

# **Allowed Return for Uisce Éireann at RC4**

Prepared for CRU

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# 1. Introduction

As part of its regulatory process, the CRU sets the rate of return that Uisce Éireann (UÉ) can earn on efficiently incurred capex in its regulated asset base (RAB). The CRU currently sets this return based on the Weighted Average Cost of Capital (WACC), which reflects the weighted average of efficient debt and equity costs, with the weights determined by gearing.

The CRU asked NERA to provide an assessment of potential alternative approaches to set the allowed return for UÉ for the RC4 regulatory period, considering the special characteristics of UÉ's funding model.

The remainder of this report is structured as follows:

- Section 2 summarises UÉ's funding model and the implications for the allowed return;
- Section 3 presents different options for the allowed return at RC, our evaluation of these options, and our recommendations

## 2. UÉ's Funding Model and Implications for the Allowed Return

This section summarises UÉ's current funding model and its implications for the allowed return.

### 2.1. Overview of UÉ's funding model

Under the funding model established by the Water Services Act of 2017, domestic customers do not directly pay for water services charges. Instead, the government pays these charges on customers' behalf ("government subvention"). As part of this funding model, the debt associated with domestic services has been replaced by government equity, while the debt related to non-domestic services has been substituted with government debt.<sup>1</sup>

UÉ's revenue is derived from two primary sources: water tariffs paid by non-domestic customers and the government subvention paid on behalf of domestic customers. This revenue, which is determined as part of the revenue control process, is intended to cover the efficient economic costs incurred by UÉ, which include operating expenses, depreciation of the RAB, and the allowed return.

UÉ is not required to pay dividends to the government. Due to the absence of a dividend requirement, the allowed return, or operating surplus, is expected to be reinvested to fund capex and to service the interest on government debt related to the non-domestic segment.

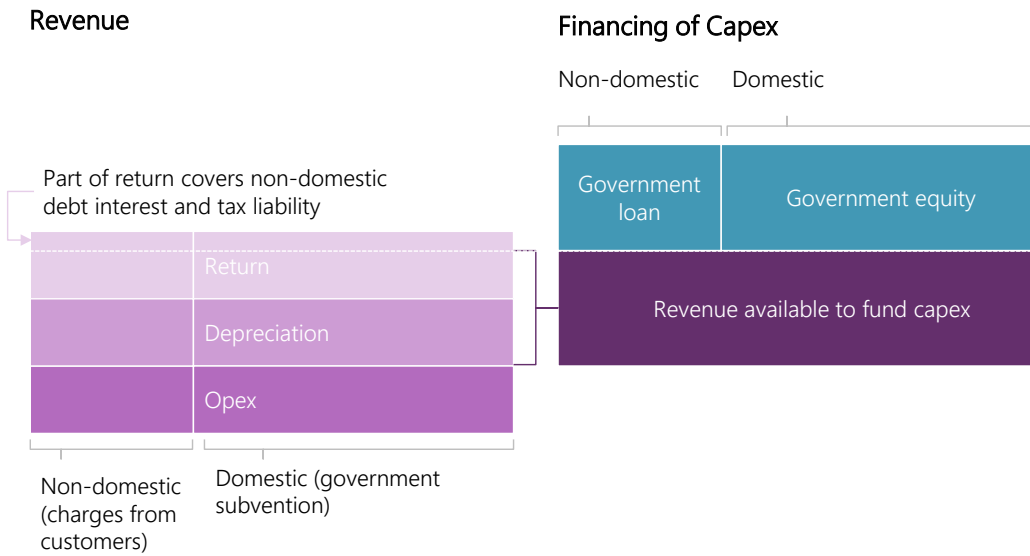
Currently, the revenue generated from the government subvention and from non-domestic charges is insufficient to cover UÉ's capex programme, resulting in a "funding gap". To address this gap, additional funding is necessary, which is provided through government equity contributions for domestic services and government loans for non-domestic services.

Figure 2.1 illustrates the funding model for UÉ.

