one investor—would be 'looking to make a quick buck'. Investors shared examples of failed sales processes[29] in the unlisted sector that attracted bids from these more opportunistic investors (described as 'special situation' or 'distressed asset' funds) at much lower valuations than sellers were willing to accept. This implies that such investors have higher required returns compared with traditional water sector investors.[30]

Investors with higher required returns would only be expected to invest in new water sector assets and services at higher prices for consumers. The entry of such investors to the sector, investors argued, would increase the sector's long-run cost of capital, which would ultimately need to be reflected in higher customer bills over the medium-term. Some investors noted that Ofwat should not assume that equity capital of this kind would always be available, and that there was an onus on the regulator to ensure that this equity remains in the sector to secure the best outcomes for consumers and the environment.

2.5 Suggestions for improving investability of the sector

Investors identified a range of changes which they considered could help address their investability concerns.

Every investor indicated that **base returns should be more appropriately aligned with the level of risk** currently perceived in the sector. Many raised concerns with an overreliance on the theoretical 'notional company' underlying the approach to setting the cost of capital allowance, on the grounds that this does not reflect how the market actually operates (since—in reality—companies' actual structures differ significantly from the notional structure assumed by Ofwat). One investor noted that the regime needed to be simpler to understand in order to attract new capital.

Some investors highlighted the Italian water sector as having a strong regulatory regime that better reflects the market context. One of these investors specifically cited the Italian regulator's introduction of a 'trigger mechanism' to address uncertainty regarding how inputs used to calculate the cost of capital allowance might evolve over the regulatory period.[31]

[29] By 'failed sales processes' we are referring to instances in which existing shareholders sought to sell equity to a prospective buyer, but a sale price could not be agreed such that no transaction took place.
[30] These transactions are typically not public, although investors expressed a willingness to provide information from such instances to Ofwat.
[31] More specifically: the Italian energy regulator (ARERA) checks, on an annual basis, whether updates to some of the assumed parameters underpinning the cost of capital allowance (including e.g. the nominal risk free rate,

Investors raised **issues with the notional level of gearing assumed by Ofwat** in its Draft Determinations.[32] To many investors, the decision to assume a gearing of 55% for the notional company in its financeability assessment appeared to be 'penal' in nature.[33] Some felt that this was exacerbated by the decision to reduce RCV run-off rates for some companies, as this would lead to a reduction in cash into companies from both debt holders and customers, placing even greater pressure on residual cash requirements to come from raising new equity. A lower notional level of gearing was seen as counterintuitive, considering the step up in investment required in AMP8.[34] A few investors therefore indicated that Ofwat should reconsider this assumption, noting that notional gearing assumptions are heavily dependent on judgement. Others argued that Ofwat is trying to 'do too much at once'—being tough on financing structures while at the same time seeking to finance unprecedented levels of investment.

Investors also raised **the need to relax performance commitment levels (PCLs)** in order to reflect a more acceptable distribution of risk. Investors pointed to the fact that most, if not all, water companies were penalised over AMP7 (2020-2025), which indicates that Ofwat's operational targets were not set in line with realistic expectations. They therefore argued that PCLs should be re-aligned to reflect actual performance at the end of AMP7.

Finally, investors pointed to the trend of declining returns—and high variability across companies[35]—as evidence of **the need to balance of upside and downside risk.**[36] Investors suggested that this could be achieved by increasing the WACC allowance, setting more realistic TOTEX allowances and better accounting for companies' actual operating and maintenance costs. Some investors also noted the need to balance regional differences in costs and the ability of companies to meet PCLs, believing that Ofwat had adopted a 'one size fits all' approach without sufficient evidence.

the inflation rate, etc.), would result in a cost of capital allowance that is at least 50bps higher/lower compared to the allowance currently in place. If this is the case, energy networks' allowances are updated accordingly. See ARERA (2021), 'Delibera 614/2021/R/com. TIWACC aggiornato', December and ARERA (2024), 'Consultazione 342/2024/R/com', July.

[32] Ofwat (2024), 'PR24 draft determinations: Aligning risk and return appendix ', July, pp. 51–52.

[33] Ofwat (2024), 'PR24 draft determinations: Aligning risk and return appendix', July, p. 44.

