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Cc: Dr Andrea Coscelli CBE, Chief Executive, CMA
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27 October 2020

Dear Kip

Ofwat Price Determinations – CMA provisional findings

We welcome the CMA's overall objective of setting a challenging set of performance targets in order to keep bills low for customers. However, we are nevertheless greatly concerned that the CMA proposes to allow the appealing companies materially greater costs than Ofwat had proposed. Moreover, these are greater costs than Ofwat should have allowed – in particular, in setting the firms' allowed rate of return (i.e. the "cost of capital"). Our overall view is that the CMA's draft decision has missed an important opportunity to protect consumers – by rejecting Ofwat's initiatives to redress the historical bias in favour of the companies which had become embedded in the price control processes.

This price control determination includes a trade-off between shareholders' and customers' interests with much at stake in the direction of price controls for multiple regulated sectors. Citizens Advice was therefore surprised, given the significance of the decision, that the CMA's provisional findings make extensive reference to the representations of parties that said that Ofwat had set the cost of capital too low – including regulated businesses in other sectors, such as energy and airports (and their advisers' reports[1]) – but make little reference to Citizens Advice's submissions that Ofwat had set the cost of capital too high[2].

To us, this approach is not in accordance with the CMA's statutory duties, in particular the WIA91 consumer objective – especially given companies' considerable lobbying position and resources to influence the CMA, compared to that of consumers.

We also note the Government's principal call to the CMA: to champion consumers, including being a strong and independent consumer voice, making positive changes across markets where consumers are losing out, working with sector regulators to ensure consistent methodologies, and using cutting-edge cross-disciplinary approaches[3].

In Citizens Advice's view, a sensible approach, and one shared by the former Competition Commission, was to allow an appropriate level of discretion to sectoral regulators. Ofwat has explained that a "step-change" is needed in water company performance, in response to criticisms of high profitability and poor value for money. Ofgem is also following a similar approach in the RIIO-2 price determinations. In our view, there is compelling evidence that this step-change approach in both water and energy needs to be bigger still. The CMA's water decision will of course also have a direct impact for other regulated sectors – especially energy – and this is likely to result in similar or even greater amounts per household bill, and unequal impact on vulnerable households.

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[1] Including by Economic Insight, Frontier Economics, KPMG, NERA, and Oxera, among others.

[2] See for example, CMA Provisional findings, 3.60-3.61.

[3] Department for Business, Energy and Industrial Strategy, The Government's Strategic Steer to the Competition and Markets Authority, July 2019.

As far as we are aware, Citizens Advice and the Consumer Council for Water are the only consumer parties to have made representations to the CMA on the cost of capital in the water appeals. In addition, water consumers have the extra disadvantage of having no challenger or disrupter firms to provide weight and evidence against industry incumbents and the large lobbying resources that they deploy. Together, these make it even more important that the CMA closely considers – and attaches extra weight to – consumer representatives' views.

In particular, we do not accept the CMA's provisional finding that a higher cost of capital is necessary to protect incentives to invest. On the contrary, it will exacerbate already high profit levels. In summary, lower allowed returns are not merely appropriate because of market movements since the last Ofwat review. There are two other critical reasons why allowed returns should be lower, above and beyond recent market movements.

First, there is wide consensus that allowed returns at previous reviews were highly generous to the companies – compared to market evidence – for example:

> *"The gap between the [regulatory allowed returns in recent UK energy and water price reviews] and our estimated [cost of capital] has come about in a number of ways:*
>
> - *Almost all regulators have been slow to bring their estimates of the risk-free rate down as market rates have decreased.*
> - *The regulatory allowed return on debt, which attempts to capture the cost of embedded debt, has also been persistently higher than the market cost of debt.*
> - *[...]regulators' assumed values of equity beta have been too high, compared to the plausible range of econometric estimates."* (UK Regulators Network, 2018)[4]

[4] UK Regulators Network, Estimating the cost of capital for implementation of price controls by UK Regulators, Stephen Wright, Phil Burns, Robin Mason, and Derry Pickford, 2018.

> *"There is [...] evidence that regulators may have been setting the [weighted-average cost of capital ('WACC')] too high in past price controls, allowing companies to earn higher returns than necessary to compensate investors, at a cost to consumers. [...] the evidence indicates why a systematic bias may occur in determining the WACC."* (National Infrastructure Commission, 2019)[5]

> *"Ofwat must strike a difficult balance between consumer interests and making it financially worthwhile for water companies to satisfy their investors. That balance has been skewed in favour of the latter."* (House of Commons Environment, Food and Rural Affairs Committee, 2018)[6]

Second, the systematic risk facing water companies at PR19 is demonstrably lower than at previous reviews, owing to appreciable changes in the price control mechanism, such as indexation of debt-servicing costs and "other material and/or highly uncertain" performance commitments.

Citizens Advice therefore strongly disagrees with the CMA's proposed adjustment to Ofwat's allowed rate of return; that such an adjustment is needed to ensure continued investment in the sector (including investment to address resilience and climate change); or that the CMA's approach reflects best regulatory practice.

On the contrary, Ofwat's proposals have not resulted in any evident waning of appetite for investment in England and Wales water companies, especially given the considerable shareholder protections afforded by the regulatory regime. Hence, the CMA's proposed cost of capital will simply result in an over-compensation to shareholders at the significant expense of customers.

[5] National Infrastructure Commission, Strategic Investment and Public Confidence, 2019, page 47.
[6] House of Commons Environment, Food and Rural Affairs ("EFRA") Committee, Regulation of the water industry, 2018.

Based on the evidence we have submitted we believe the CMA should reach a different final conclusion than in the provisional findings. Hence, when the CMA concludes its findings we expect CMA to justify its approach to redetermination much better or to resist a redesign of Ofwat's price control; to reflect a better understanding of the current and evolving balance of consumer and stakeholder exposure to risk; and better consider their respective correction or protection mechanisms.