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<sup>1</sup> Water Services Act 2017, available at [link](https://www.irishstatutebook.ie/eli/2017/act/29/enacted/en/html). <https://www.irishstatutebook.ie/eli/2017/act/29/enacted/en/html>

**Figure 2.1: Illustration of UÉ’s funding model**



Source: NERA illustration

## 2.2. Implications for the allowed return

Given UÉ’s funding model, the implications of the allowed return differ from those of a privately-owned regulated network. UÉ does not need to raise debt from private capital markets or provide returns to equity holders, nor does it have an obligation to pay dividends to the government but rather free cash-flow from operations is retained within the business for re-investment.

On the domestic side, the allowed return only affects the balance of government subvention and government capital contributions. A lower allowed return reduces allowed revenues (i.e., the government subvention), widening the funding gap and therefore increasing the requirement for government capital contributions. However, the overall contribution from government (the domestic customer subvention and the government equity contribution) is unchanged.

On the non-domestic side, the allowed return impacts the balance of non-domestic charges and the requirement for government financing. A lower allowed return results in lower revenues collected from non-domestic customers, which in turn widens the funding gap and the need for additional government debt. The main impact of the allowed return is therefore on the non-domestic side, where a lower return reduces the level of customer charges with a corresponding increase in the required level of government debt financing and vice versa.

### 3. Options for the Allowed Return at RC4

In this section, we present different options for setting the allowed return at RC4. We have evaluated these options based on five criteria:<sup>2</sup>

1. *Regulatory burden*: We assess the regulatory burden that a given option imposes on the CRU and UÉ, and whether it is justified in light of UÉ's funding model.
2. *Cost recovery and efficient price signalling*: We assess whether a given option accurately reflects UÉ's efficient cost of providing its services and whether resulting customer charges are more likely to provide appropriate price signals. We focus on price signals to non-domestic customers, given that domestic customer bills are covered by the government subvention. This criterion relates to compliance with Article 9 of the EU Water Framework Directive (2000/60/EC), which requires water pricing to cover the cost of providing water services, in line with the polluter pays principle, and incentivise users to use water resources efficiently.<sup>3</sup>
3. *Impact on non-domestic charges*: We consider the relative impact of each option on the level of non-domestic charges.
4. *Dependency on exchequer funding*: We consider the relative impact of each option on the required level of Exchequer funding (i.e., subvention to customer charges, government equity contributions and government debt funding).
5. *Financial resilience or impact on financial credit metrics*: Lastly, we assess qualitatively whether a given option could pose a risk to financial resilience in terms of UÉ and its ability to meet its operational expenses and any debt repayments. For example, a higher return element provides for stronger financial metrics, such as interest cover ratios, and therefore greater ability to meet debt repayments.<sup>4</sup>

#### 3.1. Option 1: Full WACC

The current approach to setting the allowed return for UÉ is based on a WACC approach. The WACC is calculated based on a company's average cost of capital from equity and debt, weighted according to the gearing – the assumed proportion of debt in the capital structure. The WACC is multiplied by UÉ's RAB to determine the allowed return component of allowed revenues.

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<sup>2</sup> The CRU has also previously set out principles to follow in the design of the regulatory framework, comprising stability, predictability, sustainability and cost efficiency. The first two criteria imply that we should avoid unwarranted changes to the framework. Source: CRU (March 2014) Advice to the Minister on the Economic Regulatory Framework for the public water services in Ireland. Link: [CER14076-Advice-to-the-Minister-on-the-Economic-Regulatory-Framework-for-the-Public-Wa.pdf](#)

<sup>3</sup> Specifically, Article 9 requires water pricing to "take account of the principle of recovery of the costs of water services, including environmental and resource costs, (...), and in accordance in particular with the polluter pays principle"; and "that water-pricing policies provide adequate incentives for users to use water resources efficiently."