[34] Ofwat's draft determinations state '…in any period where gearing would still be above the threshold, we have assumed sufficient new equity to return gearing to the notional level of 55%.' See Ofwat (2024), 'PR24 draft determinations: Aligning risk and return appendix ', July, pp. 51–52.

[35] Oxera (2024), 'Investability at PR24', 28 August, pp. 25–26.

[36] This is discussed further in section 4.4.1.

3 Return

3.1 Background

In our Investability report, we highlighted how the infrastructure sector traditionally attracts investors that have a low tolerance for risk and accept below market average returns in return for a stable and predictable income stream.[37] Accordingly, two key considerations when assessing the appropriate level of base returns are:

i. whether the total expected return is sufficient to attract new capital and retain existing capital; and
ii. whether there are stable and predictable cashflows for investors.

3.1.1 Ofwat's approach to setting the base return

In its Draft Determinations, Ofwat estimates an allowance for the CoE between **4.19–4.88%,** with a mid-point of 4.53%.[38] Ultimately, the point estimate is set at the upper end of this range, at 4.80%, which reflects 'aiming up' of 27bps.

In our Investability report, we did not provide an exhaustive assessment of Ofwat's approach to setting the CoE allowance, nor seek to provide an 'Oxera view' of what the allowance for PR24 should be. Instead, we explained that Ofwat's approach to setting the allowance for the CoE is based on a 'through the cycle' approach,[39] which assumes that returns to equity are broadly stable over time. We highlighted that while this 'through the cycle' approach may mean investors are fairly compensated over the long-run, the approach risks under-compensating investors when applied during a period of high real interest rates.

3.1.2 Ofwat's assumptions regarding cash distributions to investors

In its PR24 Draft Determinations, Ofwat assumes a 50% cut in dividends for England and Wales water companies over the AMP8 regulatory period in its notional financeability assessment.[40] In other words, Ofwat's assumes that

[37] Baker, M. P. and Wurgler, J. (2004), 'A Catering Theory of Dividends', *Journal of Finance*, **59:**3, pp. 1125–65. Armitage, S. (2012), 'Demand for dividends: the case of UK water companies', *Journal of Business Finance and Accounting*, **39**, pp. 464–499. Aspara, J., Pajunen, K. and Tainio, R. (2014), 'Dividend Preferences and Corporate Financial Policies in Regulated Industries: Evidence from the UK Water Sector', *Financial Management*, **43**, pp. 459–492. Bird, R., Liem, H. and Thorp, S. (2022), 'Institutional Investment in Infrastructure: Preferences and Perceptions in the UK', *Journal of Asset Management*, **23**, pp. 85–104. Megginson, W. L., and Netter, J. M. (2020), 'A Review of Infrastructure Investments: Global Trends and UK Implications', *Journal of Corporate Finance*, **65**, pp. 1025–1043.
[38] Ofwat (2024), 'PR24 draft determinations: Aligning risk and return—Allowed return appendix', July, p. 51.
[39] Oxera (2024), 'Investability at PR24', 28 August, section 5.
[40] Ofwat (2024), 'PR24 draft determinations: Aligning risk and return', July, p. 24.

companies would cut dividends by 50% (i.e. to 2%), before seeking new equity to finance investment.

As highlighted in section 4 of our Investability report, there is strong evidence to suggest that infrastructure investors place particular emphasis on the contribution of dividends to total returns (relative to gains from capital appreciation).[41] This evidence of 'clientele effects' among water sector investors suggests—contrary to a simplistic reading of some stylised economic models—that changes to the assumed profile of dividends can affect the value of the firm. As a result, policies which inhibit companies' ability to pay dividends may in turn hamper their ability to raise equity finance.

The following sub-sections summarise the feedback we heard from investors on these issues.

3.2 Required returns in water

As noted above, our report did not seek to provide an 'Oxera view' on what the appropriate CoE allowance for PR24 should be. Nevertheless, as part of our engagement, we sought views from investors as to what they considered to be an appropriate allowance.

By and large, investors indicated that Ofwat's view of a CPIH-real CoE allowance of 4.80% was significantly below what could be considered an adequate level.

Some investors indicated that the CoE allowance proposed by Ofwat was more in line with—or even lower than—the cost of raising debt under current market conditions. One investor noted that the allowance did not provide any headroom compared to the cost of new debt (which would be problematic, given the higher intrinsic level of risk associated with equity investments as opposed to debt).[42] This same investor also argued that this is an unrealistic assumption, because it assumes that equity requires a lower risk premium than historically (despite most investors viewing the current risk level as being higher than in previous AMPs).