This submission is our response to the CMA's provisional findings in the Water Price Determinations. We have already submitted detailed evidence to this appeal during the earlier phase. This document is not confidential and may be published on your website. If you would like to discuss any matter raised in more detail, please do not hesitate to get in contact. Citizens Advice has statutory responsibilities to represent the interests of consumers in Great Britain.

This cover letter sets out our overall view of the provisional findings. We provide specific comments on the provisional findings in **Annex A** and summarise our view on the cost of capital in **Annex B.**

Yours sincerely

Stew Horne
Head of Energy Networks and Systems
Citizens Advice

Annex A: Citizens Advice specific comments on the provisional findings

We have carefully reviewed the provisional findings published by the CMA. We are disappointed that the CMA has not followed the evidence based process required of the redetermination. Our view is that the CMA's draft decision risks setting back multiple regulators' attempts to redress the historical bias in favour of the companies which had become embedded in price control processes. We identify three key issues with the CMA's analysis:

- The CMA has not **given due consideration to the arguments made by Citizens Advice** and other consumer organisations.
- The CMA has **not provided sufficient evidence and justification**, particularly around the key area of the cost of capital.
- The CMA has **not achieved a reasonable balance between Ofwat's primary statutory objectives** - particularly its consumer protection duty.

In our view the CMA needs to revisit its analysis of the cost of capital. The CMA's statutory deadline is not until 18 March 2021. Currently the provisional timeline[7] indicates that the CMA is targeting early December to send determinations to Ofwat. This is an important decision, with implications beyond the water sector (evidenced by the submissions from regulated energy network companies) and it should not be rushed. The CMA's decision is insufficiently evidenced and its conclusions not properly supported by its analysis.

We contest that the CMA can, as currently proposed, set the cost of capital higher than the level that some of the appealing parties sought. Such is the potential impact to consumers of the CMA's decision, we think that this risks the possibility of judicial review, and there has been recent media speculation[8].

[7] Ofwat price determinations administrative timetable
[8] The Times (2020) Water watchdog showers criticism on rival regulator

The impact of these provisional findings, if they are taken forward, risks damaging the CMA's reputation and may undermine confidence that it can be relied upon to protect consumer interests. Ofwat's proposals in PR19, and Ofgem's proposals in RIIO-2 have aimed to redress the historic imbalance between consumers and industry, recognising the sustained historic outperformance companies have achieved. The regulatory appeal authority should be in the vanguard of excellence for regulatory practice, but its approach in the provisional findings dismisses developments in economic regulatory thinking in recent years. It also downplays the cross sectoral market anticipation of lower returns following generous PR14 and RIIO1 price controls that can be seen in the rate of return requests from regulated companies.

1. The CMA have not achieved a reasonable balance between Ofwat's objectives

a) Balancing Ofwat's primary duties

Ofwat's aim in its PR19 final determinations was to align the interests of the water companies and their investors to those of customers by setting an appropriate balance of risk and return[9]. We think that, overall, Ofwat struck a reasonable balance in its PR19 settlement, even though our evidence showed that Ofwat had been too generous in several areas and could have gone further on costs.

[9] Ofwat (2020) Reference of the PR19 final determinations: Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case

Ofwat's primary duties	Extent to which Citizens Advice considers these duties been met by the CMA provisional findings
To further the consumer objective, which is to protect the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services (consumer objective);	**This duty has not been met**. CMA has raised costs for consumers primarily through an increase in the cost of capital that is not adequately justified.
To secure that the company's functions under the WIA91 are properly carried out in respect of every area of England and Wales (functions duty);	**This duty is met.**
To secure that the company is able (in particular, by securing reasonable returns on its capital) to finance the proper carrying out of those functions (financing duty);	**This duty has not been met.** If an inefficiently high cost of capital is set, by definition the return on capital is not "reasonable."
To secure that the activities authorised by the company's licence and any statutory functions are properly carried out (licence duty); and	**This duty is met.**
To further the 'resilience objective'.	**This duty is met.** CMA has proposed making some additional funding available that supports this objective.

In its provisional findings the CMA argues that it has given equal weight to each of Ofwat's duties. However we don't think that the CMA has demonstrated that it has balanced Ofwat's duties effectively, giving much more weight to the needs of investors.

Ofwat has explained that many of the changes it introduced in the PR19 price controls reflected the need for a "step-change" in performance of companies to address a range of issues, including criticisms relating to high levels of profitability and value for money. We think that the case for this step-change in approach has only deepened with the impact of COVID-19 on affordability.

Our research, and Ofwat's own analysis, has shown that historically, returns to shareholders in water companies have on average been persistently higher than the allowed rate of return provided in the price controls – referred to as outperformance. As a result, water bills have been higher than necessary and economically inefficient. Ofwat sought to meet its consumer duty by addressing the issue of historic outperformance. This issue of outperformance is one which is increasingly being addressed by regulators in the UK and internationally[10].

We don't think the CMA has allowed Ofwat an appropriate level of discretion in its approach. Previously the CMA's predecessor (the Competition Commission) had attached significant value in the discretion of specialist regulators. A a 2010 ruling of The Carphone Warehouse Group plc vs Ofcom by the Competition Commission looks particularly relevant:

> *"We have however borne in mind that Ofcom is a specialist regulator whose judgement should not be readily dismissed. Where a ground of appeal relates to a claim that Ofcom has made a factual error or an error of calculation, it may be relatively straightforward to determine whether it is well founded. Where, on the other hand, a ground of appeal relates to the broader principles adopted or to an alleged error in the exercise of a discretion, the matter may not be so clear.* ***In a case where there are several alternative solutions to a regulatory problem with little to choose between them, we do not think it would be right for us to determine that Ofcom erred simply because it took a course other than the one that we would have taken.*** *On the other hand, if, out of the alternative options, some clearly*

[10] For example Ofgem (2020) RIIO-2 Draft Determinations - Core Document

had more merit than others, it may more easily be said that Ofcom erred if it chose an inferior solution. Which category a particular choice falls within can necessarily only be decided on a case-by-case basis"[11].