<sup>4</sup> For example, Ofwat assesses companies' financial resilience drawing on Rating Agencies' credit rating methodologies. These include ratios such as regulatory gearing; funds from operations/ net debt; adjusted interest coverage ratio. See for example, Ofwat (2024) Monitoring Financial Resilience Report 2023-24. Link: <https://www.ofwat.gov.uk/wp-content/uploads/2024/11/Monitoring-Financial-Resilience-Report-2023-24.pdf>

By applying a WACC, UÉ receives an equity return allowance despite the lack of any equity return expectation or dividend requirement. As mentioned above, the resulting excess funding for UÉ's actual financing costs is re-invested and covers part of its capital programme.

Despite the absence of any requirement for an equity return on UÉ's capital employed, there is an economic rationale for applying a WACC-based return. The capital invested in UÉ represents a use of public funds that could be allocated to alternative public projects or investments that generate returns. There is therefore an implicit cost of capital in allocating these funds to UÉ. The WACC captures this opportunity cost, by reflecting the market based return that would be required to attract funds for similar projects. Using an allowed return below the WACC implies an implicit subsidy to non-domestic customers, who are charged less than the economic cost as the opportunity cost of government funds is not reflected. As a result, setting the allowed return below the WACC risks sending incorrect price signals to non-domestic customers, distorting decisions on the use of water services (e.g., quantities demanded and choice between network connections and self-supply).

There is some precedent for allowing a WACC-based return in the context of state-owned utilities, e.g. Northern Ireland Water.

### **3.1.1. Option 1A: UÉ specific WACC (current approach)**

The current approach to setting the allowed return involves a bottom-up estimation of the WACC applicable to UÉ at each revenue review. At RC3, the CRU decided on a WACC of 3.61 per cent, based on WACC parameter estimates provided by Europe Economics.<sup>5</sup>

While the current WACC-based approach is justified for the reasons set out above, it imposes a relatively high regulatory burden on the CRU. It requires the CRU and UÉ to conduct (or commission) detailed analyses to estimate the various parameters of the WACC, which includes UÉ-specific parameters (e.g., the beta) and macroeconomic parameters (e.g., the equity risk premium). These parameters must be reviewed, consulted on, and justified at each revenue control period. Given the secondary nature of the allowed return in UÉ's overall funding framework, i.e. given that UÉ is publicly owned and a market based return is not essential to raising finance<sup>6</sup>, this level of regulatory effort may not be proportionate.

### **3.1.2. Option 1B: Benchmark WACC approach**

Given the high regulatory burden associated with the current approach, an alternative would be to combine an estimate of UÉ's cost of debt with benchmark parameter estimates for the cost of equity. The cost of debt for UÉ can be determined in a straightforward manner by drawing on the financing terms set by the government (i.e., the yield on the 10-year Ireland government bond plus a fixed 50 basis point margin). For the cost of equity, the CRU could draw on the parameter estimates it determined in its most recent energy network decision. This approach would avoid the need to re-estimate the parameters of the cost of equity at each review.

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<sup>5</sup> CRU/19/148, pp.11&119, available at [link](#).

<sup>6</sup> See section 2.1

The benchmark approach would not perfectly capture UÉ-specific risk factors, which would affect the beta parameter within the cost of equity. It may also not reflect latest market data for the other two parameters that are used to estimate the cost of equity – the risk-free rate (RFR) and total market return (TMR) – given differences in the regulatory timetable between RC4 and the energy network decisions. However, we do not expect these shortcomings to be material; UÉ has a broadly similar risk profile to regulated energy networks, given comparable regulatory frameworks. In addition, in our experience the determination of the TMR remains relatively stable over time given that regulators tend to draw on long-term time-series, and the RFR has a relatively small impact on the overall cost of equity. We therefore consider a benchmark WACC approach a reasonable alternative to the current approach, which avoids the need to estimate a bottom-up at each review.

In Table 3.1, we provide an illustrative estimate of the WACC for RC4 based on this approach. We estimate a cost of debt of 1.27 per cent (real) for UÉ, based on i) the 1-month trailing average nominal yield on the 10-year Ireland sovereign bond (2.79 per cent), ii) deflated by a 2 per cent long-run inflation assumption plus iii) a 50-basis point credit spread, in line with UÉ's current financing terms. We combine this with a cost of equity estimate of 6.07 per cent (real, pre-tax), and a 55 per cent gearing assumption, both based on the CRU's decision for GNI at PC5. We calculate a WACC of 3.69 per cent (real, pre-tax) on this basis, somewhat higher than the CRU's previous WACC at RC3 (3.61 per cent).

