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Dear Juliette,

Ofwat price determinations appeals

This submission is completely non-confidential and may be published on your website. This is our initial submission to the CMA on this appeal, and does not include our comments on other parties' submissions, and in particular on Ofwat's responses to the Statement of Cases published on 4th May. We will be providing additional comments in a further submission.

Citizens Advice has statutory responsibilities for representing energy and post consumers in Great Britain, and we also advocate and provide advice for consumers on cross-cutting issues. We are responding to the Ofwat price determinations appeals for two reasons: firstly because of the importance of water to consumers, and secondly because the CMA's decision on these appeals will set an important precedent for other sectors (such as energy).[1]

Water and sewerage are essential services, provided by privatised monopoly companies, so consumers rely on the regulator (Ofwat) to set costs at an efficient level. In setting the price determination for PR19 Ofwat identified affordability as a key issue for consumers. We have seen this in the data we get from advising clients. Within the last 12 months, Citizens Advice have

[1] Indeed, the CAA clearly state (Document: CAP 1857, RP3 reference CAA document 002, p29) that in setting the WACC for RP3 they referred to recent consultations and determinations from other UK regulators, including Ofwat, Ofcom and Ofgem, as well as the cost of equity study by Professor Wright et al. for the UK Regulators Network (UKRN).

advised over 74,000 people in person, by phone or by email about water supply and sewerage debts, and helped over 220,000 people with advice through our website. Dealing with debt repayments is consistently the biggest issue that consumers speak to us about, we receive between 2000-4000 enquiries about this a month. Households with water supply and sewerage debt may also have other overlapping issues. 61% of people we advise who have water supply and sewerage debt also have council tax arrears, 34% have fuel debts and 20% have rental arrears. This indicates that there are wider affordability issues.

There are 8 key issues that we have identified in our initial submission:

1. **The overall objective of the price controls**

   Water companies' arguments that a rebalancing of regulatory responsibilities is needed are not justified, these arguments are an attempt to secure higher returns for shareholders.

2. **Regulatory precedent and consistency**

   Ofwat's welcome step change in approach in no way departs from the regulatory principle of consistency, this change has been made in consumers' interests.

3. **Allowed rate of return**

   We ask the CMA to consider how best to ensure that total market return forecasts reflect actual investor expectations so as to ensure shareholders do not earn higher than required returns.

4. **Use of consumer evidence in Ofwat's determination**

   We are concerned that some of the appealing water companies are misrepresenting consumer evidence to claim that consumer interests would be best served by setting higher prices for a better level of service.

5. **Financeability**

   The notion that Ofwat's determinations mean that the companies cannot efficiently finance their activities is not credible, and is at odds with all evidence from the financial markets.

6. **Outperformance**

   We ask the CMA to explicitly consider how regulators should ensure that previous high levels of financial outperformance are not repeated.

7. **Incentives**

The fact that 13 of the 17 water companies have accepted Ofwat's approach provides compelling evidence that the overall approach is reasonable.

8. The impact of Covid-19

The economic impact of Covid-19 has highlighted the need for a step-change in the regulatory regime to ensure that shareholders do not profit unnecessarily at the expense of consumers.

Citizens Advice initial submission to Water Price Determinations

This preliminary submission sets out our thoughts on eight key areas which we ask the CMA to consider in its determination:

1. The overall objective of the price controls
2. Regulatory precedent and consistency
3. Allowed rate of return
4. Use of consumer evidence in Ofwat's determination
5. Financeability
6. Outperformance
7. Incentives
8. The impact of Covid-19

1. Price control objectives

The CMA's decision should consider how Ofwat's statutory duties (set out in the Water Industry Act) and the objectives set for Ofwat in the Government's Specific Policy Statement[2] for water should be interpreted and reflected in price controls.

Ofwat's statutory duties include:

- **protecting the interests of consumers**
- ensuring water companies **carry out their responsibilities** set out in their license **in an economic and efficient manner**
- ensuring that water companies can (by earning reasonable returns on their capital) **finance their activities**
- ensuring the long-term **resilience** of companies' systems in the long term and meeting the long-term need for water supplies and wastewater services.

Debates on price controls, including arguments made in these appeals by the companies, often refer to conflicting regulatory objectives or duties and the need to prioritise or balance one objective over another. We think it is important to consider two key issues.