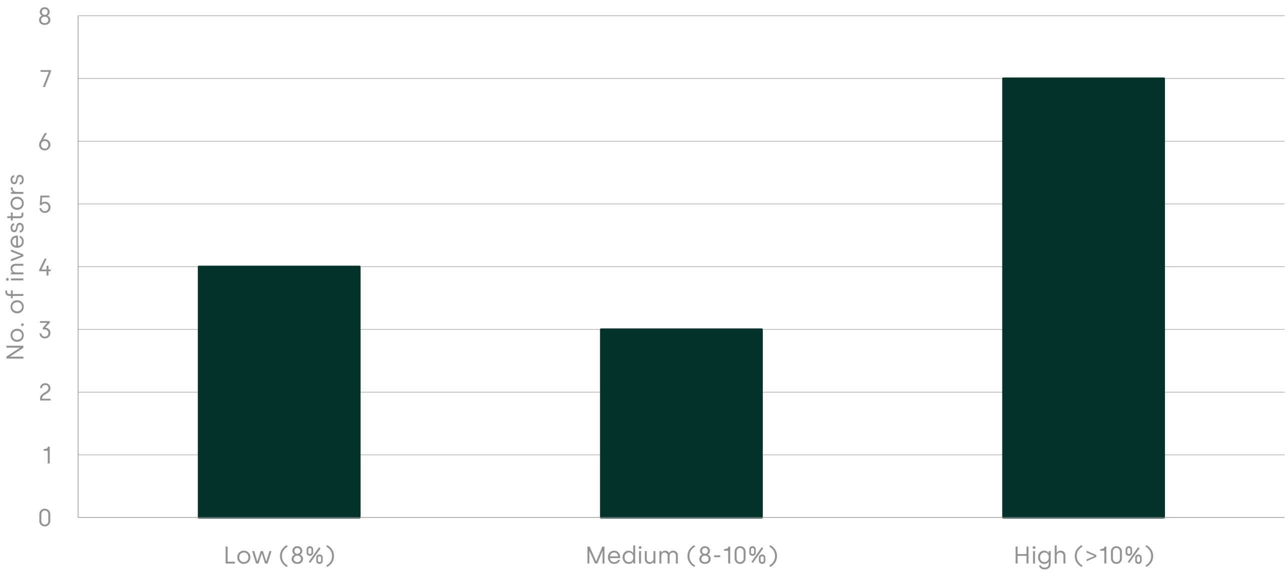
Most investors generally agreed that, based on current debt spreads and the risk profile of the sector, a minimum cost of equity of approximately 9–9.5% in

[41] More specifically: according to Dividend Irrelevance theory, the value of a firm is determined solely by its earning power and the risk of its underlying assets, not by how it distributes its earnings between dividends and retained earnings. The implication is that investors should be indifferent between a decision by the company to pay dividends or retain earnings for reinvestment. However, our report finds the presence of 'clientele effects' among infrastructure investors, which shows a strong preference among investors for dividends (as opposed to capital appreciation). The implication is that in the water sector, a decision by the company to reduce dividends can adversely affect the value of the firm. See Oxera (2024), 'Investability at PR24', 28 August, section 4.
[42] The issue here is that—for an investment in the same company—returns to equity are associated with a higher level of risk than returns to debt, since (absent insolvency) the return in debt is certain.

nominal terms would be more reasonable. This would allow for equity to be priced appropriately above senior debt (250–300bps) and 50–100bps above subordinated debt[43], given that equity risks are higher than for both classes of debt.

Figure 3.1 below shows the range of views provided (in nominal, post-tax terms) on what an acceptable return on equity in the sector should be.

Figure 3.1 Returns expected by investors



Note: The above is based on responses from 14 out of 30 investors who quantitatively answered the question. Instances where the question was not asked of the interviewee, was not answered explicitly or was answered in more qualitative terms have not been reflected above.
Source: Interviews conducted by Oxera with various investors.

Investor feedback indicated that the returns on offer in water are unattractive compared to other investment opportunities, even after accounting for differences in risk.[44] The views expressed include that:

[43] 'Senior debt' refers to debt which has the highest priority for repayment, making it the least risky and often the safest option for lenders. 'Subordinated debt' refers to debt which has a lower priority for repayment than senior debt (making it relatively riskier).
[44] We provide more details on investors' views of risk in section 4 of this report.