**Table 3.1: Illustrative estimate of RC4 WACC under Option 1B**

|                                   | Value | Approach  |
|-----------------------------------|-------|---|
| Cost of debt (real)               | 1.27% | 1-month trailing average yield on 10Y Ireland government bond as at 28 Jan 2025, deflated using 2% inflation based on ECB target plus 50bps credit spread |
| Cost of equity (real, pre-tax)    | 6.07% | Based on CRU PC5 decision, including CRU adjustment to "aim-up" to 67 <sup>th</sup> percentile of estimated range   |
| Gearing                           | 55%   | Based on CRU PC5 decision   |
| WACC (real, pre-tax) <sup>1</sup> | 3.69% | Includes 27bps excess Ireland inflation premium as per PC5 decision   |

Source: NERA analysis of CEPA (30 June 2023), PC5 Allowed Return, and financial market data (Factset). ECB inflation target: <https://www.ecb.europa.eu/mopo/strategy/pricestab/html/index.en.html>

Note: (1) CRU determines a pre-tax WACC in the water and energy sectors which means that regulated networks are compensated for tax via a tax-wedge applied to the post-tax cost of equity allowance. An alternative approach would be to set a post-tax WACC and provide for corporate tax costs as a separate allowance.

In the case that the CRU decides to adopt this approach, we recommend it updates the above estimate closer to the RC4 decision, to reflect latest yield data for the cost of debt and its most recent energy network decision for the cost of equity.

### 3.2. Option 2: Cost of debt

An alternative to a WACC-based approach would be to set the allowed return equal to the cost of debt, on the basis that there is no equity return expectation on UÉ. UÉ's actual cost of capital only consists of the interest cost on the non-domestic government debt.

There is precedent for using the cost of debt as the allowed return in the case of Network Rail in the UK, where the Office of Rail and Road (ORR) adopted this approach in recognition of the company's public ownership and absence of private equity financing.<sup>7</sup>

Adopting a cost of debt-based approach would not fully reflect the opportunity cost of capital of the funds employed in UE's business, which is captured by the WACC. However, it would result in relatively lower non-domestic charges, and a muted increase in charges relative to RC3. As set out in Appendix A, we calculate a lower increase in non-domestic revenues over RC4 under the cost of debt-based options compared to WACC-based option 1B.

There are two options for setting a cost of debt-based allowed return: A notional approach applies an estimate of the cost of debt based on prevailing interest rates to the full RAB, which covers both domestic and non-domestic elements. An actual approach would instead simply pass through UE's actual interest costs, which is the actual interest paid on its non-domestic debt. We discuss these two options below.

### **3.2.1. Option 2A: Notional cost of debt applied to full RAB**

Under the notional approach, the allowed cost of debt would be set based on the debt interest rates set by the government in lending to UÉ (i.e., the prevailing 10-year Irish government bond yield plus 50 basis points). The resulting figure, which we calculate as 1.27 per cent (real) based on yields as of January 2025 (see Table 3.1), would be applied to the full RAB, covering both domestic and non-domestic components.

The rationale for applying the cost of debt to the full RAB, including the domestic portion, is that although there are no actual financing costs on the domestic side, the public funds have an opportunity cost, e.g. could have otherwise been used to reduce government debt. By doing so, the government would have avoided interest payments on that debt, so that the opportunity cost of using those funds is approximated by the cost of debt.

The notional cost of debt approach would impose a relatively low regulatory burden on the CRU. The current WACC estimation process would be replaced by a simpler calculation involving current Irish sovereign yields and the fixed financing spread. No changes to the existing revenue model would be required.

However, the notional cost of debt approach would not reflect the market-based opportunity cost of capital of the equity financed portion of the RAB and therefore sends weaker price signals to non-domestic customers.