[2] https://www.gov.uk/government/publications/strategic-policy-statement-to-ofwat-incorporating-social-and-environmental-guidance

Firstly, We agree with Ofwat that *"the [statutory] duties are not mutually exclusive*", [3] or contradictory. This is because all of Ofwat's duties can be achieved through its standard 'building block approach of separately assessing each of the costs the companies are allowed to recover:

- Efficient levels of opex capex and depreciation to provide the required service levels and resilience,
- Asset life assumptions for calculating depreciation,
- The **minimum** level of return on capital required by investors.

Revenues and hence prices are then calculated to enable the company to recover its costs and a return on capital. Once those cost elements are determined, all Ofwat's duties can be met **without conflict**:

- Consumers' interests are served – prices are as low as possible for the required service levels,
- The companies can recover efficient levels of costs,
- The companies can finance their activities by paying a sufficient return to investors to enable the companies to finance their activities.

Any arguments which are framed as tensions between regulatory duties and objectives are therefore unjustified. Of course, there are disagreements around what each of those cost elements should be, but these should be assessed on their merits, not in the context of reconciling conflicting objectives.

Secondly, any arguments which are incorrectly framed as tensions between regulatory duties and objectives are unhelpful as they only serve to mask a far more important conflict the regulator faces in setting prices. This is the conflict between the objective of the company (and its shareholders in particular) to maximise prices and thus profits and the objective of consumers who desire an efficient level of prices for a good level of an essential service.Allowing companies to recover higher levels of costs or capex, or a higher rate of allowed return will not necessarily lead to better levels of service, or lower prices for consumers; it is much more likely to simply lead to higher returns to shareholders. We agree with Ofwat that:

[3] Ofwat, *Reference of the PR19 final determinations: Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case,* paragraph 3.14.

"the companies' real complaint is simply that Ofwat's funding was less generous than they would like. They seek to frame this argument by stating it in the language of the statutory duties. But in reality there is no legal point to be made."[4]

Taking a balanced view

In contrast with the need to balance regulatory duties, where there is no need to reconcile competing objectives, we do agree that there is a case for taking a balanced view in specific areas of uncertainty or subjectivity where there is no correcting ex post adjustment.

In their submission to the CMA, Ofwat argue that:

"the disputing companies do not have an incentive to draw attention to instances where Ofwat may have made generous decisions. On the contrary, the four companies will have raised issues in their statements of case on a selective, rather than comprehensive, basis. …the redetermination process is not a facility for referring on specific issues, but one in which companies receive a full redetermination of their respective price controls."[5]

We agree with Ofwat on this point. In its redeterminations, we would therefore urge the CMA to take a balanced approach to its work with a similar amount of effort assessing those areas where Ofwat may have been unnecessarily favourable to the companies as those areas (identified by the appealing companies) where its approach may have been unfavourable. This particularly applies to the calculation of the allowed rate of return and financeability assessment.

In addition, the Government's SPS[6] which came into force in November 2017 required Ofwat to challenge the water sector to plan, invest and operate to meet the needs of current and future customers, in a way which offers the best value for money over the long-term. It is important that in its determinations in PR19 that Ofwat strikes an appropriate balance between the needs of future and current consumers. But that does not automatically

[4] Ofwat, *Reference of the PR19 final determinations: Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case,* paragraph 3.43.

[5] Ofwat Reference-of-the-PR19-final-determinations-Introduction-and-overall-stretch on costs and outcomes – response to cross-cutting issues in companies statements of case, paragraph1.9

[6] https://www.gov.uk/government/publications/strategic-policy-statement-to-ofwat-incorporating-social-and-environmental-guidance

translate into higher bills for consumers. We agree with Ofwat's statement in their submission that

> *"It is a false dichotomy to suggest that the choices available to Ofwat (and now, therefore, to the CMA) are between achieving short-term savings and delivering long-term investment. Challenging companies to demonstrate that their proposed expenditure is efficient is intrinsic to our primary statutory duties. Nothing in the resilience objective relieves the companies of the requirement to demonstrate such efficiency, or offers a blank cheque for future expenditure. It can also safely be assumed that no customer wants to pay for inefficiency".*[7]

It is also vital that it sets a framework that meets the policy goals of water security and net-zero carbon. We think Ofwat have set good foundations in PR19, although we note that others have raised concerns about the effectiveness of long-term incentives.[8] We are not commenting specifically on this part of the framework but is it crucial in our view that the cost of capital is not conflated with the need to fund and incentivise valuable innovation. We do not agree that a higher cost of capital is required for innovation, and where innovation is riskier, or investment is highly anticipatory it is in consumers' interests to use separate mechanisms to do this within the price control structure.