- **Ofgem is seen as likely to offer better returns for lower risk** in RIIO-3.[45] One investor noted that while early indications of Ofgem's approach for RIIO-3 were 'not particularly attractive', they were still positive compared to the PR24 Draft Determinations;
- **better risk-adjusted returns are available in other markets**, such as European energy networks or US water utilities;
- **US utilities in many states are offering 8–9% nominal returns** (with some investors noting that certain US states—e.g. Pennsylvania—are offering returns just shy of 10% in nominal terms);
- **the German electricity transmission regime allows 7.7% nominal returns**, and highlighted that this market alone could absorb much of the infrastructure capital available.

We also sought investor views on Ofwat's 'through the cycle' approach to estimating the CoE allowance (which assumes that returns to equity are broadly stable over time).

In our discussions, market participants did not have an issue with the use of the through the cycle approach itself per se, but indicated that the current approach does not reflect reality and needed to be more pragmatic. As stated by one investor, if Ofwat continues to rely on a CAPM[46] approach to calculating the CoE, then taking a long-term view on returns to equity may be appropriate, but that the approach should be adjusted to 'reflect a future that looks different to the past', in order to attract new capital into a higher risk environment.

Another investor noted that a through the cycle approach would be acceptable in other contexts, if there was not such a need to raise significant levels of new equity. This investor reiterated that, given current market volatility, Ofwat should not place excessive reliance on one single theoretical tool. This investor suggested that using other tools—such as looking at valuations and where water companies are trading with dividends—would allow for a more accurate assessment of what the market is willing to accept at a given point in time.

[45] As noted in our Investability report, Ofgem uses a 60% notional gearing and has indicated a CoE range of 4.57–6.35%. This compares to a 4.85% (midpoint) allowance for the water sector at 60% gearing, 61bps lower than Ofgem's midpoint estimate. See Oxera (2024), 'Investability at PR24', 28 August, p. 70

[46] The Capital Asset Pricing Model (or CAPM) is the framework used by Ofwat to calculate the expected rate of return for an asset or investment. CAPM is used to determine if an investment's expected returns are worth the risk involved, based on the expected return of the market and a risk-free asset, as well as the asset's sensitivity to the market (beta). See Oxera (2024), 'Investability at PR24', 28 August, section 5.1.

Finally, some investors were also critical of Ofwat's use of MARs[47] as evidence of the investability of its Draft Determinations. Specifically, while Ofwat pointed to MARs remaining broadly in line with the long-term average of 1.1x RCV, investors disputed that this provides evidence that investors anticipate future sector wide outperformance. These investors argued that Ofwat's conclusion from this evidence was considerably more optimistic than market sentiment, given that: i) these MARs relate only to a subset of specific firms, which typically have better relative performance, and so their MARs are not representative of the sector as a whole, and ii) wider market evidence—including evidence from unlisted MARs—suggest a more pessimistic market view of future sector performance.

3.3 Expected cash flows to investors

Investors expressed universal concerns about the prospect for dividends, based on the PR24 Draft Determinations.

In particular, existing investors made clear that cashflow stability, particularly through dividends, is a critical consideration for those investing in the water sector. A number of investors noted that Ofwat's assumptions about a lower level of dividend yield being acceptable to investors in its financeability assessment at PR24—without a corresponding decrease in risk—has made them hesitant to commit further capital to the sector.

As mentioned in our Investability report, the type of capital currently invested in the water sector accepts below market average returns for the ability to have stable and certain cash-flow.[48] Many investors argued that the combination of a low proposed return and reduced ability to pay out shareholder dividends means that they are taking on disproportionate levels of risk for little or no additional return.