Based on our illustrative calculations set out in Appendix A, we estimate that Option 2A would result in a real increase in non-domestic revenues of 64 per cent over RC4 relative to RC3 (based on UE's RC4 cost submissions), which is significantly lower than under Option 1B (91 per cent). Conversely the Exchequer funding requirement would increase relative to Option 1B, due to lower allowed revenues and therefore a larger funding gap. Based on our illustrative modelling we estimate a EUR 0.3bn additional debt required for non-domestic capital programme under this option relative to 1B, given the lower amounts recovered from non-domestic charges.

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<sup>7</sup> PR23 final determination – financial framework. Available at [link](#).

### 3.2.2. Option 2B: Actual cost of debt

An alternative cost of debt-based approach would be to allow for a pass-through of UÉ's actual financing costs - that is, the actual interest costs incurred on its non-domestic government debt.

The rationale for this approach is that it compensates UÉ for its actual, accounting-based cost of debt. The approach has precedent from the current approach for Network Rail in the UK, where the ORR does not provide an ex-ante return allowance but allows for a pass-through of Network Rail's interest costs.<sup>8</sup>

The actual cost of debt approach does not reflect any opportunity cost of capital associated with the equity financed portion of the RAB and therefore sends relatively poor price signals to non-domestic customers.

An additional downside of the actual cost of debt approach is that it provides weaker financial resilience. Unlike the other approaches considered, the allowed return would include no headroom relative to actual financing costs and therefore weaker credit metrics and risks to meeting operating and debt financing obligations in the event of revenue or cost shocks.

This approach results in the lowest non-domestic customer charge and in turn the lowest customer contribution to fund capex, and risks therefore to the capex programme in the absence of further government funding.

NewERA estimates that Uisce Éireann's financing costs over RC4 will be approximately €19 million per annum (nominal).<sup>9</sup> Based on this estimate, we calculate a real increase in non-domestic charges of 51 per cent compared to RC3 levels under this option and based on UÉ's cost submissions (see Appendix A), which is significantly lower than under Option 1B (91 per cent). At the same time, the actual cost of debt pass-through would result in the highest Exchequer funding requirement among the different options considered. As shown in Appendix A, we calculate an additional EUR 0.4bn additional debt is required to maintain the RC4 proposed capex programme.

## 3.3. Other options

In the context of a state-owned utility, there are alternative approaches to set the allowed return that depart from the traditional cost of capital framework. These include the financial tramlines approach adopted by the Water Industry Commission for Scotland (WICS) for Scottish Water, which focuses on maintaining financial viability within set parameters rather than estimating a return on capital. Another option is the use of a Social Discount Rate (SDR), which is applied in the context of public sector investment appraisal.

### 3.3.1. Option 3: Financial tramlines (Scottish Water)

For Scottish Water, the WICS does not set an explicit allowed return but uses a financial tramlines approach. Under this approach, it sets upper and lower bounds for key credit ratios - such as the cash interest cover ratio and funds from operations (FFO) to debt ratio. If Scottish Water's financial

<sup>8</sup> Network Rail is transitioning to a fully grant funded model but is allowed to pass-through interest costs on legacy debt. See PR23 final determination – financial framework. Available at [link](#).

<sup>9</sup> We understand that this assumes no additional debt financing over RC4 relative to current levels.

position moves outside these bounds, customer charges are adjusted. For example, if the utility accumulates excessive cash reserves, charges may be reduced; conversely, if it approaches financial stress (i.e., breaches the lower tramline), charges may be increased to restore financial stability.<sup>10</sup>

WICS has replaced its previous WACC-based approach on the basis that Scottish Water, as a publicly owned utility with no private equity investors, does not strictly require a conventional return on capital. Instead, the regulatory focus of the WICS is on ensuring financial viability and charges responding quickly to changes in financial performance.<sup>11</sup>

Applying a similar approach to UÉ would remove the need to estimate a WACC. However, it would still put a relatively high regulatory burden on the CRU and UÉ, as it would require implementing the new framework, including identifying appropriate financial metrics and thresholds for UÉ, modifying the revenue model, and familiarising stakeholders with the approach.