2. Regulatory precedent and consistency

The appealing water companies have argued that Ofwat has unfairly changed their methodology since PR14, and done so in a way that fails to apply the regulatory principle of consistency.

The Water Industry Act requires Ofwat to apply the principles of regulatory best practice of transparency, accountability, proportionality, consistency and targeting.[9] The meaning of regulatory consistency is set out in the UK Government's document, Principles for Economic Regulation.[10] This document explains that the principle of consistency is relevant because it can support consumer interests:

"Coherent, adaptable but stable regulation:

[7] Ofwat Reference-of-the-PR19-final-determinations-Introduction-and-overall-stretch *on costs and outcomes – response to cross-cutting issues in companies' statements of case,* paragraph 2.26.
[8] https://www.ofwat.gov.uk/wp-content/uploads/2019/07/Ofwat-innovation-response-Sustainability-First.pdf
[9] Water Industry Act 1991 Part 1 Section 2 Para 2(4)
[10] Principles of Economic Regulation, Department for Business Innovation & Skills, April 2011

"Efficient investment is an important part of promoting the long-term interests of consumers. It is important that the regulatory frameworks avoid adding undue uncertainty to the business environment

To a large extent this is achieved by building a stable and transparent regulatory environment with a long track record of consistent regulatory decision making."[11]

The context of this definition is not at the detailed level of price control methodologies cited by the companies[12] but at the level of government policy and overall regulatory framework:

"A balance needs to be struck between the principles of predictability, adaptability and coherence. In order to maximise the benefits from a stable regulatory system Government should offer a credible commitment to restrain itself, as strategic visions should not be changed too frequently and should be updated according to a pre-announced calendar."[13]

We agree with Ofwat's comments in its submission to the CMA on this point:

"We consider that, far from being a breach of regulatory best practice, the fact that we have developed our approach and thinking to reflect the lessons learned from PR14, our consultations through PR19 and the evolving issues for the sector is plainly a strength of our decision-making, and a reflection of our experience and specialist understanding of the sector. For Anglian Water to suggest otherwise is wholly without merit. Regulatory certainty does not require matters to be fixed for all time, and whilst there is a balance to be struck between certainty and flexibility, Ofwat is right to learn from experience and adapt accordingly"[14]

In its submission, Ofwat has explained why it considered a "step-change" in its approach to be necessary:[15]

- The corporate behaviour of water companies has been a cause for concern. This includes the:
    - The adoption of highly geared financial structures

[11] Ibid paragraph 25-26.
[12] Anglia Water argue Ofwat has been inconsistent "in its approach to WACC assumptions, *assessment* of cost allowances (including its assessment of leakage, growth and future productivity), efficiency assumptions and ODIs" Anglia Water PR19 CMA Redetermination Statement of Case , 2 April 2020, Para 464
[13] Ibid paragraph 28
[14] Ofwat, Reference of the PR19 final determinations: Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case, May 2020, paragraph 3.21
[15] Ofwat *Reference of the PR19 final determinations: Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case,* May 2020, paragraphs 2.7 -2.10

    - Payment of high dividends and loans from regulated companies to shareholders
    - Service failure and misreporting
- Critical independent reviews of the regulators' repeatedly setting over-generous review resulting in investors earning excess returns and customers paying higher bills than necessary
- Stagnating company performance
- On average, historical out-performance of cost allowances

We think Ofwat is right to reflect on these matters and to have concluded that a step-change was necessary. In our view regulatory consistency should not prevent a regulator from changing its approach to better meet its duties - consistency is only relevant where it supports those duties.

3. Allowed rate of return

In this section we provide comments on past levels of returns earned by the water companies and the use of historical returns in estimating Total Market Returns input to the cost of capital calculation.

We will provide further comments on detailed aspects of the calculation of the allowed rate of return in our next submission.