In our view, the selection of assumptions in the cost of capital calculation is an area where there are a number of plausible assumptions, each of which has sufficient merit to be adopted with, to use the Competition Commission's language, 'little to choose between them'. It is therefore clearly an area where Ofwat should be given some degree of regulatory discretion to arrive at an overall balanced outcome, and where the CMA should demonstrate that before selecting an alternative option, it explains why it 'clearly [has] more merit' than Ofwat's approach.

b) The CMA response to information asymmetry

As we have set out in our previous submissions, there is a significantly asymmetric relationship in the price control process between industry and the regulator in terms of resources and knowledge. In some other regulated sectors, such as telecoms and aviation, consumers' interests in the price control process are to some degree promoted by the wholesale customers of the regulated firms (who themselves operate in competitive retail markets to provide services to customers). These wholesale customers have the resources and financial incentives to challenge the regulated firms and the regulator and provide a useful counterbalance to the resources of the regulated firms

The asymmetric characteristic of the regulatory regime for water (and energy) has driven the persistent levels of excessive outperformance and the absence of any significant counterbalancing input from retail operators in the water sector makes it even more critical that the CMA takes full account of the submissions of consumer groups.

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[11] Competition Commision Reference under section 193 of the Communications Act 2003
The Carphone Warehouse Group plc v Office of Communications Case 1111/3/3/09 Determination

In order for the CMA to reach a 'fair' and balanced view it is therefore essential that it properly considers the counterbalancing views to industry put forward by Citizens Advice and other consumer organisations. This is why we are disappointed that the CMA has not taken our views into account in this determination, and why we do not consider that the CMA has ensured that the price controls meet Ofwat's consumer protection duty.

c) The impact of this decision will increase cost pressures on consumers

Consumers are suffering because of the direct impact of Covid19 and because of its impact on their incomes. 6 million consumers are behind on bills and over 3 million of these are behind on water bills. Covid19 has exposed the already precarious position of consumers surviving on negative budgets pre-covid. Our research shows that since 2016, the proportion of people Citizens Advice helps with debt, who have negative budgets has grown from under a third to nearly 2 in 5 (38%)[12].

The CMA's decision will increase bills by around 3%. If the CMA cost of capital increase was applied across the water sector and not just to the four companies the impact would be £1.8bn in nominal prices. National Energy Action estimate Ofwat's PR19 proposals would have reduced water poverty levels across England and Wales when compared to 19/20 levels by 8%. The impact of the CMA's provisional decision would be a only a 6% reduction in water poverty levels compared with Ofwat's Final Determinations. Both of these estimates are based on a measure of water poverty as 3% bill-to-income ratio after housing costs.

It's not just in the water sector where cost increases will be felt. It's likely that some or all of the CMA's decisions will set a precedent that will result in unnecessarily higher bills for consumers in other sectors. Ofgem are still working through exactly what the impacts could be if directly applied but early

[12] Citizens Advice (2020) Negative Budgets: A new perspective on poverty and household finances

estimates suggest an impact of this decision if applied to energy would increase costs to energy consumers over the next RIIO-2 price control period by approximately £2bn above Ofgem's current position in their draft determinations for the Transmission and Gas Distribution sectors. That could mean up to £10 per household per year. And the Electricity Distribution sector price control ED2, which is at an earlier stage, could see similar impacts of around half that magnitude. Our analysis shows there is good evidence that both Ofwat and Ofgem have been conservative and could have gone further and set a lower cost of capital.

Citizens Advice encouraged the CMA to view the redetermination in the context of the current and developing risks of affordability challenges for consumers. We presented in our response that there are not consistent or reliable affordability and debt protections in the water sector for all consumers, or specifically for consumers in vulnerable situations[13]. We highlighted the regional variation in customer issues and the lack of coverage of priority service registers. The CMA, rather than look for an opportunity to consider how the price control can benefit all consumers and specifically consumers in vulnerable situations, has produced provisional findings that are likely to intensify affordability challenges over the coming years. In this respect we think the CMA has not given due consideration to the practical implications of its decision.

The CMA can not support consumers interests if it views the price control separately from the evidence of the detriment that the water bill rises mean for consumers due to the current context of consumer challenges. Equally, the CMA does not appear to have considered the cumulative impact of their proposed increased rate of return on other regulated sectors. Given the work the CMA has undertaken across other sectors, such as a holistic review of energy sector regulation, we would expect that the CMA would be in a position to recognise the heightened impact of price control decisions due to limitations of existing

[13] Citizens Advice (2020) Redetermining Water

affordability and debt protections[14]. For example, there are already 2 million energy consumers entitled to the warm home discount who don't receive this protection and could be exposed to additional unmanageable costs[15]. The CMA should also consider the efficacy of the mechanisms in place to ensure increases in prices will result in additional necessary investment and not unnecessarily high returns to shareholders.

2. The decision has not fully considered Citizens Advice's arguments

We are disappointed that the CMA has not given due consideration to all the issues raised by Citizens Advice in our submission to the PR19 appeal. Citizens Advice raised issues in a number of areas (see table below).

We are pleased that the CMA has recognised our arguments on the value and use of consumer evidence, better coordination of the priority services register, and retail margins. The CMA has also encouraged additional focus on the needs of consumers in vulnerable situations and included many of the suggestions we made on the use of consumer evidence.

However, on the critical area and broadly impacting issue of cost of capital and outperformance our arguments have not been properly considered.

