

October 2020

Reference of the PR19 final determinations: Overview - response to CMA provisional findings

Overview

The PR19 Final Determinations represented, in Ofwat's view, a significant step towards improving the outcomes delivered by the water industry. The sector was stagnating on several fronts and had been losing the confidence of its customers and wider stakeholders. Through PR19, Ofwat challenged it to make real progress on operational performance; to make investments to achieve long term resilience and environmental sustainability; and to focus investors on making returns through delivering for customers and the environment.

The Competition and Markets Authority (CMA) agrees in principle that the industry needs to improve. To a large extent it has provisionally upheld the efficiency and performance challenges we have placed on the four disputing companies. Regrettably, however, the Provisional Findings, taken in the round, risk having the opposite result.

If confirmed, they would impose unnecessary costs on customers with no assurance of any additional short or long term benefit either to customers or to the environment. In our view, the CMA's allowed return would provide companies and their investors with windfall gains and with the ability to pay excessive dividends. The overall effect of their proposals would be to significantly weaken the incentive on companies and their investors to focus on delivering services that matter to customers and on improving financial resilience. The Provisional Findings also threaten to undermine Ofwat's ability to regulate effectively in the customer interest, and to cause wider uncertainty across regulated industries.

We have considered the Provisional Findings in the round. The combined impact of five elements gives us most concern:

Weighted Average Cost of Capital (WACC): The CMA has provisionally decided to significantly increase the allowed return to the disputing companies by 54 basis points to 3.5%. This is almost a 20% increase on the WACC in Ofwat's final determinations and is above the rate of return sought by the companies in their business plans. The CMA's approach to arriving at the cost of capital is not appropriate in the water context and the stated rationale is neither clear, nor supported by the evidence. We are deeply concerned about the damage this would cause to customers in the short and long term.

We understand that 'aiming up' on the WACC may be relevant in other sectors, such as fibre rollout, where there is greater demand uncertainty and in order to provide stronger incentives for investors to accelerate discretionary investment. In water, there is no practice of investing beyond regulatory obligations and, as revenue allowances are fixed, there is limited incentive to do so. Any increase in returns is therefore likely to flow to dividends and experience bears this out.

High Gearing: The CMA has recognised that Ofwat is right to be concerned that high gearing in the industry has the potential to damage the interests of customers. Yet it has provisionally decided to remove the incentive we introduced to discourage this, without putting in place any substitute and leaving a gap in the regulatory framework.

Leakage: The CMA proposes that Yorkshire Water's customers will pay an increase of £93.3 million to reduce leakage to a level that other companies have already comfortably surpassed without additional customer funding. We do not believe this is justified.

Incentives for efficient business plans: The CMA recognises that companies need an incentive to submit accurate and efficient business plans. However, by proposing to set the same cost sharing rates for all disputing companies at a level much more favourable than our final determinations, it would significantly undermine this incentive. This will make it very much harder for us to strike a good deal for customers in the future.

Standard of evidence: The CMA has in some places set too low a bar on the standard of evidence the disputing companies had to provide to be awarded customer funding. We are concerned this may undermine customer confidence and our ability in future to protect them from paying too much.

Ofwat hopes to work with the CMA to understand better the concerns that have led it to these Provisional Findings. Particularly, it appears that concerns about investment in, and financeability of, the water sector may underpin the proposals on the WACC. We believe there are appropriate, targeted and proportionate ways to address any such concerns and would welcome an opportunity to explore these with the CMA. We are optimistic that the CMA can and will align the interests of investors and companies with those of their customers, to ensure sustainable improvements into the next price review and beyond.

Below, we summarise our key concerns. The Provisional Findings taken as a whole could result in:

- higher bills, with no assurance of customer benefits in return and likely higher dividends for investors;
- reduced incentives on companies to improve performance and removal of a constraint on 'gearing up' at the expense of customers;
- a reduction in our ability to regulate in customers' interests in future and wider regulatory uncertainty.

We end by summarising our other key process and substantive concerns and note our request for an extension to the current timetable.

Higher bills and higher dividends

Our objective from the outset has been to make sure customers get value for money, with every pound paid to the water companies delivering a real benefit in the short or the longer term. 90% of the higher bill proposed by the CMA delivers nothing in terms of additional benefits for customers or the environment or even any further investment obligations. Ofwat is responsible for ensuring that customers do not pay more than they need to. This unnecessary cost is particularly concerning now, in the context of an ongoing pandemic, with many more households likely to struggle to pay for their essential water and wastewater services.

Yorkshire Water customers would be required to pay substantially more for leakage levels which other companies have shown can be achieved at no additional cost.