Water companies' past performance

As discussed in section 1 above, Ofwat is required to ensure that companies can make a reasonable return on their capital. It is in consumers' interests for that level of return to be as low as possible, whilst ensuring that efficient operated and financed companies can provide the required level of service.

Historically, regulators have set price controls which have ended up benefiting shareholders over consumers. We have quantified the extent that consumers have overpaid for water in our Monopoly Money analysis which we estimate as £11bn over the last 15 years.[16]

The appealing water companies seek to argue that there has not been historical outperformance of price controls. Any suggestion that water companies, as a group, have in some way 'under-performed' financially in the past is misplaced. All independent analyses and commentators agree on this point.

[16] https://www.citizensadvice.org.uk/Global/CitizensAdvice/Consumer%20publications/Monopoly%20Money%20-%20How%20consumers%20overpaid%20by%20billions.pdf

Ofwat and the press have characterised the PR19 price controls as “tough”, better reflecting the real market cost of capital and setting rates of return that are much better in line with markets.

We agree that there was a need for Ofwat to get tougher, especially given that some appealing water companies were making double digit returns, and set allowed rates of return more in line with what the market requires for a very low-risk monopoly essential service. We agree that Ofwat should incentivise companies with financial rewards if they can demonstrate exceptional levels of service and innovation, but consumers should not be paying over the odds for a reasonable level of performance, and shareholders should face downsides for under-performance – as they would in a competitive market.

Ofwat’s structure of incentives and penalties seeks to provide, in part at least, the correcting price and profit signals that would be seen in a competitive market. However, it is important that these are balanced – and historical levels of out-performance indicates that this has not been the case and that, in short Ofwat has been too generous in the past. We discuss outperformance further in Section 6.

Finally we note that whilst we support the overall level of allowed returns in the price controls, there are individual assumptions where Ofwat has arguably been generous to the companies – and these should be considered in the CMA’s review, alongside the specific topics challenged by the companies. We will provide more detail on these areas in our later submission.

Total Market Return (TMR)

The huge amount of detailed analysis and arguments around measuring historical TMR for use in price controls of the allowed rate of return provides an unhelpful distraction from a fundamental problem in its use. This is that the conceptual CAPM framework on which the calculation of the allowed rate of return is based requires the TMR to reflect the forecast level of return which investors require in the market today to invest (or the ‘expected’ level of return).

The use of historical rates of returns as a proxy for investors’ required rates of return is well established in the UK. However, it is critical not to lose sight of the fact that the measure is only a proxy – and if the evidence suggests that it is not a good proxy, then action needs to be taken, particularly if it risks harming consumers.

Since the early 1900s the economy has experienced distinct economic phases, some of considerable duration. This is illustrated in Figure 1 below.

Figure 1: Historical real equity market returns in the UK[17]

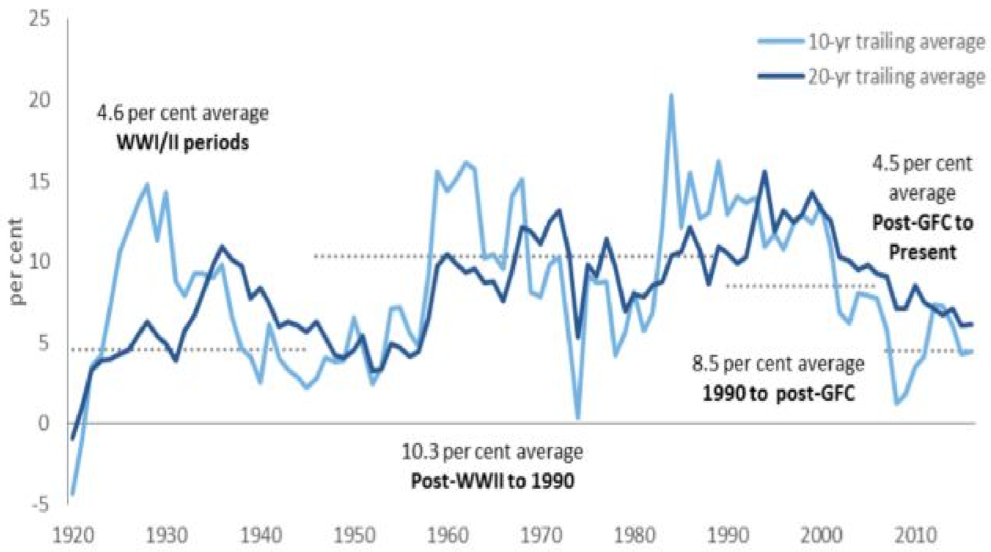

Figure 1 shows that there have been significant variations in the trends of equity returns during different periods. Ignoring these differences in periods of relatively low returns risks is likely to provide shareholders with a higher return than is required or expected by the market.