Issue raised by Citizens Advice	Reason this issue is important	CMA response
Information asymmetry in the water sector.	The asymmetry makes the price control one sided and structurally favours industry	**CMA does not give detailed consideration to Citizens Advice's arguments .**
Persistent historic	Water companies have consistently	CMA summarizes Citizens Advice evidence from Monopoly Money **but does not engage with the arguments in**

[14] Citizens Advice (2020) Excess debts - who has fallen behind on their household bills due to coronavirus?
[15] Citizens Advice (2020) Energy consumers face unprecedented challenges this winter

outpermance	outperformed at the expense of consumers	**detail.** The CMA states that there is no problem with outperformance in the water sector.
Application of statutory framework	Ofwat has identified tackling historic out performance as key to meeting the consumer duty	**Some discussion of consumer group views**. However, the CMA fundamentally disagrees that there is an issue with outperformance and concludes that "aiming up", and therefore increasing bills, is in consumers' interests.
Utilisation of consumer evidence	It's important that outputs and plans are shaped by consumer and stakeholder view, and it's clear how regulators weigh decisions.	There is s**ome discussion of consumer group views**. We think CMA's decision around the use of consumer evidence has considered our evidence.
Equity Beta	The equity beta estimates how risky a company is. We argue Ofwat has over estimated this.	The **CMA does not give consideration or acknowledge the arguments Citizens Advice makes** on: • the case for a lower beta based on Ofwat's data • our analysis of the fundamental risks faced by companies; and • our discussion of the relationship between gearing and beta.
New debt outperformance wedge	Companies have consistently outperformed new debt allowances.	The CMA **does not give detailed consideration to Citizens Advice's arguments.**
Embedded debt outperformance	Companies have consistently outperformed embedded debt allowances.	The CMA **does not give detailed consideration to Citizens Advice's arguments.**
Inconsistency of beta and debt out performance	Beta could be overestimated because debt outperformance.	The CMA **does not give detailed consideration to Citizens Advice's arguments.**

Total market return	This is a key part of estimating the return equity investors expect. Citizens Advice argues Ofwat overestimated this.	The **CMA does not discuss or acknowledge our evidence for lower long run historical returns**. The CMA discussed the use of forward looking forecasts, **but does not consider our evidence.**
Retail Market adjustment	Ofwat's risk adjustment corresponding to retail activity was too generous.	The **CMA discussed our arguments and proposes to adopt our recommendations.**
Use of an equity performance wedge to address outperformance	Companies have consistently outperformed equity allowances.	The **CMA does not discuss this proposal, or the evidence** provided by Citizens Advice.
Financeability	Citizens Advice argued that Ofwat is right to judge financeability against a notional efficient company, and that all of the water companies are financeable.	CMA summarises Citizens Advice and Consumer Council for Water arguments, but **does not engage with this evidence in its analysis.**
Impact of Covid 19	Citizens Advice argued that the impact of Covid19 meant there should be more support for vulnerable consumers.	CMA has lifted these recommendations out of the appeal for Ofwat to consider.

The impact of a lack of proper consideration of our submission is in stark contrast to the volume of analysis given to the submissions of the appealing companies and those of other regulated firms seeking to use this appeal to influence price controls in other sectors.

Another area that CMA does not consider sufficiently is an asymmetry in opportunities for future changes to price controls. Where the cost of capital can be demonstrated to have been set too low, then regulated companies can use the Interim Determinations (idoc)[16] and Substantial Effect Determination processes to re-open the price control. In the last 15 years of price controls that Citizens Advice analysed in Monopoly Money these processes have never been used to reset the cost of capital suggests that regulators have always set rates comfortably above companies needs. Ofwat has consistently aimed up, meaning industry benefited at the expense of water consumers by £11bn. While consumer groups have super complaint powers, there is no formal mechanism for other stakeholders to re-open the price control. Given the opportunities for companies to re-open the price controls which are not available to consumer groups, the CMA should positively act to counterbalance this asymmetry by erring in favour of consumers where there is an opportunity to do so.

3. The CMA has not provided sufficient justification for its decision

We are disappointed with the lack of evidence and analysis the CMA has provided in support of many of its findings in the provisional findings, particularly in its estimate of the cost of capital.

There is scant evidence in some of the key areas that drive major costs for consumers. The CMA has used the CAPM model as the basis for setting the cost of capital. We agree this model is the basis of good economic regulation of monopoly network companies.

However, the CMA has failed to engage with the wider arguments put forward by regulators, stakeholders and the UKRN that challenge the traditional CAPM model.

In particular, the development of the CAPM model, as applied by Ofwat (and Ofgem in its current proposals) to address persistent outperformance of previous regulatory settlements represents an important improvement in the

[16] Ofwat Interim Determinations

price control process which can help ensure consumers' interests are protected. If the CMA genuinely wants to be seen as the gold standard of regulation it needs to engage with the arguments about how regulation continues to evolve.

There are several key examples within the provisional findings where the CMA has failed to provide sufficient justification:

- **Aiming up**

CMA argues that by putting the cost of capital at the "sits at the 58th percentile of our WACC range, so is 'aimed' slightly above the midpoint[17]." However, the CMA has also taken a "cautious' view, effectively aiming up, on the majority of the constituent parts of the cost of capital calculation – compounding the effect of its cautious approach. There is no assessment at this point of what the impact of consumers will be of this decision. The CMA reason that the risk of underinvestment outweighs the risk of higher bills for which there are "well established arguments", but there is no cost-benefit assessment or quantification of these risks[18]. The CMA do at some length consider the financeability arguments that industry have put forward in their evidence to the appeal.

