COVID-19 and NATS Appeal

This note picks out the key issues relating to COVID-19 that we have submitted to the CMA water price determinations appeal, which may be relevant to the NATS/NERL appeal.

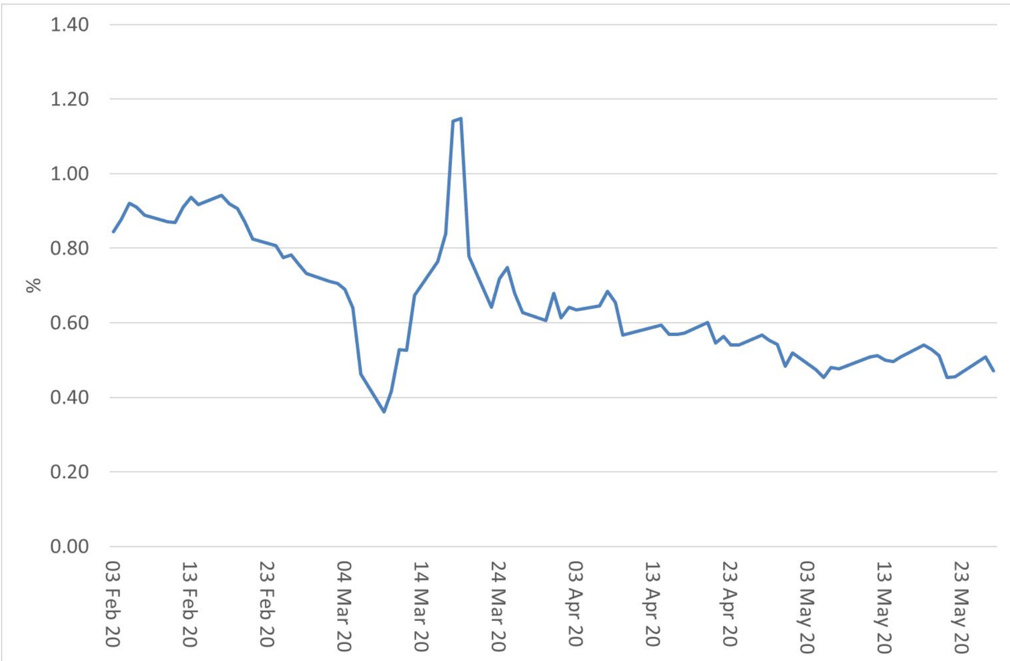
Impact of COVID-19 on financial markets

While future performance of financial markets remains uncertain, the impact of COVID-19 to date on debt and equity markets is illustrated in the charts below.

Risk-free rate

The price on government UK gilts has fallen in response to a drop in the base rate increased investor demand for gilts, as shown in Figure 11 below.

Figure 11: UK 15-year gilts yield (spot rate) 3 February 2020 to 27 May 2020



Source: Bank of England data

Equity markets

After sharp falls at the beginning of the pandemic, stock markets have recovered, but remain significantly lower than before the crisis, as illustrated in Figure 12 below which shows the FTSE 100 share index.

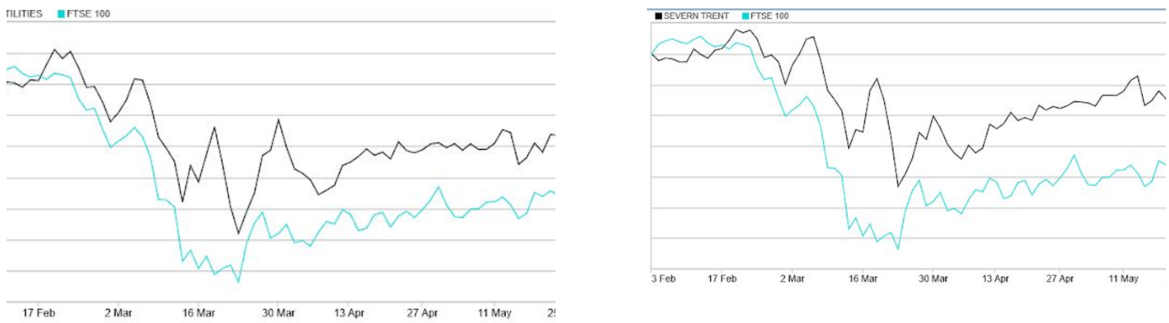
Figure 12: FTSE 100 Share index, 3 February 2020 – 27 May 2020

Source: London Stock Exchange

Utility company share prices

In line with historical measures of beta, the share prices of utility companies such as water companies have dropped less than the overall market, as shown in Figure 12 below.