Whether the tramline approach in fully cost-reflective price signals, including an appropriate reflection of the opportunity cost of capital, depends on how the tramlines are calibrated. However, it is unlikely to reflect a market-based opportunity cost on the equity financed portion of the RAB, as the primary focus is on debt coverage ratios rather than equity return benchmarks.

The tramlines approach would likely result in lower non-domestic charges than a full WACC-based model, though the exact effect would depend on the specific calibration of the tramlines.

### 3.3.2. Option 4: Social Discount Rate (SDR)

Under the Public Spending Code, a Social Discount Rate (SDR) is applied to appraise public projects.<sup>12</sup> The SDR reflects society's time preference for benefits and costs – i.e., the value placed on present versus future benefits – and is intended to guide efficient allocation of public funds. It reflects a “social hurdle rate”, which is the minimum rate of social return including all social costs and benefits a government project must achieve to be considered a good use of public funds.

Given that UÉ is a fully state-owned utility, with its capital programme funded by the Exchequer, this investment can be viewed in the same way as funding for other public projects. On this basis, it could be argued that the SDR provides an appropriate benchmark for the return on public funds committed to the business.

The regulatory burden associated with adopting an SDR would be low. There would be no need to estimate a WACC or cost of debt; instead, the allowed return would be set directly based on the SDR published by the government.

However, using an SDR may not necessarily result in cost reflective charges, as it functions as a social hurdle rate for evaluating public investments, rather than a measure of the return required by investors or reflective of financial risk. Applying the SDR as an allowed return may therefore over- or understate the true economic cost of capital faced by UÉ.

<sup>10</sup> WICS, Customer Forum Note 7 – Financial Tramlines, pp.24-25, available at [link](#).

<sup>11</sup> WICS, Customer Forum Note 7 – Financial Tramlines, p.23, available at [link](#).

<sup>12</sup> [<https://www.gov.ie/en/department-of-public-expenditure-ndp-delivery-and-reform/policy-information/project-evaluationappraisal-applicable-rates/>]

The current SDR set by the government is 4 per cent (real), which is higher than the WACC at RC3 (3.61 per cent) and our estimate of the RC4 WACC under Option 1B (3.69 per cent). Applying the SDR would therefore result in the highest non-domestic charges of all the options considered, which may be difficult for stakeholders to accept, particularly in the current context where the WACC itself may overcompensates UÉ for its actual financing costs.

### 3.4. Summary and Recommendations

Table 3.1 summarises our relative evaluation of the different options for setting UÉ's allowed return.

As shown:

- The bottom-up WACC approach (Option 1A) and the financial tramlines approach (Option 3) would place a relatively high regulatory burden on the CRU, without offering clear advantages over other options across our assessment criteria. We therefore do not prefer these approaches.
- The use of a Social Discount Rate (Option 4) would lead to higher non-domestic charges than a WACC-based approach, without providing clear economic or regulatory benefits. For this reason, we also do not prefer this option.
- The actual cost of debt pass-through approach (Option 2B) imposes a relatively low regulatory burden but provides weak price signals to non-domestic users, making it the least likely of the options considered to align with Article 9 of the Water Framework Directive (WFD). It also results in the highest Exchequer funding requirement and weaker financial resilience.

On balance, our evaluation supports two possible approaches: the WACC approach (Option 1B) and the notional cost of debt approach (Option 2A). From an economic perspective, the WACC-based approach is preferred as it promotes cost recovery and is more likely to lead to cost-reflective pricing for non-domestic customers, and minimises dependency on government debt financing of the non-domestic capex programme. It also provides headroom to promote financial resilience.

By contrast, the notional cost of debt approach sends only partially correct price signals as it does not reflect any equity-related opportunity cost but does allow for an opportunity cost based on government debt cost. The resulting lower non-domestic charges means greater dependency on government debt financing with the risk that the capital programme is constrained, in the event of constrained government funding.