We do not think the CMA has justified its decision to aim up given that the risk is borne by consumers in the form of lower prices, and not by the water companies. Instead the CMA have disregarded the evidence provided by Citizens Advice, Ofwat and other third parties and has been too cautious. The reality is that investors still find water and energy companies very attractive. For example, as Ofwat note in their submission 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*

[17] Paragraph 9.676
[18] Paragraph 9.667

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.[19]*"*

More recently media coverage continues to highlight that "utility companies, particularly in the water industry, have policies committing to growing the dividend at inflation or above, making them very attractive given the current economic climate.[20]"

These low risk companies, with a low but steady return on investment are highly desirable. At Ofgem's recent Open Meetings for the RIIO-2 price controls, the chair of Ofgem's independent Challenge Group, Roger Witcomb, said his group has had discussions with investors (who he described as "neutral") who are satisfied that Ofgem's proposed returns regime (which is lower that Ofwat's) provides adequate incentive to invest.

It should be clear that if Ofwat's price controls really did mean that the appealing companies would not be able to finance their current and future investments the same should apply to the water companies which did not appeal. The fact that only 4 of 17 decided to appeal provides further compelling evidence, if needed, that Ofwat's allowed rate of return was more than sufficient for water companies to finance their current and future investments. As justification for it's appeal approach, the CMA should explain what evidence it is using that higher returns are necessary for the appealing companies but not others.

- **The need to provide higher returns to stimulate investment**

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[19] Ofwat, Reference of the PR19 final determinations: Cross-cutting issues, March 2020, paragraph 5.13.

[20] https://www.thisismoney.co.uk/money/investing/article-8466027/Is-investing-utility-giants-bright-idea.html

The CMA has provided no evidence to support their conclusion that a higher cost of capital is required to ensure investment in the water sector. Instead the CMA appears to us to have simply accepted the appealing companies' assertions (again which lack any supporting evidence) that higher returns are needed to ensure adequate levels of investment.

The CMA does not consider how Ofwat can use the licence conditions and other mechanisms to ensure investment is made and how these effectively offset any potential consumer harm which could arise from a failure by the companies to invest.

- **Tackling historic outperformance**

The CMA dismisses the existence of historic outperformance in the water sector but provides little reasoning for this beyond:

> *"9.352 We do not consider there to be evidence to support the use of a performance wedge. The evidence provided by the appellant companies strongly suggests that once tenor and credit rating are adjusted for, there is no evidence of water company outperformance."*

This issue was central to Ofwat's proposal to rebalance the price control. The CMA are not clear about how they reconcile the consumer protection duty against their conclusion that outperformance is not a concern.

- **Estimating the equity beta**

The CMA's analysis of beta is scant given its proportionate impact on the cost of equity. The CMA takes no account of the changes in systemic risk that Ofwat have made in removing risk from water companies, which will reduce beta. Although this is hard to measure, we do know that the direction of travel is for beta to be lower.

- **Risk Free Rate**

The argument for not entirely using Ofwat's recommendation of UK gilts and for using a range that includes a different index is not well substantiated. Such a move could be seen as a divergence from regulatory consistency. The CMA do not discuss the merits of this, yet several times elsewhere in the provisional findings the CMA stress that regulatory consistency is important and provides benefits[21].

- **Sharing factors**

We are concerned about where CMA has landed on sharing factors. Recommending uniform sharing factors for the appealing companies sets a precedent that strips regulators of a way to differentiate incentives between companies, based on confidence in the information and performance delivered. We think this will be an increasingly important regulatory tool as regulators grapple with funding anticipatory investments to mitigate the impact of changes in how networks are used to meet net zero commitments, adapt to climate change and respond to changes in working habits impact. Anticipatory investment exposes consumers to additional risk of underutilised assets where investment needs are misjudged. As network performance varies, regulators should have the option to reflect this in funding. We don't think the CMA provides a full explanation for why adopts its recommended position, nor any analysis about if there is benefit for consumers derived from their recommendation versus Ofwat's position in PR19 final determinations.

[21] Paragraphs 89, 5.407 and 9.445

Annex B: Response to the CMA's provisional findings on the cost of capital

In Citizens Advice's submission to the CMA's redetermination of the PR19 water price control[22], we said that we were responding to the Ofwat price determination appeals for two reasons:

1. the impact of water bills on household incomes; and
2. the CMA's decision will set an important precedent for other regulated sectors, such as energy.

We therefore focused in particular on cross-sector issues, such as the allowed rates of return.

As the provisional findings highlight, the CMA's allowed rate of return – i.e. the allowed cost of capital – will have a considerable impact on customers' bills. Namely, based on average household bill of £400, of which 20% relates to return on capital[23], and total PR19 cost allowance of £49.6bn[24], every percentage point increase in the allowed rate of return will result in an increase of £3.4bn in total bills over the price control review period.

Accordingly – foremost – Citizens Advice submitted that Ofwat's determination of water companies' equity beta materially overstated water companies' non-diversifiable risk, as it implied a level of non-diversifiable risk far greater than the actual level borne by investors.

Citizens Advice also commented on the other main components of allowed returns, Total Market Returns ("TMR") and the cost of debt, and the related question of financeability.

[22] Of 25 June 2020.

[23] See CMA Provisional findings, 2.20.

[24] Ofwat, PR19 Final determinations: Overall stretch on costs, outcomes and cost of capital policy appendix, December 2019, Figure 1.

Equity beta

Citizens Advice submitted that Ofwat's determination of water companies' equity beta materially overstated water companies' non-diversifiable risk, as it implied a level of non-diversifiable risk far greater than the actual level borne by investors.

Ofwat's proposed water company unlevered equity beta of 0.29, asset beta of 0.36, and notional equity beta of 0.71 implies that firms' risk profiles varies pro-cyclicality with the wider economy to a substantial degree, for example, that a 1.00-percentage point change in the UK economy would imply a 0.36-percentage point change in water companies' profit before interest costs, or 0.71-percentage point change in shareholders' profit, on average. In Citizens Advice's view, this is not plausible. On the contrary, England and Wales water companies' financial performance is not pro-cyclical to any material degree, for a combination of reasons.