Across the sector we saw a 7% reduction in 2019-20, with six companies achieving reductions greater than 10%. This dramatic shift not only demonstrates that reductions are possible without additional cost to customers, but also highlights the important role that Ofwat can play in stimulating better performance by robust challenge in the face of stagnating performance which now risks being compromised. For Yorkshire Water, its poor performance means that even if it achieves its proposed leakage reductions at PR19, it will still not reach the 2019-20 average sector leakage (normalised by mains length) by 2024-25.

We are also concerned that the CMA is proposing customers of Northumbrian Water and Anglian Water pay £20.4 million and an additional £38.9 million respectively on **enhancement projects where the customer benefit is unclear and the cost not well supported**. The standard of evidence is low by reference to the standard met by the very many schemes for which we allowed funding.

The proposal on the WACC is the most concerning. The cost to customers of the disputing companies of the CMA's higher allowed return is £0.5 billion over 2020-25. We are concerned that, if unchanged, this would result in a very material and unnecessary increase in expected returns for investors across the water sector and potentially other regulated sectors. In the water sector alone, had we applied this to all water companies, this would cost customers £1.9 billion over 5 years.

There is nothing in the CMA's proposals that would prevent investors simply extracting their newly-increased returns in the form of higher dividends or through asset premia on transactions. The history of the water sector, as recently as a decade ago, demonstrates that we can have no confidence that these higher returns will translate into increased investment in services for the benefit of consumers and the environment.

A cost of capital that proved (with hindsight) to be generous at the PR09 review led to large dividend payments to shareholders, at 10.3% pa, on average, with the range going

as high as 30% per annum. This was far in excess of the component dividend rate of 5%, or the 7.1% allowed cost of equity. It also led to over-inflated valuations of companies and loss of incentives to drive real service and performance improvements.

Unlike in other sectors, such as telecoms, the level of investment in this heavily regulated monopoly sector is to a large degree a function of a planning process overseen by the Environment Agency and Drinking Water Inspectorate, with associated funding ultimately allowed by Ofwat in our final determinations. There is no need to compensate for uncertain demand: revenue reconciliation mechanisms already address this.

An increase in the WACC increases the value of water companies and is good for investors. But we have seen no evidence over the thirty years since privatisation that this kind of gain directly increases the level of investment. It clearly comes at an extra cost to customers through increased bills. The fact that a higher rate of return provides no benefits to customers is why the National Audit Office¹, Public Accounts Committee² and Citizens Advice³ criticised Ofwat's 2009 decision on WACC and why our approach in PR19 has been to set WACC in the middle of the range suggested by market evidence, in contrast to the "aiming up" approach the CMA proposes.

The Provisional Findings suggest that the CMA's approach is largely motivated by, and intended to further, the long term interests of customers, but provides no compelling explanation as to how it would achieve this effect, or why customers should bear this cost. It intends through a higher allowed return 'to promote investment in the sector more broadly'. However, we see no evidence that a higher return than we awarded is required to keep the sector investable, or that there is any risk of under investment in this sector. Evidence from market transactions and share price movements since our final PR19 determinations show that, with the return we allowed, there is a healthy appetite to invest, and expectation from investors that water companies will outperform the price review settlement. More generally research indicates that investor demand for infrastructure assets is increasing.

There are alternative mechanisms to achieve higher investment (such as increasing outcome delivery incentives) and financeability, that can better address any residual concerns and align with customers' interests. These are identified in the main body of our submissions.

We are also struggling to understand why the embedded cost of debt used by the CMA in arriving at allowed returns is higher than the observed debt costs for every water and

¹ National Audit Office, '[The economic regulation of the water sector](#)', October 2015.

² House of Commons Committee of Public Accounts, '[Economic regulation of the water sector](#)', January 2016.

³ Citizens Advice, '[Monopoly Money. How consumers have overpaid by billions](#)', May 2019.

wastewater company bar one (Southern Water). The result is a wholly unnecessary additional cost, with customers of the disputing companies ultimately paying more to service their companies' embedded debt than the companies actually need.

Reduced incentives to improve performance for customers and the environment

The CMA's Provisional Findings, if confirmed, would have the overall effect of reducing the incentive on disputing companies to improve performance, efficiency and financial resilience. They open up opportunities for the companies to further increase gearing, with the attendant risk to customers.

The proposed changes to the WACC would allow the water companies to earn higher base returns, making it less important for management or owners to focus on improving efficiency and service. This weakening of performance incentives is exacerbated by the CMA's proposals to:

- reduce the cost challenge in relation to leakage;
- alter the cost sharing rates for disputing companies so that they bear a lower proportion of any overspend against allowances; and
- give companies the 'benefit of the doubt' in awarding allowed costs for some poorly justified enhancement schemes.

As well as reducing the benefit customers should get from better service and efficiency, we are concerned that the CMA's proposals remove the Ofwat mechanism to inhibit the disputing companies' investors from seeking further financing gains from 'gearing up' at the expense of customers. While the CMA has recognised the potential risk to customers from high gearing, its proposals leave Ofwat with no mechanism to address this, even though it could undermine financial resilience and place a higher risk on customers from potential company failure.