**Table 3.2: Our evaluation supports Option 1B (“benchmark WACC”) or Option A2 (“notional COD applied to full RAB”)**

| Option                                       | Regulatory burden   | Cost recovery / Article 9 compliance   | Non-domestic charges                       | Exchequer funding dependency       | Financial resilience  |
|--|---|--|--|------------------------------------|---|
| <b>1A – Bottom-up WACC</b>                   | Need to estimate WACC at each review                                | Non-domestic charges reflect opportunity cost of capital and are fully cost reflective. Efficient price signals to non-dom. users              | Relatively higher charges                  | Relatively lower                   | Financial resilience issues unlikely (allowed return exceeds actual financing costs and debt requirement is relatively lower) |
| <b>1B – Benchmark WACC</b>                   | Use recent CRU energy network COE decision instead of re-estimation | As above   | Relatively higher charges (see Appendix A) | Relatively lower (see Appendix A)  | As above  |
| <b>2A – Notional COD applied to full RAB</b> | Adopt current 10Y bond yield + 50bps                                | Does not reflect market-based opportunity cost of capital of equity financed portion of RAB. Partially correct price signals to non-dom. users | Relatively lower charges (see Appendix A)  | Relatively lower (see Appendix A)  | Financial resilience issues possible (allowed return still exceeds actual financing costs but less headroom than under 1A/1B) |
| <b>2B – Actual COD</b>                       | Pass-through of actual cost of debt                                 | No opportunity cost reflected on non-domestic equity financed portion of RAB. Poor price signals to non-dom. users                             | Relatively lower charges (see Appendix A)  | Relatively higher (see Appendix A) | Financial resilience issues more likely (no headroom relative to actual financing costs)                                      |
| <b>3 – Tramlines</b>                         | Need to implement new framework                                     | As for Option 2A   | Relatively lower charges                   | Relatively lower                   | Resilience implied by the mechanism, although depends on calibration  |
| <b>4 – Social Discount Rate (SDR)</b>        | Use current SDR   | Reflects societal time preference, which may not reflect market-based opportunity cost of capital. Partially correct price signals             | Relatively higher charges                  | Relatively lower                   | Financial resilience issues unlikely (allowed return exceeds actual financing costs and debt requirement is relatively lower) |

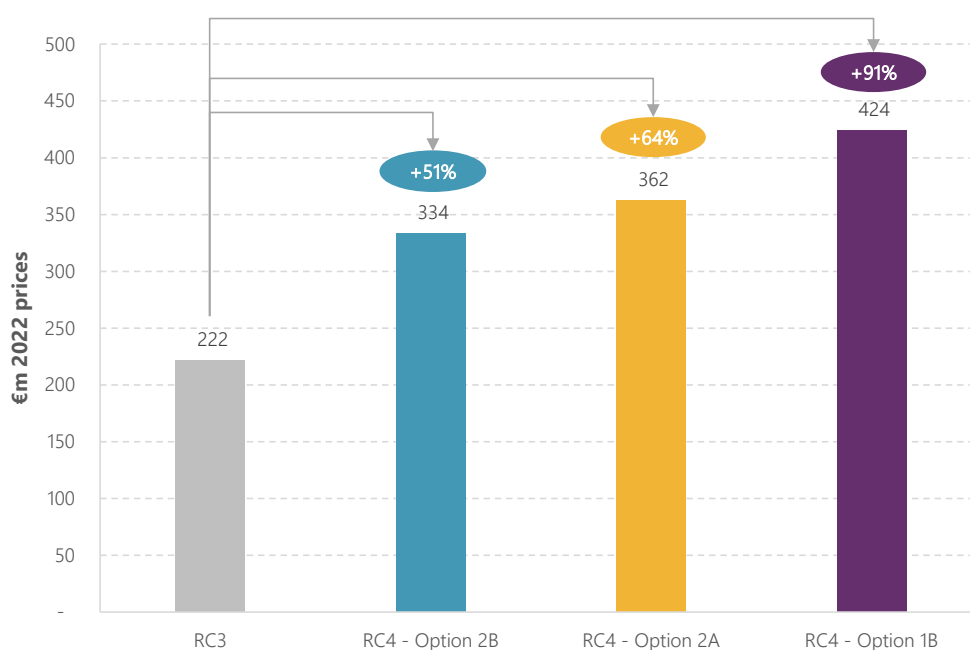
Note: Green = relatively favourable, red = relatively unfavourable, amber = mixed/moderate.