First, water is fundamentally a non-cyclical industry, generally impervious to the wider economy and other economy-wide economic shocks, with neither revenues nor costs likely to vary materially or at all with wider economic conditions. The only likely components of pro-cyclical water company performance are bad debt risk, extreme weather risk, or political risk.

However, from the perspective of the typical global investors in the UK water companies – global banks, asset management firms, private equity funds, plus major pension funds, and/or other global institutional investors and multinational corporations[25] – much or all of such risk is readily diversifiable from the perspective of such investors. Namely, much or almost all investor risk facing the water companies should be considered as diversifiable (i.e. "non-systematic"), as most such risks are local to the UK.

[25] Namely, see list of UK water company owners/parents at en.wikipedia.org/wiki/United_Kingdom_water_companies.

For comparison, we note the CMA's NERL/CAA Regulatory Appeal Provisional findings report's assessment of non-diversifiable risk of NERL's air traffic control business[26]. In this, the CMA highlights the considerable differences of risk between NERL's business – namely, of volume risk related to air travel demand – and the risk faced by water utilities, of almost zero volume risk[27].

Second, the underlying feature of the England & Wales water regulation regime – and UK economic regulation more generally – is that non-diversifiable risk is almost entirely borne by customers, rather than by investors. Furthermore, the large majority of diversifiable risk is also borne by customers rather than investors.

For example, Ofwat and Ofgem have long since highlighted that: *"[Water and energy] companies' exposure to unanticipated cost shocks is limited to the extent that there are regulatory mechanisms that can be used to deal with them for example in the water sector the interim determination and substantial effect mechanisms"*[28].

Indeed, Ofwat's PR19 final determination describes in much detail how water company investors are afforded considerable risk protections:

- *"Water companies and their investors already benefit from significant risk protection [...] We have added additional uncertainty mechanisms at final determination, which further reduce risk exposure of water companies. [...]*
- *"Companies and their investors in this sector have significant protection from risks compared to companies operating in a wholly competitive environment. [...]*
- *"The revenue risk faced by water companies is low as a result of the reconciliation mechanisms and regulatory protections in place."*[29]

[26] CMA, NATS (En Route) Plc /CAA Regulatory Appeal: Provisional findings report, 2020.

[27] Para. 12.46. The water companies are of course subject to revenue controls, rather than tariff controls, which eliminates volume risk.

[28] See Financing Networks: A discussion paper, Ofgem and Ofwat, 2006, para. 71..

[29] Ofwat, PR19 Aligning risk and return technical appendix, pages 5, 17, 33.

The CMA Provisional findings confirm the same features of the regulatory regime[30]. Namely, the substantial "risk protections" – to the companies and their shareholders, rather than to customers – include price control re-openers, inflation indexation of companies' regulatory capital value and allowed revenues, application of revenue controls rather than price controls, performance commitments ("PC") and outcome delivery incentives ("ODIs"), total expenditure ("totex") sharing mechanism, labour cost adjustment mechanism, plus multiple other cost-sharing, "uncertainty", reconciliation, adjustment, and special/bespoke allowance mechanisms.

In addition, while transferring risk from investors to customers, customers also typically face greater downside than upside risk. For example, while companies can seek a price control re-opener in the event of unexpected higher costs, such an option is not readily available to customers in the event of unexpected lower costs.

Third, PR19 adds a series of new uncertainty mechanisms that further shift risk from investors to customers, in particular, the indexation of debt servicing costs, as well as other material and/or highly uncertain performance commitments[31].

Furthermore, the CMA itself proposes a further reduction in companies' exposure to financial risk[32], such as the introduction of "deadbands" that mitigate the risk to companies of factors outside their control[33].

The effect of this reduction in systematic risk at PR19 compared to PR14 must therefore mean a reduction in the equity beta, all else being equal. Indeed, it is only fair that a transfer of systematic risk from investors to customers is compensated for in lower customers prices (i.e. via a lower cost of capital). However, betas estimated using historic share price data from previous price

[30] See for example Provisional findings, 2.85(c), 9.251.

[31] For example, see Ofwat, PR19 Aligning risk and return technical appendix, pages 83.

[32] CMA Provisional findings, 2.(d), 93.

[33] CMA Provisional findings, 71.(b).

control review periods will of course not reflect such lower future systematic risk.

Moreover, in general, estimating regulated companies' equity betas based on short-term share price movements is likely to result in over-statement of firms' underlying non-diversifiable risk, as reflected in the non-cyclical nature in particular of the water industry and the multiple protections that transfer risk from investors to customers.

This is because short-term share price movements reflect the risks borne by short-term investors, not those borne by the long-term investors that characterise the large majority of investors and which the regulatory regime is intended to encourage. Such short-term correlation of share prices with market movements is a result of the high volume of share trading in market indices (and near-market indices). In contrast, share price movements only tend to diverge significantly when individual shares enter or exit an index, which happens infrequently. Hence, short-term movements in individual share prices versus a market index will typically not be a good indication of the long-term non-diversifiable risk, especially for low a priori-risk regulated utility companies.

Such assessment is fully consistent with best practice, for example the 2018 UKRN cost of capital report, which notes research that:

> *"On the basis of a priori reasoning the risk profile of cashflows for regulated businesses is almost entirely idiosyncratic [i.e. diversifiable]."*[34]

And correspondingly asks:

> *"If regulators wish to estimate the [cost of capital] appropriate to a relatively long horizon (say, 10 years), is it appropriate to estimate beta over such a*

[34] UK Regulators Network, Estimating the cost of capital for implementation of price controls by UK Regulators, Stephen Wright, Phil Burns, Robin Mason, and Derry Pickford, 2018 ("the UKRN cost of capital report"), page 54.

> *short sample (often distinctly shorter than the horizon itself) and using high frequency (daily or weekly) data?"*[35].