In our submissions to Ofgem in relation to the RIIO-2 price controls (and referred to in our submission to the CMA in the NATS/CAA appeal) we have demonstrated that the evidence on actual investor forecasts of TMR indicated materially lower rates of TMR than those obtained from Ofgem's historical ex post analysis.[18]

We do not think that sole reliance on past market conditions is appropriate because it ignores the significance of recent and anticipated market trends. Recently in its provisional findings report on the NATS/CAA appeal, the CMA

[17] CEPA, report for Ofgem: *Review of Cost of Capital Ranges for Ofgem's RIIO-2 for Onshore Networks*, February 2018, Figure E.3 based on CEPA analysis of Credit Suisse Global Investment Returns Yearbook 2017 https://www.ofgem.gov.uk/ofgem-publications/130262

[18] Citizens Advice, submission to Ofgem, Ofgem call for evidence on the Electricity Transmission, Gas Transmission, Gas Distribution and Electricity System Operator Business Plans for RIIO-2, February 2020 https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/energy-policy-research-and-consultation-responses/energy-consultation-responses/ofgem-call-for-evidence-on-the-electricity-transmission-gas-transmission-gas-distribution-and-electricity-system-operator-business-plans-for-riio-2-citizens-advice-submission/

has set out its case for why it does not consider forward-looking approaches, including surveys of investors and other market participants, to be as robust as statistically historical data. At a simple level that is inevitable – forecasts will inevitably be a less robust data source in terms of variability, but that should not mean they should be dismissed, particularly where, as we demonstrated in our submissions to Ofgem in our RIIO-2 submission, they indicate real market investors making real investment decisions require a lower level of return than that that indicated by a proxy for exactly that real world expectation.[19]

It cannot be sensible to set rates of return to be earned by shareholders in 2020 based on returns achieved more than 100 years ago whilst ignoring actual forecasts of market returns made by real investors making decisions today, particularly when that will lead to unnecessary gains to shareholders at the expense of consumers in an obvious breach of the regulator's statutory duties.

In our submission to the CMA on the CAA/NERL appeal we said that when assessing the CAA's final determination for the period 2020 to 2024, the CMA should consider supplementing 10-year and 20-year trailing average outturn TMR data up to 2019 with a simulation of expected returns for years 2020-2024. Providing the CMA were mindful of any risks (including forecast errors) that this approach might introduce, this could be a useful way of combining outturn TMR data with various expectations of TMR.

4. Use of consumer evidence in the price control

Sound use of consumer evidence and engagement is a key part of ensuring that water companies improve outcomes for consumers when developing their business plans, and where done well should give confidence to Ofwat in its adoption of the companies' business plans as the basis for price controls.

However, consumer engagement is not an end in itself – its value is where it produces better outcomes and decisions. Many decisions in the business planning process involve trade-offs and disagreement. Water companies can help the regulator and challenge groups by highlighting where trade-offs exist, where disagreement lies, and why certain solutions were chosen over others. The companies should be transparent about which groups may be disadvantaged by certain decisions and how they plan to mitigate this. Consumer engagement can come through direct engagement,

[19] Citizens Advice, submission to Ofgem, *Ofgem call for evidence on the Electricity Transmission, Gas Transmission, Gas Distribution and Electricity System Operator Business Plans for RIIO-2,* February 2020

representatives on stakeholder panels or bilateral relationships, and in challenge groups. Citizens advice considered in detail the best practice for engaging consumers for energy network price controls, many of the findings are equally applicable to the water sector, or already draw on direct experience from this sector.[20]

Consumer evidence is vital to make sure water companies understand what customers want - customers of a monopoly supplier do not have the ability to exercise choice in a way they can in a competitive market. To a lesser extent this can demonstrate and provide qualitative understanding of people's willingness to pay but it simply cannot demonstrate whether what people are willing to pay is what they need to pay. That is the job of good regulation.