Other investors indicated that they would accept lower dividend yields if the level of return was increased 'to double digits', on the basis that there was a finite period of asset growth which needed funding and for which the risk was adequately rewarded. However, the majority argued that a dividend yield assumption of 5–6%, seen widely across the UK and European utility sectors (as illustrated in our Investability report), is an inherent pre-requisite for utility sector shareholders. This is consistent with the evidence in our Investability report which

[47] MARs represent the ratio of enterprise value (i.e. share capitalisation and net debt) to RCV. Regulators often use MARs as a 'cross check' to gauge the market's view of how the sector is likely to perform against regulatory settlements. Regulators generally interpret a MAR above one (i.e. a MAR premium above zero) as evidence that the market considers companies will outperform the regulatory settlement over a long horizon.
[48] Oxera (2024), 'Investability at PR24', 28 August, p. 57.

shows how utility sector yields tend not to reduce, even during periods of significant increases in levels of new equity being raised.[49]

Another investor indicated that uncertainty around the sector's future investment requirements make Ofwat's current dividend assumptions less realistic, since it is difficult for investors to ascertain when the sector will revert to positive net cash flow to equity.

A few investors cited Pennon's experience of cutting dividends, which resulted in its share prices dropping, as evidence of the additional weight infrastructure investors place on stable cash distributions to investors.[50]

[49] Oxera (2024), 'Investability at PR24', 28 August, pp. 52–53.
[50] Shares in Pennon Group PLC were down 6% following the announcement. See Reuters (2024), 'UK's Pennon to pay 3.5 million pounds compensation for Brixham water contamination', 21 May.

4 Risk

4.1 Background

Our Investability report explored the exposure facing investors under the Draft Determinations and the resulting implications for investability. We focused on risk through two specific dimensions.

- **Overall level of risk**. Our report considered the overall level of risk exposure investors would bear under the Draft Determinations. We found that despite the sector being historically seen as a low-risk investment opportunity, multiple factors in recent years have led to a material revision in the risk outlook for the sector, including (but not limited to): a declining trend—and increasing variability in—returns across companies; negative media attention and increased regulatory intervention; and, a recent Moody's report noting the potential for a downward revision in its assessment of the stability and supportiveness of Ofwat's regulatory framework. Our report concluded that these factors raise further investability issues that need to be addressed by Ofwat by lowering overall risk levels.[51]

- **Downside skew**. Our report also explained how an important question when setting price controls is whether the terms offered would represent a 'fair bet' to investors.[52] For the price control to offer a 'fair bet', regulatory parameters should be set in such a manner that there is an equal likelihood of an efficient firm outperforming as there is of it underperforming (i.e. a symmetrical distribution around the base return),[53] to ensure the expected return on equity is at least equal to the base return. Our analysis indicated that the package put forward by Ofwat contains considerable downside skew and—as such—is unlikely to offer investors a 'fair bet'.

Throughout the course of our engagement, we held wide-ranging discussions regarding the risks facing investors in the England and Wales water sector under

[51] Oxera (2024), 'Investability at PR24', 28 August, pp. 26, 86, 93–94.
[52] Oxera (2024), 'Investability at PR24', 28 August, section 6.
[53] See, for example, Competition and Markets Authority (2017), 'SONI Limited v Northern Ireland Authority for Utility Regulation', November, p. 197, para. 7.237; Civil Aviation Authority (2023), 'Economic regulation of Heathrow Airport Limited: H7 Final Decision, Section 3: Financial issues and implementation', CAP2524D, March, p. 60, para. 11.3; Competition and Markets Authority (2023), 'H7 Heathrow Airport Licence Modification Appeals: Final Determinations', 17 October, p. 259, para. 7.163.