The report therefore argues that:

> *"If [UK utility regulators] are concerned to assess the nature of systematic risk at long horizons, [they] should ensure that our estimation techniques are consistent with that horizon [whereas, in contrast…] what is now standard practice in beta estimation: the use of relatively short (2- 5 year) samples of, usually daily data […] reflects the relatively short-term objectives of most users of estimated betas in the finance industry."*[36]

The UKRN report then goes on specifically to argue for estimation of beta based on *"longer-term data and at lower frequencies"*, on grounds that this is *"more relevant to the long horizons used by regulators"*, and that this *"results in distinctly lower equity beta estimates"*[37], namely, of raw beta estimates in the range 0.3-0.5 (and towards 0.3 at lower estimation frequencies), on the basis of United Utilities and Severn Trent Water, the same two listed water companies on which Ofwat, the CMA (and Ofgem[38]) rely on for their beta estimates. This compares to Ofwat's considerably higher raw beta estimates of 0.58-0.66 and "updated final view" of 0.63, and the CMA's notional equity beta range of 0.65-0.80, and CMA "point estimate" of 0.76.

We note also that Ofgem argues that its forthcoming RIIO-2 price control should seek to determine the "forward-looking" betas for the regulated energy network companies focusing on the "longest horizon available"[39].

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[35] UKRN cost of capital report, page 51.

[36] The UKRN cost of capital report, page G-139.

[37] The UKRN cost of capital report, page 9.

[38] In its RIIO-2 Draft Determinations, 2020.

[39] Ofgem, Consultation - RIIO-2 Draft Determinations – Finance Annex, para. 1.8.

As part of Ofgem's RIIO-2 review, Ofgem commissioned a report on estimating beta by one of the UKRN report co-authors, which the CMA also cites[40]. This report particularly highlights the "time-varying" nature of beta and hence the considerable challenges of estimating forward-looking betas, especially when based on historic data, namely:

> *"It is extremely difficult to argue that beta should be treated as a constant except perhaps in the very short run. [...Hence,] if one wishes to produce beta estimates for horizons further than days or even months the issue of time variation in the future as well as the past has to be acknowledged."*

We therefore disagree therefore with the CMA's comment that the Robertson report *"did not identify any general concerns with daily data"*[41]. On the contrary, Robertson identifies considerable concerns with using high frequency short-term data.

Accordingly, overall, on the basis of the lower longer-run raw equity betas argued for in the UKRN report – of 0.3-0.5 – Ofwat's final determined asset beta would fall from 0.36 to 0.21-0.30, notional equity beta from 0.71 to 0.33-0.55, and the overall allowed rate of return would fall by between 0.5%-1.2%-points on all inflation measures.

The CMA was therefore wrong to provisionally determine an equity beta even higher than Ofwat's.

Total Market Return (TMR)

On the Total Market Return ("TMR"), Citizens Advice said that – to be fully consistent with the Capital Asset Pricing Model ("the CAPM") – the TMR should

[40] Ofgem, RIIO-2 Sector Specific Methodology Consultation report by Donald Robertson on estimating beta, 2018.

[41] CMA Provisional findings, para. 9.265.

not just be based on the average returns on UK equities, but on the average returns on a wider and more diversified asset portfolio, including bonds, property, infrastructure, private equity, and other such assets that are readily available to the typical investors in UK water companies.

Such a portfolio is necessarily more diversified than equities alone, therefore a much better fit for the CAPM's requirement that the "market portfolio" should represent the most diversified (and readily available) portfolio of investments. Such a portfolio is also likely to exhibit lower average returns than equities alone, owing to the inherently geared nature of equities on average.

Correspondingly, estimation of water company betas with respect to UK equities alone is likely to result in overestimation of the relevant non-diversifiable risk. This is because the risk associated equities – assumed by the UKRN report as having a beta of 1 – itself represents a diversifiable risk, especially from the perspective of highly sophisticated global investors. Hence, water company betas estimated with respect to UK equities should represent at most an upper bound estimate.

As evidence of the long-run average returns on such a wider portfolio of assets, Citizens Advice referred to the research of economist Thomas Piketty, who finds that the real return on capital – a measure based on long-run directly observable historic averages of return on capital – is currently in the range 3-4%[42]. This approach is based on the method of comparing directly observed and recorded national income from capital, with recorded national wealth, to derive the average rate of return on all capital (such as including land and real estate, infrastructure, private equity, and other non-listed assets, rather than just the estimated return on public equity alone).

[42] Source: Thomas Piketty, Capital in the 21st century, 2013 (section: The Return on Capital in Historical Perspective).

Accordingly, we said that adjusting this approach to the same basis as Ofwat's estimated TMR suggests that Ofwat's TMR of 6.50% (real-CPIH basis) and 5.47% (real RPI basis) is too high, and should be closer to 4%. This would result in a reduction of the allowed water company cost of capital of 0.4%-0.7%.

The CMA's Provisional findings nevertheless makes no reference to Citizens Advice's position.

The CMA only says that, to calculate TMR, it placed the most weight on historical ex post returns (from 1900 to the present day), and placed some weight on both historic ex ante approaches and forward-looking evidence as a cross-check when selecting our range[43].

The CMA notes that there is no universally accepted method for deriving TMR[44], but that in order to estimate the TMR, the CMA "reviewed data over the longest period possible", namely equities only data from 1900-2019[45].

First, Citizens Advice disagrees that the CMA data represents the longest period possible. Professor Piketty's data series covers a much longer time period, from 1770 to 2010. The data series also highlights how returns on capital tended to be higher during the 1900-2010 period than for the full time series.

Second, Citizens Advice considers that the CMA has wrongly focused just on equities data rather than also considering returns on a wider market portfolio of assets.

Accordingly, the CMA has wrongly determined the TMR.

[43] Provisional findings 80.(d).

[44] Provisional findings 9.143.

[45] Provisional findings 9.153.