There is an array of evidence collected by water companies from consumers and consumer challenge groups (CCGs) that outlines how bill payers want water services that are reliable and future proof, while also having stability in their bills.

We are pleased to see that good evidence has been provided by water networks about what service consumers want to see from water services.[21] However, we have not seen evidence that any utility company has yet engaged with consumers in a way that helps them to evaluate the implications of capital costs and a fair rate of return. We do not believe that consumers would choose to continue paying over the odds for their water services when networks can still pursue their most efficient strategy for long term sustainability. As a result, it remains for regulators to judge how to secure consumers preferred outcomes cost-efficiently.

We are concerned that in their appeals, several water companies have portrayed the impact of Ofwat's determinations as delivering less investment and so leading to different outcomes for consumers.[22] As outlined below, we do not think Ofwat's decisions will impede investment or risk quality of service. Citizens Advice believes these arguments present a false argument.

Water companies have a strong incentive to grow their regulatory asset base and they have an obligation to maintain their networks with long term

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[20] https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/CitA_Strengthen%20Consumer%20Voice%20in%20Energy%20Networks%20Price%20control_2018.pdf

[21] For the 2019 price review, water companies consulted with more than 1.5 million customers across England and Wales to understand the improvements they expect and the level of bills they are willing to pay.

[22] For example: Anglian Water https://assets.publishing.service.gov.uk/media/5e8dc457e90e07077abf9a4c/Anglian_Water_PR19_CMA_Redetermination_Statement_of_Case_Corrected.pdf

efficiency as part of their licenses.[23] They have a range of options to procure finance and fulfil their obligations to invest proactively in their service.

5. Financeability

The appealing water companies have argued that they are not financeable as a consequence under terms of the determination and that therefore Ofwat is in breach of its Ofwat's financeability duty.

Many of the companies' arguments relate to Ofwat's use of a notional, efficiently financed company to determine the allowed rate of return. Whilst the companies do not disagree with the principle of using a notional company to calculate the cost of capital and assess financeability, they disagree with its application for various reasons, primarily that the interest rates on their existing debt are higher than assumed for the notional company.

In their submission to the CMA Ofwat state:

> *"it is wholly consistent with our duties that customers should not pay more than a company's efficient costs. Similarly, they should not pay more than what it should cost for an efficient company to raise finance, and should not carry the cost of a company's financing choices."*[24]

We strongly agree with Ofwat that financeability should be based on the structure of a notional capital-efficient company. If an individual company is not efficiently structured, then that is for the company (and its shareholders) to address – any inefficiencies should not be paid for by consumers.

Because of this we don't agree that any arguments from the appealing water companies that Ofwat is not meeting its duty to ensure companies are able to finance their activities (because of calculations based on their own funding structure or debt costs rather than those of an efficiently structured company) are justified. We think it is for shareholders, not consumers, to manage the risks based on assumptions about rate of return, for companies to manage any legacy debt profiles, and shareholders to take the risk.

[23] Ofwat asks companies to put their plans for the next five years in the context of the longer term, and to make indicative 15-year performance commitments. We will work with the UK Government, the Welsh Government and other water regulators to set a number of strategic long-term targets for the sector

[24] Ofwat 2020, Reference-of-the-PR19-final-determinations-Introduction-and-overall-stretch

In assessing the water company arguments relating to financeability we consider the fact that of the 17 water companies, 13 have accepted the price controls and allowed rates of return indicates that Ofwat's approach is reasonable. The 13 companies which accepted Ofwat's determinations would not have done so if the allowed returns did not enable them to continue to finance operations, raise new debt and pay a dividend. If 13 companies can do so, it is implausible that the four companies appealing the price control cannot do so. Any arguments that the allowed rates of return do not allow them to finance operations are simply not credible. As discussed in section 1, the arguments mask the underlying objective to unnecessarily increase profits to shareholders.

There is significant evidence that investor appetite for UK water industry assets remains very high even after the allowed levels of levels of return in the PR19 price controls.