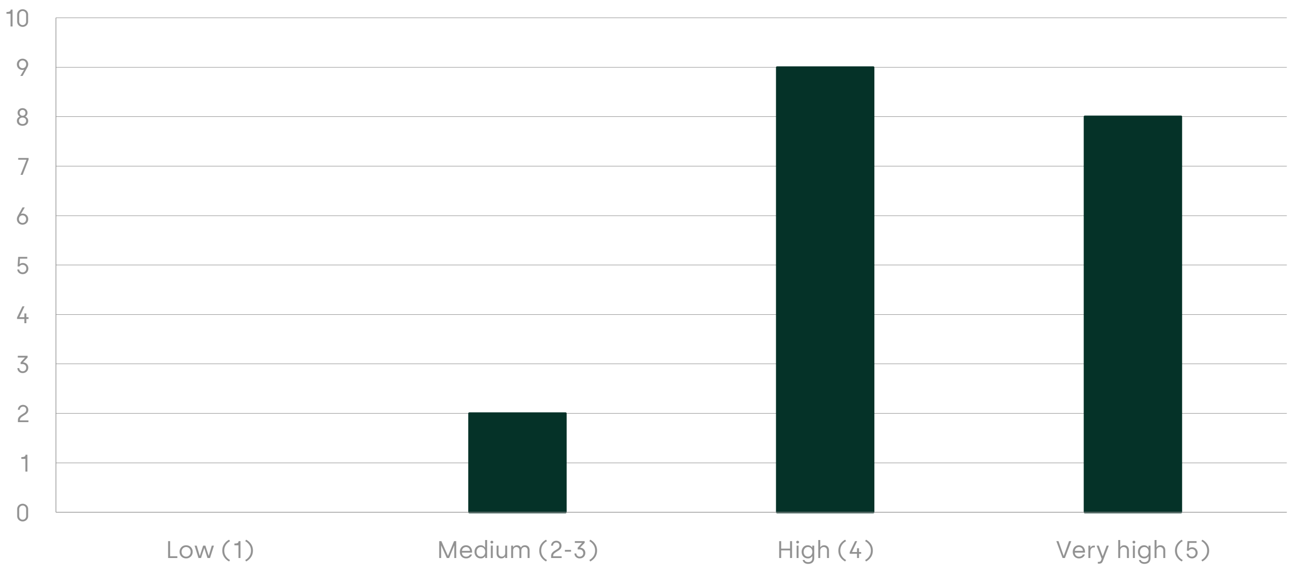
Ofwat's Draft Determinations. We now summarise the views expressed in relation to:

i. the overall level of risk at PR24 and how it compares to PR19;
ii. how the level of risk in the sector compares to other sectors and jurisdictions; and
iii. what areas of risk were of most concern.

4.2 Overall levels of risk

We sought views from investors on the degree of risk they perceived in the England and Wales water sector. As shown in Figure 4.1 below, nearly all the investors we interviewed indicated that risk levels in the water sector were either 'high' or 'very high'.

Figure 4.1 Investors' perception of risk in the England and Wales water sector



Note: This data reflects investors' responses to the question: 'How would you characterise the overall level of investor risk in the England and Wales water sector today?' Investors were asked to provide a rating on a scale of 1 to 5, where 1 indicates 'low risk' and 5 indicates 'very high risk'. It captures the responses of investors who clearly indicated a response on this scale, and excludes vaguer responses where a subjective determination would have been required to classify appropriately.
Source: Interviews conducted by Oxera with various investors.

The vast majority of investors felt that the overall risk level was markedly higher than in previous periods, including PR19, and higher than would be expected for the water sector. Many attributed this to Ofwat failing to sufficiently take into account the level of investment required at AMP8 (and beyond), as well as the broader market context. In particular, investors pointed to interest rate spikes in recent years as a contributing factor to why they perceived the overall risk level as being higher than at PR19. Investors (across listed and unlisted companies) also raised downside skew as an important concern, amplified by the levels of underperformance seen in AMP7. Furthermore, nearly all investors stated that the overall level of risk was exacerbated by increased regulatory, political and reputational risk.[54]

Only two investors disagreed with this view, indicating that the water sector remained attractive and that the problems in the sector were specific to some companies rather than sector wide. Others noted that there were aspects of Ofwat's regime, such as inflation indexed revenues and returns, that meant the sector remained attractive to investors.[55] These investors highlighted that the use of the inflation index in the calculation of the allowed return on capital helps mitigate risk, by ensuring inflation-linked cashflows from investments in water companies.[56]

4.3 Comparison to other sectors and jurisdictions

Many investors reflected on how, in light of the PR24 Draft Determinations, Ofwat's regime compared unfavourably to other jurisdictions in terms of the risk/return trade-off. Specific observations included the following.

- **Nearly all investors argued that Ofgem's regime reflected better returns for lower risk**. Many cited the lower levels of regulatory intervention and fewer penalties by Ofgem as being more attractive from an investor perspective. Some indicated that Ofgem reflected a 'tough but fair' regulatory approach, which looked at longer timelines than those considered by Ofwat, creating a more investment friendly environment.