Risk-free rate (RFR)

Citizens Advice did not specifically comment on the risk-free rate ("the RFR") to the CMA, as we agreed with Ofwat's approach. We nonetheless disagree with the CMA's approach.

First, we agree with the CMA that regulatory decisions comprising equity betas materially below one increases the importance of the risk-free rate[46], as also highlighted in the UKRN cost of capital report. Moreover, we agree with the UKRN's unequivocal recommendation that "regulators should use the (zero coupon) yield on inflation-indexed gilts at their chosen horizon to derive an estimate of the risk-free rate at that horizon"[47].

Second, we agree with the CMA that "it would be consistent [...] to assume that the cost of borrowing by low-risk investors therefore forms a 'lower bound' for equity returns"[48].

However, we strongly disagree with the CMA's assertions and findings that:

- the Modigliani-Miller CAPM/WACC theorem requires that all market participants can both borrow and lend at the same price, and that all debt is considered as risk free[49];
- because "the investors in water companies cannot [...] be assumed to be able to borrow at the risk-free rate, if it is set at the UK [index-linked government gilts ('ILG')] rate [...that] this implies that a CAPM model based on the ILG rate may understate the return required by investors on

[46] Provisional findings 9.43.
[47] Provisional findings 9.49.
[48] Provisional findings 9.92.
[49] Provisional findings 9.75.

equities, if it underestimates the return associated with a 'zero-beta' asset"[50];

- "the CAPM should not assume that investors would accept a lower return on zero beta (or very low beta) equities than the cost of financing that return by borrowing [...and] the cost of borrowing by low-risk investors [...] could therefore be another way of estimating the return on a zero-beta asset"[51];
- "the yield on ILGs is likely to sit below the 'true' estimate of the theoretical RFR"[52]; and
- "As a result, on the balance of evidence we consider AAA-rated non-government bonds to be a suitable input into our estimate of the RFR"[53].

On the contrary, according to the Modigliani-Miller theorem:

- debt is just another asset – like equities – and therefore only "risk-free" borrowers such as the UK government will be able to borrow at the risk-free rate;
- a "zero-beta" equity is a theoretical but in practice non-existent asset as, as commonly agreed, only index-linked government gilts ("ILGs") approximate to being risk-free – hence non-zero-risk investors that borrow to finance ILGs should necessarily expect a lower return on those ILGs than the corresponding cost of borrowing to finance that return; and
- the cost of borrowing by low-risk investors forms a lower bound for equity returns because the lowest-risk equities should be expected to have small but non-zero betas.

[50] Provisional findings 9.86. Investors in water companies of course are unlikely to be as "risk-free" as issuers of ILGs, albeit many such investors, e.g. various global banks, are able to borrow at rates close to corresponding government borrowing rates.

[51] Provisional findings 9.92.

[52] Provisional findings 9.135.

[53] Provisional findings 9.93.

Accordingly, the cost of borrowing by low-risk investors is not "another" way of estimating the return on a zero-beta asset. On the contrary, it will always over-estimate the return on a zero-beta asset, i.e. the RFR.

Hence, in conclusion, we strongly disagree that with the CMA's estimated range for the CPIH-real RFR as lying between -1.40% (based on ILG yields as a lower bound) abd -0.81% (based on "very-highly rated non-government yields" as an upper bound), as compared to Ofwat's PR19 final determination of -1.39%[54]. On the contrary, the CMA should have determined the same RFR as Ofwat.

Overall cost of capital and financeability

Having established its ranges for the components of the cost of capital, the CMA then selected point estimates, noting that:

> *"We have provisionally decided that it is appropriate to reflect the risk of error in our cost of capital component metric estimates when choosing a point estimate for the WACC, given the potential costs of setting the cost of capital too low. We also consider that there are reasons specific to this determination, related to asymmetry and financeability, which justify a degree of caution against setting the cost of capital too low. [...]*
>
> *On the cost of equity, we acknowledge that our estimates are significantly more likely to suffer from error. We adjust for this by picking a point estimate of the cost of equity midway between the midpoint and the top of the range"*[55];
>
> *"In our judgement, this approach acknowledges the varying potential for error in our estimates whilst also appropriately adjusting for any asymmetric risks to*

[54] As at Provisional findings 9.141.

[55] As at Provisional findings 9.674.

customers from underinvestment without being unnecessarily generous to shareholders"[56];

"The increase in WACC relative to Ofwat's determination contributes favourably towards financeability."[57]

As Citizens Advice stated in its submission to the CMA, we disagree that there are grounds for the CMA "aiming up" in this way. In particular, we do not agree that there are grounds of asymmetry or financeability for justifying "caution" against setting the cost of capital "too low".

First, we agree with the CMA that: "As a matter of principle, if the WACC is set at a reasonable level, both debt and equity investors should earn sufficient returns to cover the costs of financing."[58] Hence, if the cost of capital is set at a reasonable level to start with, there is no financeability justification for subsequent "aiming up". Aiming up will only result in the cost of capital being too high.

Second, we disagree that there is any asymmetry justification for aiming up. On the contrary, the PR19 regulatory regime contains multiple pre-existing and new mechanisms for transferring risk from shareholders to customers. This itself implies a large asymmetry justification for "aiming down" in favour of customers, not "aiming up" in favour of investors.

Third, Citizens Advice considers that the CMA has already chosen ranges that overstate almost every individual component of the cost of capital. Hence, deciding to "aim up" when choosing point estimates only compounds the CMA's already "aimed up" approach. Accordingly, the CMA is guilty of the same systematic bias and skewing in favour of investors over customers as criticised in

[56] As at Provisional findings 9.675.

[57] As at Provisional findings 10.51(a).

[58] As at Provisional findings 10.58.

the UKRN, National Infrastructure Commission, and House of Commons Environment, Food and Rural Affairs Committee reports.

The overall effect of this is to be unnecessarily generous to shareholders and unjustifiably raising customers' bills.