It should be beyond dispute that Ofwat's allowed rates of return are adequate for all water companies to finance themselves and are therefore in line with Ofwat's duties relating to financeability. The market provides all the necessary evidence:

For example, as Ofwat note in their submissions to the CMA:

> *"Since our final determinations were published on 16 December 2019, the share prices of Severn Trent Water and United Utilities Water have implied a premium of market value over regulatory capital value. Analyst reports have recently pointed to premia of around 20% for United Utilities Water and well in excess of 20% for Severn Trent Water, though we note share prices in more recent weeks have been impacted by market turbulence related to the expected impacts of Covid 19. One analyst noted that our allowed return is above their WACC assumption, while another has suggested that these premia indicate that investors see our determinations in a favourable light."*[25]

All of the water companies, including the four who have appealed their determinations continue to be able to raise investment grade debt.

We do not agree with the appealing companies' submissions suggesting that they will not be able to finance their on-going activities or new investment, or

[25] Ofwat, Reference of the PR19 final determinations: Cross-cutting issues, March 2020, paragraph 5.13. https://www.ofwat.gov.uk/wp-content/uploads/2020/03/Reference-of-the-PR19-final-determinations-Cross-cutting-issues.pdf

even that there is a risk they will not be able to do. We have not seen convincing evidence of this. If they were right the financial markets would have reacted by slashing the prices for debt and equity. This has not happened. We view that the appealing companies' claims for higher returns are not about financeability, they are claims for unnecessary higher returns for shareholders.

Incentivising investment

The water companies have argued in their appeal that Ofwat's final determination will not enable them to invest in the way that they need to deliver the required levels of service. As discussed in section 1, we think these arguments are nothing other than an argument for higher profits.

6. Outperformance

The water companies have argued that historical levels of returns higher than the allowed rate of return are not relevant in determining the cost of capital for future periods. However, we think this is wrong for two reasons: asymmetry of information and absence of competition.

The evidence of historical out-performance reflects (in part at least) the level of information asymmetry in the price control process. In part this stems from Ofwat's reliance on the business plans prepared by the companies themselves as the starting point for the price control models.

Critically, the regulators' adjustments to the business plans are constrained by their ability to identify unnecessarily conservative assumptions in business plans - a one-sided process which is limited by time and resources available to the regulator. Notwithstanding Ofwat's attempts to incentivise companies to produce acceptable business plans, there remains a much stronger incentive for the company to game the business plan process to gain a higher level of prices. For example, Ofwat's review of the initial business plans of the four appealing companies found that their overall costs were between 15% and 20% of that considered to be "efficient and reasonable".[26] This problem is recognised in telecoms regulation where, rather than rely on the companies' own "top-down" assessments of their own costs, the regulator starts from scratch to build its own "bottom-up" model of

[26] Ofwat, *PR19 initial assessment of plans; Overview of company categorisation,* January 2019. We note that of the 17 water companies, only 3 submitted initial business plans which Ofwat regarded as of sufficient quality to be 'fast-tracked'. Of the rest, ten were categorised as 'slow tracked – and required the companies to do further work (including the four companies appealing the price controls) and four were rated as "significant scrutiny" requiring, substantial rework and increased regulatory scrutiny.https://www.ofwat.gov.uk/wp-content/uploads/2019/01/PR19-inital-assessment-of-plans-Overview-of-company-categorisation-FINAL.pdf

efficient costs. The two approaches can be reconciled, but bottom-up models typically generate lower costs than a top-down model, in part at least reflecting the inherent incentives of the company to present a more favourable view on its expected costs and capex.

In a competitive market, higher than 'normal' levels of returns would stimulate new market entry and lower prices, which over time would be expected to reduce returns to a normal level. But the (wholesale) water industry is a near monopoly market with only marginal levels of competition in very limited areas. The normal competitive market mechanisms do not work, and higher levels of return do not stimulate new market entry or lower prices (which suggests that some form of 'market correcting' downward price adjustment could be justified. Rather than stimulating entry at a firm level, higher levels of return push up demand from investors to invest in the companies – demand which in a competitive market would in part be met by an opportunity to invest in new entrants. In turn this leads to the higher market to asset value ratios consistently seen in the water (and energy) markets.

In the energy sector Ofgem has sought to address this issue by introducing an out-performance wedge into the cost of capital calculation; an approach which we support.

Where no out-performance wedge is explicitly applied to the allowed return calculation (as in this case) it is reasonable to apply an allowed return that is at the lowest end of any calculation range of reasonable assumptions in order to ensure expectations of systematic outperformance are reflected in the allowed return.

7. Incentives

The appealing water companies have claimed that incentives in Ofwat's determinations are asymmetrically skewed to the downside.

