

Competition and Markets Authority  
By email: [waterdetermination2020@cma.gov.uk](mailto:waterdetermination2020@cma.gov.uk)

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## Ofwat Price Determination 2020 – Third party submissions

This submission is from Dŵr Cymru (Welsh Water). We are the appointed undertaker of water and wastewater services to 3.1 million people in Wales and neighbouring parts of England.

We should say, at the outset, that there were many aspects of the price review on which Ofwat should be commended. It managed an enormously complex and challenging review, it published clear and comprehensive documentation at each stage, and generally provided opportunities for companies and others to input into the methodology as it was developed and implemented.

We have carefully examined the detailed submissions of the main parties. Inevitably there are many points with which we agree, and some where we disagree. When we made the decision not to ask Ofwat to refer our Final Determination to the CMA it was on the basis that it should be taken as a package. There were areas where we considered Ofwat's challenges to be excessive and did not agree with its decisions. In particular, it includes performance targets that we do not think we will be able to achieve, even though we will be committing significant financial and other resources to strive to do so.

We do not think a recapitulation of our principal concerns would significantly assist the CMA. Those that are of greatest relevance to the four determinations at issue are the subject of detailed submissions from the parties themselves.

### ***The Role of 'Leaps of Faith' in Making Determinations***

However, there is one over-riding issue that cuts across many of the areas of dispute in the four cases to which we wish to draw the CMA's attention. We believe it goes to the heart of why almost a quarter of companies rejected their determinations at this price review, the previous highest being around 8% of the industry in 1999. This issue will be central to how the CMA develops and rationalises its own determinations. Moreover, if upheld in these inquiries it will have far-reaching implications for future reviews.

In a nutshell, our concern is this. As Ofwat has stressed, it is under a statutory obligation to exercise its powers in such a way that is "*best calculated*" to meet certain objectives. At previous price reviews Ofwat's reasoning generally employed a combination of evidence, methodology, and judgement. One could dispute how it had interpreted evidence or why it considered that an expectation was reasonable, but there was invariably a 'roadmap' or 'audit trail' that could be objectively reviewed.

At this price review, for the first time, Ofwat has relied on a number of 'leaps of faith' that are more in the way of assertions than reasoned judgement, and cannot be objectively assessed because they are by

their nature purely subjective. The problem with creating gaps in the 'roadmap' in this way is that it removes the boundary to the size of the demands that can be placed on companies. It creates a risk that such claims become increasingly unrealistic at future reviews, undermining trust and confidence in the regulatory system and damaging the industry in the eyes of investors and other stakeholders. In other words, if it is legitimate to apply unparticularised "stretch" in making a price determination, there is no constraint on how far it might go.

Salient examples of the use of *assertion* in place of *evidence-based judgement* include the following:

- the claim that improvements in performance can be achieved without additional cost allowance. In support of this assertion, Ofwat points to examples of companies that have been both low cost and high performance (on selected measures and at certain times), and states that "*it is simplistic and inaccurate to suggest a necessary trade-off*" between cost and performance. We consider that a major leap of faith has been employed by Ofwat in arriving at this position;
- the expectation that companies should all be able to meet targets based on a forward-looking upper quartile derived from companies' own estimates and (costed) plans, of the future achievable industry upper quartile level, in accordance with Ofwat guidance. This assertion is unproven and inconsistent with operational experience. In previous reviews it was recognised that the operational conditions, network characteristics, historical investment patterns and indeed customer preferences naturally vary across companies. There are therefore good reasons why the optimal level of performance will vary likewise. Ofwat is in a position to collect the data to establish the (appropriately stretching) performance targets for each company, taking into account the factors that affect each company's operations. We have urged Ofwat to do so in the coming period in preparation for PR24.
- the view that, notwithstanding its observation that productivity in the industry has shown little or no improvement over the past ten years, the fact that certain other sectors of the economy were able to achieve relatively fast productivity growth in the period up to 2014 indicates that the water industry can do the same from 2018/19 through to 2024/25. As this is against a backdrop of respected institutions (such as the Bank of England and the Office for Budget Responsibility) expressing concern at the apparent inability of productivity in the UK economy to improve, and the successive failure of near term forecasts of productivity improvement to materialise, we believe it represents a significant degree of hopeful optimism, rather than a balanced, evidence-based judgement; and
- the suggestion that, although Ofwat's own analysis shows that the risk adjusted 'downside' for companies is far greater than the upside (the Covid-19 crisis being a timely reminder of how catastrophic risks in particular are skewed to the downside), expected returns for an efficient company will nevertheless be adequate to cover the cost of capital. To square this circle it is strongly suggested that an information asymmetry in favour of companies will provide the required counter-balance to the known overall downside. Notwithstanding that we would dispute the magnitude of any such information asymmetry (and despite what the commentators cited by Ofwat have said), it takes a leap of faith to state, in effect, that the things we know about are expected to produce inadequate returns, but we are confident that things we do not know about will compensate.

By way of conclusion, we note that Ofwat invites the CMA to consider the option of making a downward adjustment to its assessment of the required rate of return to compensate for the perceived information asymmetry and the expectation that this will reveal scope for out-performance in due course. As we have made clear, we do not consider that the taking of 'leaps of faith' has a legitimate place within the scope

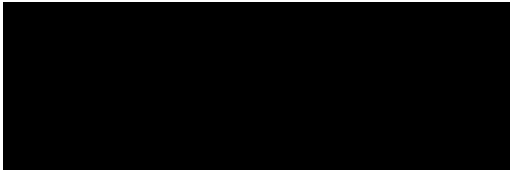
of the “best calculated”. Therefore, irrespective of how demanding the four appellants’ determinations turn out to be, we would urge the CMA to eschew the taking of ‘leaps of faith’ in undertaking its “best calculations” and arriving at its conclusions.

Finally, there is one additional observation we would like the CMA to consider.

***The Cost of Capital and Financeability***

On the calculation of the Weighted Average Cost of Capital (WACC), the arguments over the estimation of the various CAPM components are plentiful in the submissions to the CMA. We have nothing to add to that debate at this stage, but we do wish to make a wider point. We note that Ofwat (and others) appear to treat the cost of capital and financeability as two separate topics, whereas we consider that they are part of the same issue. As the CMA and others have stated, *the* cost of capital is the minimum return that investors and creditors require in order to commit their capital to finance undertakers’ functions. If the result for the WACC obtained by applying one methodology does not permit undertakers to finance their functions (as was the case for the majority of companies in Ofwat’s final determinations, evidenced by the widespread use of financeability adjustments) then by definition that result cannot be correct. We would therefore suggest that the CMA takes a more holistic approach in approaching the question of the required rate of return in its own determinations.

We hope this letter will be of some assistance. Should the CMA wish to take up any of these issues with us, we would be more than willing to provide further information.



Best regards

**Eleri Rees**

**Strategy and Regulation Director**