



Making a positive difference  
for energy consumers

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## Ofwat Price Determinations: Comments on the issues raised in the References

Dear Sarah

We write further to the call for third party submissions by 11 May 2020 on the issues raised in the References from Ofwat and the Main Party Submissions, and our previous correspondence indicating that we are interested in the outcome and may want to contribute to the review. We outline below our views on finance and cost assessment issues.

### Finance issues

We set out our initial thoughts on finance issues in the table below.

| Issue raised    | Ofgem comments   |
|-----------------|--|
| Risk-free rates | <p>We note the arguments raised suggest the use of nominal gilts rather than real gilts. However, doing so raises another question on the Inflation Risk Premium, which, when taken into account should render the two options (nominal or real) numerically similar, if not identical. The CMA should also consider the “price of tomatoes” argument listed in the UKRN report and as referred to by Cochrane (2011).<sup>1</sup></p> <p>We note Anglian Water’s claim that an indexation policy should, for consistency, apply to all WACC allowance elements, if it is applied to any. However, Ofgem’s RIIO-1 Price Control shows that even updating</p> |

<sup>1</sup> <https://www.ukrn.org.uk/wp-content/uploads/2018/06/2018-CoE-Study.pdf#page=34>

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|---------------------------|--|
|                           | just one part of the WACC allowance can benefit both consumers and investors.  |
| Total Market Return       | As per our response to the CMA's Provisional Findings in the NATS reference, we continue to consider the CMA's estimate of 5-6% (RPI-real) to be reasonable, noting that it aligns with estimates for the RIIO-2 price control. <sup>2</sup> It is not clear to us whether the water company appellants have yet fully considered the NATS Provisional Findings on this matter. For example, Yorkshire Water notes that it is still considering the points raised by the CMA regarding risk-free rate and expected market return. <sup>3</sup>   |
| Equity beta               | <p>Given the importance of accuracy, and the difference between the parties in the reference, the CMA may wish to consider various estimation approaches, at least for information purposes. In the lead-up to setting the RIIO-2 price controls, noting the statistical limitations of OLS, we estimate equity beta over long periods (e.g. 5 to 20 years), rather than using rolling windows, while also cross-checking with GARCH estimates. The CMA could also have regard to UU and SVT if these represent a better proxy for the pure-play notional water network than PNN.</p> <p>The CMA could also consider the de-levering and re-levering issue raised by Indepen.<sup>4</sup> We think the CMA may want to consider carefully how it makes any gearing adjustments in this redetermination, as there is a risk of inconsistency and over-remuneration should actual and notional gearing be calculated on different bases.</p> |
| Debt beta                 | We refer the CMA to the UKRN study on debt beta as published in December 2019 <sup>5</sup> , noting also that the CMA may wish to consider the MM cross-check as per the NATS reference. If notional gearing and actual gearing are aligned then this could render debt beta moot.   |
| Gearing sharing mechanism | In response to Ofwat's proposed gearing sharing mechanism, we note Yorkshire Water's arguments that WACC is not sensitive to the gearing   |

<sup>2</sup> [https://assets.publishing.service.gov.uk/media/5ea199f686650c031ce2c44b/Ofgem\\_new.pdf](https://assets.publishing.service.gov.uk/media/5ea199f686650c031ce2c44b/Ofgem_new.pdf)  
[https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2\\_sector\\_specific\\_methodology\\_decision\\_-\\_finance.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_finance.pdf)  
and following, p. 30.

<sup>3</sup> [https://assets.publishing.service.gov.uk/media/5e8dc82686650c18cc99f228/Yorkshire\\_Water\\_-\\_PR19\\_redetermination\\_Statement\\_of\\_Case\\_02.04.2020\\_--.pdf](https://assets.publishing.service.gov.uk/media/5e8dc82686650c18cc99f228/Yorkshire_Water_-_PR19_redetermination_Statement_of_Case_02.04.2020_--.pdf) para 220 p 71.