As a principle, we agree that cost sharing mechanisms and other incentive mechanisms, where appropriately calibrated, are a useful regulatory tool for driving efficiency and innovation which would happen as a matter of course in a competitive market. The best way of assessing incentives is ex post – where, as we show in Monopoly Money, companies have regularly earned high rates of return, in part because of incentive structures. In part this is due to high levels of information asymmetry. So even if the incentives were in some way asymmetric this would not necessarily be unreasonable if the expected level of performance remained sufficient for the company to earn a reasonable level of return.

As for financeability, we consider the fact that 13 of the 17 companies accepted Ofwat's approach to incentives confirms that Ofwat's approach is not unreasonable. If it allows 13 companies to earn a reasonable level of return overall, then there is no reason to believe the four companies appealing the determinations cannot also do so.

8. The impact of Covid-19

Even before the current coronavirus crisis, around 3 million consumers said that they were struggling to pay their bills. More recently, Citizens Advice research has found that over 13 million people have already been unable to pay, or expect to be unable to pay, at least one bill because of the coronavirus outbreak[27]. The current crisis has greatly exacerbated the issue of affordability for people in the short term and may have long term impacts on the affordability of essential services.

Current Impact of COVID19 on affordability

Coronavirus has had a sudden and unprecedented impact on people's jobs and incomes. Nearly 4 out of 10 (38%) households have reported lost income because of this crisis, with nearly 1 in 10 (8%) households reporting losing 80% or more[28]. 6.3 million employees have been furloughed via the Job Retention Scheme - nearly a quarter of all employees[29]. The Office for Budget Responsibility has warned that unemployment could rise to 2 million in the second quarter[30], indicating the economic uncertainty is unlikely to be short-lived.

Many people were already struggling before this pandemic. Over 7 million people have no savings to fall back on[31], whilst 10% of all adults in Great Britain say they could not cover their costs for longer than a week if they lost their main source of income[32]. The current economic situation and social distancing measures amplifies these challenges. People are limited in their

[27] https://www.google.com/url?q=https://www.citizensadvice.org.uk/about-us/how-citizens-advice-works/media/press-releases/millions-facing-financial-cliff-edge-when-coronavirus-protections-end2/&sa=D&source=hangouts&ust=1589298018343000&usg=AFQjCNExaiZ39CnTM7XFL8E60151i60eRg

[28] Poll of 2,000 adults conducted on behalf of Citizens Advice by Opinium (carried out between 2-7 April)
[29] HMRC (2020) https://twitter.com/HMRCgovuk/status/1257324798847451136
[30] Office for Budget Responsibility (2020) Coronavirus Reference Scenario
[31] Financial Conduct Authority (2018) Financial Lives Survey
[32] Office for National Statistics (2020) Early Indicator Estimates from the Wealth and Assets Survey

ability to take up work due to a dwindling job market[33], whilst also having little prospect of reducing their outgoings through things like moving home.

Long term impact of COVID-19

The long-term impacts of COVID-19 are not clear. Short term impacts are putting economic stress on all the economy, and longer term impact on financial markets is highly uncertain. However, the market has shown clearly that regulated monopoly as utilities are seen as safe havens for investors in the current climate.[34]

This supports arguments Citizens Advice have been making for some time that these businesses are fundamentally less risky than assumed by regulators, and it is in consumers' interests to redress this balance in future price controls.

We look to UK regulators, including the CMA in its decision here, to ensure consumers are protected both from the short- and long-term effects of this crisis. We think this could be done by recognising the low risk nature of regulated monopolies to a greater extent when estimating equity betas, and/or (notwithstanding our reservations for using very long term data for calculating TMR) by using available economic precedents (such as the recovery from the 1918 Spanish Flu pandemic) to indicate how markets may respond, although we would caution using this data with significant caveats given the structural changes that have occurred since this time in global markets and in the UK.

We hope that you find this response helpful. Please contact me if you wish to discuss anything in this submission in more detail.

Yours sincerely

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Citizens Advice

[33] Office for National Statistics (April 2020) Coronavirus and the Economic Impacts on the UK

[34] https://www.spglobal.com/ratings/en/research/articles/200324-emea-utilities-should-withstand-covid-19-better-than-most-sectors-11400913

https://www.ifs.org.uk/publications/14773