There is a real risk from these proposals both that the water sector will be more attractive in the future to investors who do not take into account the customer interest in making decisions on their financial structures, and that Ofwat's ability to prevent this will be diminished. We consider that such a move would undo much of the work Ofwat and the companies have done in recent years to improve the quality and commitment of investors in the sector.

Reducing our ability to regulate and wider regulatory implications

Price reviews stand in for the role that competition would play if the water companies operated in a truly competitive market and had to compete daily for their customers' business. They are the key tool Ofwat uses in meeting its duty to protect customers' short and long term interests, alongside its other primary duties. But the proposals in the

Provisional Findings will risk depriving many of Ofwat's policy levers of their efficacy, and could impact the effectiveness of utility regulation more generally.

A key challenge to any regulator in a price review is asymmetry of information. The CMA recognises this in its Provisional Findings. In particular, we need to encourage companies to reveal their accurate and efficient forecasts of costs to allow us to conduct cost benchmarking.

In the last decade, regulators have found a way of rewarding companies that set costs that are close to the efficiency frontier, and that help bridge the information asymmetry gap. We allow these companies to keep a higher proportion of any savings they make on allowed revenues than companies with inefficient forecast costs. The incentive also protects customers of those companies who do not produce high quality, efficient business plans from having to pay a higher amount if the company overspends. By removing the differentiated sharing rates without regard to these incentives, the CMA's proposals would remove a key tool Ofwat – and other regulators – use to regulate in customers' interests.

The CMA has also effectively removed the benefits to water companies from being fast tracked as the increase in allowed returns on redetermination far outstrips the returns from fast track status. We have used the fast track process to encourage companies to submit high-quality, well-evidenced and stretching business plans. In PR19 three companies responded to this incentive, allowing us to set performance, efficiency and evidential expectations for the rest of the industry. If the CMA proposals are confirmed, we are unlikely to find this incentive is effective in future reviews. Given the asymmetry of information between regulator and regulated companies, this could have a high cost for all customers.

Returning to the WACC in this context, we also note that the approach proposed in the Provisional Findings in relation to the WACC differs from that adopted by another CMA panel in another regulated sector – namely, air traffic control charges – less than six months ago. In addition to the potential implications for the water sector, the CMA's radical change of approach in relation to important determinants of the return on capital would create wider regulatory uncertainty and disruption.

The CMA has in the past emphasised the importance of regulatory stability and predictability in maintaining a long-term competitive cost of capital for the benefit of consumers in all regulated sectors. That suggests a measure of restraint which should apply to the CMA itself as well as to sectoral regulators. In particular, it ought to limit the extent to which the panel departs radically from decisions made by its predecessors without a clear and robust case for doing so and without an adequate opportunity for thorough consultation and consideration of stakeholders' views. Ofwat does not consider that such a case has been demonstrated; nor is there any evidence that the CMA has fully considered the importance of regulatory certainty.

Other process and substantive concerns

Finally, Ofwat does not believe that it will be possible for some of the CMA's provisional decisions to be subject to sufficiently fair and effective scrutiny in the time that the CMA currently proposes to take. Ofwat also has concerns about a wide range of errors that the CMA has made in the provisional findings.

We have done our best, in the other documents comprising our response, to explain our concerns about some of the conclusions that the CMA has provisionally reached (which include novel approaches with potentially far-reaching ramifications). However, Ofwat has found certain aspects of the Provisional Findings to lack explanation and is unclear as to how (if at all) the CMA has addressed certain submissions or evidence that Ofwat and other parties have already made to it. Moreover, the CMA is apparently still considering further information on leakage that has been requested after the Provisional Findings. Fairness requires that we have an opportunity to respond to what the CMA will conclude on the basis of that or any other new evidence.

In the light of the seriousness of our concerns about the impact on customers of the Provisional Findings and the other issues we highlight above, Ofwat respectfully urges the CMA to take the time that it needs to conduct a fair procedure and to reach substantive conclusions that are fully supported by, and can be explained by reference to, robust evidence. This entails taking additional time to engage in further adequate consultation and to ensure that all relevant considerations are taken properly into account.

Guide to the rest of our submission

In addition to this Overview, there are three further parts to our response:

- our response on risk and return including the approach to the cost of capital and to the gearing outperformance mechanism;
- our response on cost and outcomes issues including the approach to leakage, incentives for a good plan and the standard of evidence; and
- our response on process and substance concerns and the need for the CMA to take the full time available to make its final redetermination.

We are also providing a number of supporting expert adviser reports together with calculation spreadsheets. We stand ready to provide the CMA with further information on request.

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