<sup>4</sup> [https://www.ukrn.org.uk/wp-content/uploads/2019/01/final\\_beta\\_project\\_riio\\_2\\_report\\_december\\_17\\_2018\\_0.pdf#page=8](https://www.ukrn.org.uk/wp-content/uploads/2019/01/final_beta_project_riio_2_report_december_17_2018_0.pdf#page=8)

<sup>5</sup> <https://www.ukrn.org.uk/publications/considerations-for-uk-regulators-setting-the-value-of-debt-beta/>

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|---------------------------|---|
|                           | level – we agree that this is an important issue to consider. <sup>6</sup> Therefore, we would recommend the CMA consider deploying the same approach to checking WACC allowances as was used in the NATS Provisional Findings. <sup>7</sup>  |
| Allowed returns on debt   | We recognise the challenges Ofwat mentions in relation to assessing whether derivatives have been incurred at market rates, particularly given the bespoke nature of some of the derivative contracts entered into by regulated utilities. <sup>8</sup> Separately, we support Ofwat’s perspective that regulated utilities can outperform corporate debt indices in a variety of ways.   |
| Allowed return on capital | As per our response to the CMA’s Provisional Findings in the NATS redetermination, where the CMA considered whether the price control may be asymmetric, we continue to agree with the CMA that regulators should exercise judgement on the various aspects of the price control package, before arriving at an overall view to set an allowance.<br><br>In the context of setting allowed returns, we note Anglian Water raise an important issue on expected outperformance. <sup>9</sup> Ofgem’s long-stated position is that there is a sound basis to consider expected outperformance when setting allowed returns. Should outperformance be expected in the water sector, we support Ofwat and the CMA taking this into account. |
| Financeability            | We support Ofwat’s position of assessing credit strength in the round for the notional company, rather than relying on any one metric. We note that rating agencies’ published methodologies put weight on multiple factors, qualitative and quantitative, and that they retain some discretion in whether and how they consider stated metric threshold levels in their overall rating assessments.  |

## Cost assessment issues

We set out our initial thoughts on cost assessment issues in the table below.

| Issue raised | Ofgem comments |
|--------------|----------------|
|--------------|----------------|

<sup>6</sup> <https://assets.publishing.service.gov.uk/media/5e8dc82686650c18cc99f228/ Yorkshir Water - PR19 redetermination Statement of Case 02.04.2020 --.pdf> para 256 p 77.

<sup>7</sup> <https://assets.publishing.service.gov.uk/media/5e7a2644d3bf7f52f7c871f3/Provisional Findings Report - NATS - CAA.pdf> para 12.107 and following).

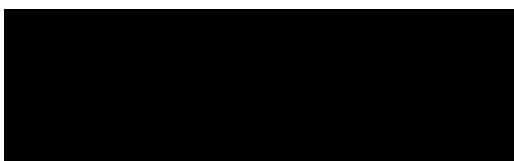
<sup>8</sup> <https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Allowed-return-on-capital-technical-appendix.pdf> p. 87.

<sup>9</sup> <https://www.anglianwater.co.uk/siteassets/household/about-us/9b-financeability-of-the-notionally-efficient-firm-top-down-analysis-final-stc-28-08-19.pdf> Executive Summary, p. 5.

|                       |   |
|-----------------------|---|
| <p>Benchmarking</p>   | <p>In RIIO-1, Ofgem set the efficiency benchmark at the upper quartile level to explicitly account for the potential measurement errors of models. It also recognised that inefficiency might not be the only cause of variation across the assessed companies.</p> <p>However, in general, statistical robustness of the models may justify setting a tougher benchmark beyond the upper quartile as Ofwat has.</p>  |
| <p>Frontier Shift</p> | <p>We support Ofwat’s position of applying a frontier shift (ongoing efficiency net of RPE). While we note that for some un-modelled costs, network companies may have a lower degree of control, appropriate productivity gain may still apply.</p> <p>On setting the level of ongoing efficiency, the identification of suitable comparator sectors is always necessary to establish an appropriate level, as is the time period over which to consider, as there is not likely to be an exact match.</p> <p>On incorporating an adjustment component within the expected productivity gains, we agree in principle that this could be used to capture additional productivity gains not adequately captured within the comparator sectors.</p> |

We would welcome an invitation to participate in third party hearings on these and any other matters raised in these references and/or any issues relating to RIIO-2 that the CMA would benefit in understanding further.

Yours sincerely,



Simon Wilde  
**Senior Financial Advisor**  
 Systems & Networks