## Appendix A. Impact on non-domestic charges and Exchequer funding

We have modelled the impact of adopting a WACC-based approach (Option 1B), and cost of debt based approaches (Options 2A and 2B) on non-domestic revenues and required Exchequer funding. Our modelling is based on the RC4 revenue model as populated by UÉ as part of its RC4 submissions (i.e., before any adjustments decided by the CRU) and incorporates a number of simplifying assumptions.<sup>13</sup> Our analysis is therefore illustrative and undertaken to demonstrate the likely difference in non-domestic revenues and required funding between options, rather than exact absolute levels.

Figure 4.1 shows the increase in average annual non-domestic revenues in RC4 over RC3 under the three different allowed return options. As shown, we calculate that the WACC-based approach (Option 1B) results in a 91 per cent increase in non-domestic revenues, which is significantly higher than under the cost of debt-based approaches, under which non-domestic revenues increase by 51 per cent (Option 2B) and 64 per cent (Option 2A) in real terms.

**Figure 4.1: Increase in average annual non-domestic revenues under different allowed return options**



Source: NERA analysis of UÉ populated RC4 revenue model (240913 RC4 Revenue Model Incl K-Factor Detail - NERA - UÉ Response v2.xlsx)

<sup>13</sup> Specifically: i) We calculate UE’s tax liability, which influences its Exchequer funding requirement, on a notional basis by applying the corporate tax rate of 12.5 per cent to notional profit (i.e., allowed revenues minus allowed opex, allowed depreciation, and financing costs of EUR 19m p.a., as estimated by NewERA); ii) We assume that non-domestic revenues account for a fixed 24 per cent of total revenues in each year, based on instructions from the CRU; iii) we apply the same 24 per cent to allocate the funding gap between non-domestic (i.e., debt financing) and domestic (i.e., equity contribution).

In Table 4.2, we set out the estimated Exchequer funding requirement under the different allowed return options. As shown, we estimate that Option 2B results in a EUR 0.5bn higher Exchequer funding requirement than Option 2A,<sup>14</sup> and a EUR 1.7bn higher funding requirement than Option 1B.

**Table 4.3: Impact of allowed return options on Exchequer funding requirement over RC4 (EUR bn, 2022 real prices)**

|  | <b>Option 1B<br/>(Benchmark WACC)</b> | <b>Option 2A<br/>(Notional COD<br/>applied to full<br/>RAB)</b> | <b>Option 2B (Actual<br/>COD)</b> |
|--|---------------------------------------|---|-----------------------------------|
| Total revenue                                  | 8.8                                   | 7.6   | 7.0                               |
| Revenue available to fund capex <sup>1)</sup>  | 3.3                                   | 2.1   | 1.6                               |
| Capex  | 8.6                                   | 8.6   | 8.6                               |
| <b>Funding gap<sup>2)</sup></b>                | <b>5.3</b>                            | <b>6.4</b>  | <b>7.0</b>                        |
| Loan requirement                               | 1.3                                   | 1.5   | 1.7                               |
| Equity requirement                             | 4.0                                   | 4.9   | 5.3                               |
| <b>Total funding requirement for<br/>capex</b> | <b>5.3</b>                            | <b>6.4</b>  | <b>7.0</b>                        |

Note: 1) Calculated as total allowed revenue minus allowed opex, interest and tax; 2) Funding gap calculated as capex minus revenue available to fund capex; 3) Assuming 24% of funding gap is allocated to non-domestic and therefore covered by loan

Source: NERA analysis of UÉ populated RC4 revenue model (240913 RC4 Revenue Model Incl K-Factor Detail - NERA - UÉ Response v2.xlsx)

<sup>14</sup> The difference to the figure implied by the totals in the table is due to rounding.



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