Figure 12: United Utilities, Severn Trent, share price compared to FTSE 100 3 February 2020 - 27 May 2020



Source: London Stock Exchange

The financial market data shown in the charts above indicates that the markets continue to show levels of volatility, and accordingly it is extremely difficult to know what, or at what level the markets may show some signs of stability.

On that basis it would not be appropriate to attempt to update the price control parameters, particularly for cost of capital to reflect updated forecasts.

Existing mechanism for opening price controls

We think it would be appropriate to use any established mechanisms and processes for re-opening of the price controls available to CAA and NERL. If market circumstances change and either CAA or the NERL consider it necessary to re-open the price control to ensure regulatory objectives are met, then we would prefer that these mechanisms be used. They provide an appropriate framework, including consultations, for such a decision.

Impact on consumer evidence and output cases

Our report from Europe Economics raises the issue of how COVID-19 may have impacted the underlying assumptions and consumer evidence supporting proposals and decisions in PR19.

It will be important for the CMA to consider the impacts on the following areas, some of which overlap with the impact on highly anticipatory investment (below):

- Customer willingness to pay for improvements to quality of service or the environment may be lower
- Consideration of affordability issues is especially important, given that many households are struggling financially
- During the crisis, there may be greater political sensitivity to any investment proposals that increase customer prices or allow companies to earn high returns

The CMA could carry out its own research to look at the impact of COVID-19 on consumer views, to help assess the impact on the evidence.

Highly anticipatory investment and COVID-19

Citizens Advice has been looking at the ways in which investment for highly anticipatory investment can be delivered in ways that most benefit consumers. We have focussed primarily on energy infrastructure, but recognise the close parallels with other sectors. We commissioned Europe Economics to look at a suite of different highly anticipatory investment vehicles, and some further analysis considering the ways in which the COVID-19 crisis affects our previous analysis of risk allocation mechanisms for highly anticipatory infrastructure investments. We have also attached our summary table of the different mechanisms.

The analysis identified a number of implications for firms seeking to justify highly anticipatory investments. In particular:

- Reductions in the demand caused by the COVID-19 crisis may weaken the case for highly anticipatory investment[1]
- Customer willingness to pay for improvements to quality of service or the environment may be lower
- Consideration of affordability issues is especially important, given that many households are struggling financially
- During the crisis, there may be greater political sensitivity to any investment proposals that increase customer prices or allow companies to earn high returns
- Highly anticipatory investments need to be analysed against different COVID-19 scenarios, and ranges for estimated impacts are likely to be wider

[1] Our analysis focuses specifically on energy, although we consider there is equal applicability to other sectors.

- The case for applying real options analysis is especially strong in the current context, with the value of the real option to wait now likely to be higher
- There may be impacts on the return that regulators need to allow companies to earn

The analysis also considered possible impacts on the most appropriate allocation of risk:

- Companies may need to take on a higher share of demand risk than previously, as many customers may be less able to bear risk due to the crisis, and may have become more risk averse
- Firms need to think carefully about how risks should be allocated between customer groups, including whether relatively more of the risk borne by customers can be allocated to future customers and to higher income customers

Based on this analysis for the suitability of the 15 risk allocation mechanisms, we conclude that the following risk allocation mechanisms may be particularly suitable in the light of the current COVID-19 crisis:

- Price control reopeners or interim reviews, to reflect the potential advantages of waiting until more information is available before firms commit to large irreversible investments
- Mechanisms that allow demand risk to be shared with firms, such as error correction mechanisms or capex triggers based on demand exceeding a specified threshold
- Caps and floors on returns from highly anticipatory investments, to avoid companies earning excessive returns during a time when many households are struggling
- Economic depreciation (in which depreciation revenue from customers is profiled over time in line with usage), to allocate more risk to future customers rather than current customers

Some of the other risk allocation mechanisms may continue to be relevant in specific circumstances. For example, ring-fenced funding from customers that use the new infrastructure may continue to be relevant in cases in which the infrastructure is discrete, with scope for separate user charges.