- **Some investors mentioned that the water sector in England and Wales was among their most risky regulated investment** in the OECD, and that this risk is predominantly driven by 'regulatory risk'.[57]

- **In terms of regulatory stability and returns, many indicated that the England and Wales water sector is far behind other regulated sectors in**

[54] We return to this point in section 4.4.3 below.
[55] Ofwat's framework to set allowed return on capital incorporates long-term estimates of inflation to reflect the long-term horizon of both equity and debt investments into the sector. See Ofwat (2024), 'PR24 draft determinations: Aligning risk and return—Allowed return appendix', July, p. 108.
[56] Oxera (2024), 'Investability at PR24', 28 August, p. 56.
[57] One investor stated that the England and Wales water was: 'the least attractive regulated sector in the OECD and potentially globally.'

Europe, such as the electricity sector in Italy or Spain, or the gas sector in Portugal.

4.4 Commentary on specific areas of risk

We sought views from investors on the greatest areas of concern with respect to risk at PR24. In the following subsections, we focus on the main issues raised.

4.4.1 Achievability of performance targets

As discussed in our Investability report, the PCD framework for PR24 includes penalties for non-delivery and/or late delivery of outputs.[58] In addition, company outturn performance over AMP7 suggests that Ofwat has set PCLs at levels too stringently. The collective impact is considerable downside skew in the risk distribution.

Feedback we have gathered from investors suggests this is seen as a particularly difficult issue, attracting significant reputational risks around any decisions to enter the market or commit new capital. Several investors indicated that performance targets were set unrealistically high, such that outperformance was very difficult even for the best performers.

4.4.2 Dividend and financing risk

Investors repeatedly emphasised how water companies will need to raise finance at a time when demand for infrastructure capital is increasing across the UK, Europe and internationally. Many investors expressed concerns with the water sectors' ability to raise the levels of capital needed for AMP8, particularly given:

- Ofwat's proposed CoE allowance; and,
- increases in the cost of new debt due to the spike in interest rates.

Furthermore, the increasing barriers to dividend payments—and greater uncertainty around when (and if) dividends will be paid out—may make it more difficult to attract capital from infrastructure investors. Some investors argued that Ofwat's lower assumptions on notional dividend yields, and likely implications of proposed gearing changes, would be inconsistent with current investors' criteria. One investor indicated that where there is appetite among investors to forego dividends, it is typically tolerated as a 'one-off' and requires payout certainty in the future, which in turn is contingent on the credibility of the regulatory regime—the latter of which many investors expressed doubts about in the current climate.

[58] Oxera (2024), 'Investability at PR24', 28 August, section 6.2.

4.4.3 Regulatory, political and reputational risk

A recurring theme in our engagement was the high level of regulatory and political risk in the water sector, and the resulting reputational risk to companies and their investors.

Several investors indicated that the regulatory environment was less supportive than in other sectors and jurisdictions. They highlighted, in particular, the level of regulatory intervention and the high degrees of uncertainty, which some investors claimed was driven by an 'inconsistent regulatory approach'. One investor noted that equity investors' tolerance for downside risks stemming from regulatory intervention was much lower than tolerance for accepting downside risk stemming from performance incentives (e.g. due to not meeting performance targets).

Many also pointed to the complexity of Ofwat's approach, and its overreliance on models that are perceived to be theoretical and not reflective of reality. Many conveyed that more regulation or more detailed regulation does not necessarily mean better regulation, and that Ofwat's approach has become increasingly complex.[59]

Some investors argued that the strict penalties and sectoral investigations for some companies created concerns of a 'contagion' effect across the sector. In the words of one investor, such an environment can 'spook' market participants due to reputational risks. Some investors we spoke to mentioned that the prospect of individual shareholders or executives being held personally responsible made the sector even less attractive, further complicating companies' ability to raise new capital.

4.4.4 Variability in returns

Finally, investors also raised concerns about the variability in returns observed within the sector.

Specifically, investors indicated that the observed variability in returns is more consistent with a high-risk regime than a low/medium risk regime expected in a 'core' infrastructure sector.

[59] While levels of complexity do not directly affect actual underlying risk exposure, they do make it more challenging for investors to assess the level of risk to which they will be exposed. We note that while existing investors in the England and Wales water sector will already be aware of the basic frameworks/theoretical models used by Ofwat to set price controls, the complexity of the current regime may be particularly problematic from the perspective of companies seeking to raise external equity from new investors to the sector.

One investor stated that Ofwat's return on regulated equity (RoRe) range of ±4.6% is an implicit recognition that variability in returns have increased materially. The same investor argued that investors should expect returns closer to the bottom of this range rather than the middle, given the downside risk skew in performance targets and insufficient TOTEX allowances.