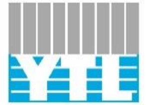

Kirstin Baker
Panel chair – NATS En route Ltd appeal
Competition and Markets Authority
By email

Direct line: [redacted]
Email: [redacted]

Date: 15th April 2020

Dear Kirstin

Response to the provisional findings for the NATS En route Ltd price determination

Wessex Water is an appointed water and sewerage undertaker, serving customers with water and sewerage services in Somerset, Dorset and Wiltshire. We also provide sewerage services for the conurbations of Bristol and Bournemouth.

Our previous contribution to this price determination appeal was a report on the cost of equity authored by Professor Gregory (commissioned with Anglian and Northumbrian Water). We are grateful for this opportunity to comment on the CMA's provisional findings and again we limit our comments to the assessment of the appropriate cost of equity as this has the most immediate relevance to our own business.

Background

The CMA's redetermination for NATS En-route Ltd (NERL) uses very similar estimates for total market return (TMR) and the risk-free rate (RFR) to Ofwat's PR19 determination in the water sector. We were able to accept our 2019 price determination in the round, but we made Ofwat aware of our concerns about the cost of equity estimation at the point of acceptance.

It is clear to us that the CMA panel has considered its estimate of the allowed cost of capital very carefully in the provisional findings. Wessex Water remains concerned however about the substantial reduction in the cost of equity that regulators are allowing now compared to those of just four or five years ago, and the potential long-term impact that this could have for consumers of essential services.

Our understanding is that the great majority of the reductions have occurred not because market data has changed over that time, but because the same data has been reanalysed and reinterpreted[1].

[1] A KPMG analysis (Published as part of Anglian Water's recent statement of case to the CMA) suggests that c.1.5% of the reduction in Ofwat's allowed cost of equity from PR14 to PR19 comes from changes in methodology. This is more than 60% of the total reduction.

Consumers deserve value for money and investors should not expect to be over-compensated if new evidence and/or empirical analysis points to a lower prevailing cost of equity. However, the investors regulated sectors wish to attract will typically invest for periods of 10 to 15 years or more, and therefore in our view:

- the evidence for such a substantial shift should be very strong

- we should be confident that the resulting allowances will be sufficient for the period of the price control, taking into account the risk of short-term market distortions and volatility impacting that analysis.

Without this, the potential resulting increase in non-diversifiable risk will be to consumers' detriment in the long run and, in the case of an underestimate being made, will compromise the ability of utilities to finance important improvements in long-term resilience.

Regulatory stability and certainty therefore has value in and of itself to consumers and so care should be taken when incorporating new evidence or reinterpreting existing evidence to avoid undue volatility or uncertainty in regulatory decisions. The comments we make on the key inputs to the assessed cost of equity in the next sections are made with this principle in mind.

Risk Free Rate (RFR)

The estimate of -2.25% real RPI made for the provisional findings is based on current UK market data on Gilt yields (-2.40%) and includes an adjustment of 15bp to account for expected increases in interest rates over the price control period. The draft decision takes the spot rate on the 28th of February cross-checked with a three-month average and a six-month average.

To us, the continued wide divergence of expert views on the appropriate estimate to use for the RFR is troubling and suggests that the evidence is not clear cut[2].

As price controls set the allowed risk-free rate for a period of five years they need to consider the forward-looking expectations of investors across that period. We therefore draw your attention to the following:

- The six-month period covered in the provisional findings analysis encompassed significant market volatility in the UK, in particular the potential consequences of a no-deal Brexit. We therefore think the use solely of a UK estimate (without for instance assessing US TIPS as an alternative risk-free opportunity for investors) increases the risk of an error being made in the forward five-year estimate.

- The use exclusively of index-linked bonds to assess the risk-free rate also increases the risk that a single market distortion in the data leads to an error in the estimate, unless investors in RPI index-linked bonds can be shown to be equally attracted to utilities and will remain so when their cashflows and valuations are now increasingly diverging from RPI.

Our recommendation therefore is that the RFR estimate takes greater account of long-run equilibrium measures and continues to place some weight on alternative calculations of the RFR, for instance by placing some weight on values calculated from nominal gilt yields.

Alternatively, if the evidence can be shown to be sufficiently strong for a narrower evidence base to now be used, then indexing the risk-free rate allowance against movements in the data might be an alternative means of reducing the impact of volatility in those values. Indexation of the cost of equity has not yet been fully adopted in any of the UK regulated sectors and the mechanics would need careful thought.

---

[2] We note that KPMG's and Economic Insight's calculated ranges for the RFR on a nominal basis (as published in April 2020 by Bristol Water) are +1.46% to +2.18% and +0.72% to +1.20% respectively.

Total Market Return (TMR)

We note that the biggest reductions in the TMR since the CMA last determined on the cost of capital have come about because:

- the range under consideration has narrowed, with +6.0% being considered the top-end estimate compared to +6.5% previously

- the CMA has used a figure at the middle of the range rather than the top of the range.

The use of a figure in the middle of the range should in our view imply both that:

- the negative consequences of under-estimating the TMR is this context are not a worse outcome than over-estimating it

- the evidence for a lower number in the range is as strong as the evidence for a higher number in the range.

We do not repeat here the long-rehearsed and well-understood arguments about the negative consequences of under-investment in an essential service provision.

On the latter point however, given that this continues to be a subject of ongoing expert debate and analysis, it is perhaps surprising that the range has both narrowed and that the weight placed on lower-end estimates has appeared to increase compared to previous determinations.

In terms of the evidence base, the choice of the mid-point of the range (5.5%) implies that most weight has been placed on the lowest of the CPI-based estimates given that:

- the CPI estimates themselves on average produce a figure somewhat above 5.5%

- the decision states that some weight was also placed on RPI-based estimates of TMR, which give higher figures for the TMR.

In this context it should be clear that the evidence is strongest for the estimates of calculating CPI deflated TMRs that have had most weight attached to them. If this evidence is not compelling our view is that it would be better that less weight was applied to these estimates and a higher point estimate adopted.

Equity Risk Premium (ERP)

The ERP is a simple function of the TMR and the RFR. What is of note in the provisional findings (and in the recent Ofwat determination) is that the ERP has been stretched-out by the adoption of a much lower RFR.

The consequence of this under the standard CAPM formulation is that the adopted level of gearing (absent changes to the level of debt beta) now has a far more significant consequences for the allowed cost of capital. In the particular example of the NATS determination this has led to the CMA calculating the WACC based on a level of gearing (30%) much lower than that used by the CAA or NATS.

Going forward, this may lead sector regulators to review their approach to gearing. Our observation here is that the debate itself appears to be a consequence of the apparent stretched nature of the current CAPM inputs. We think it is worth considering that this may be more related to current market distortions, particularly in the UK, and/or the narrower set of metrics used, rather than a consequence of economic fundamentals.

Summary

It is clear to us that the CMA has considered its estimate of each of the constituent parts of the allowed cost of capital very carefully in the provisional findings. Nothing in this response should be taken to imply that we consider that new evidence and empirical analysis should be ignored.

Our concern is however that the resulting material reduction in the cost of equity allowance may rely too heavily on a narrower range of evidence. In particular:

- the use solely of UK index-linked bonds to assess the risk-free rate
- the greater weighting applied on the lowest estimates of the TMR assessed on a CED/CPI basis.

This narrower evidence range increases the risk that the resulting allowance will prove insufficient to attract much needed investment in the post-Brexit uncertain environment. The recent equity market turmoil has served as a useful reminder that short-term equity valuation and risk appetite can change significantly, so much so that all the market indications that regulators have believed to be clear signs of lower forward looking expected equity returns can vanish and show opposite signs within a matter of weeks and days. It is therefore prudent for regulators not to take cues from short-term phenomena and focus more on a stable long-term regime.

Our preferred solution to this would be for the CMA to place greater weight on alternative calculations of the inputs when considering its point estimates, including long-run equilibrium measures. This is likely to result in a cost of equity allowance that is higher than the middle of the provisional range.

I hope this is helpful. Do please get in touch if we can be of any further assistance.

Yours sincerely

Phil Wickens
Director of regulation & reform