Water Price Appeals 2020; Anglian Water, Bristol Water, Northumbrian Water and Yorkshire Water.

Submission to CMA on its Provisional Findings

by Sir Ian Byatt

My name is Ian Byatt. I was Director-general of Water Services from privatisation in 1989 to 2000, Chairman of the Water Industry Commission for Scotland from 2006 to 2011 and have advised the Northern Ireland Government. Previously, I was Deputy Chief Economic Adviser to the Treasury, advising on micro economic issues, including those of the Nationalised (Utility) Industries

I can claim a long-term relationship with the regulation of water services. In the light of this I consider that the CMA, in its provisional findings is overestimating the cost of capital to the detriment of water customers as they struggle with Covid 19.

The cost of capital; average or marginal; bond or equity?

The estimation of the cost of capital has been a key problem in setting price limits for water companies which comply with the regulator's statutory duties.

Treasury officials had thought primarily in terms of a return to equity. This was duly reflected in the Treasury' Green Book. It also found expression in the MMC's decisions on the rate of return for Manchester Airport.

The 1967 White Paper recommended long-run marginal cost pricing LRMC following the pioneering work of Marcel Boiteux at EdF. The Treasury was, however never fully successful in imposing it in practice, because of the effect on prices.

Ofwat moved its thinking away from LRMC because it could conflict with covering the accounting costs of privatised utilities. This unfortunately neglected the relevance of the marginal rate of return at a time when companies were raising new capital primarily through bonds.

Estimates of the weighted cost of capital(WACC) have exceeded the outturn weighted cost of capital. This has resulted from using the existing level at a price reviews , when it has subsequently fallen over the 5 year period as a result of a continuing decline in interest rates and a big increase in perceptions of the appropriate level of gearing. as the corporate bond market has revived.

In consequence, the marginal cost of capital to water companies has systematically been below the average (weighted) cost of capital. The average cost has been overstated as regulators did not anticipate a fall in the WACC; the marginal rate has been below the average rate, Both these factors have provided financial gains to companies, which have not, as has greater operating efficiency, been passed on to customers by the periodic price review process.

Privatisation and the recovery of the corporate bond market

At privatisation, the government's financial advisers, Schroders, advised that price limits for the privatised water authorities should respect a limit to gearing of 35%. This implied a large equity element in the weighted cost of capital and a rapid increase in price limits over ten years after privatisation. It assumed that capital would primarily be raised in equity.

Since then the Corporate Bond market has revived and water companies have been able to borrow on a large scale.

One of Ofwat's first tasks was to review this in preparation for the price review being planned for 1994 (PR94). We argued that gearing could reach 50 or even 75%. We were derided in the City, but thinking changed crisply when Northern Electric borrowed in order to pay a large dividend to brush off a takeover bid.[1]

Meanwhile interest rates have continued to fall. When the Treasury first issued indexed gilts they carried a yield of over 3%. The National Debt Office is now borrowing at zero, or slightly negative, inflation adjusted returns. The Bank of England is now exploring a world of negative real interest rates.

Changing perceptions of optimal gearing, helped to create a situation where the marginal cost of capital was a bond rate and not the weighted cost of capital. At successive price reviews, this bond rate also fell below the regulator's assessment. For many years of this century, appointed water companies were able to pay rapidly rising dividends regularily outperforming the increase in FRSE dividends.

High prices and rising dividends increased customer antagonism to the privatisation and independent regulation settlement. As they put it, they considered that companies should retain funds for future investment rather than borrowing to pay higher dividends.[2]

As a consequences I have argued in recent work that the regulatory settlement should include a sliding scale so that dividends could only increase (above some specified level) if prices fell.

The notional dividend set in PR19 could be used A A fifty/fifty split could be appropriate, but other proportions could be set in the licenses for appointed water companies. It is likely that any such change would need the approval/agreement of the CMA.

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[1] Under the (disputable) classic CAPM model with a zero low debt beta the use of a higher gearing does not reduce the cost of capital. So customers would see no benefit from ab increase in gearing used by regulators estimating the WACC.

[2] See my 2017 paper 25 years of water regulation; looking backwards and forwards.

Such a dividend/price sliding scale was used to regulate the British Gas Industry in the 19th Century.

Trends in bond yields since PR19 and current returns to equity

Perception of further increases in gearing may now have stabilised, but interest rates have fallen since Ofwat's final determinations in PR19. And they may fall further. There seems little shortage of funds looking for profitable investment. The venture capital market seems (see PitchBook)to be recovering rapidly from the perceived effect of Covid 19 lockdowns.

Meanwhile returns to equity have fallen sharply following fears of recession and now Covid 19. UK dividends have already dropped to their lowest level for ten years.[3] They are widely predicted to fall further. Chances of a quick economic recovers seem stalled in the face of current and future further lockdown. This implies a continuation of low equity returns, which should be reflected in CMA redeterminations.

The Bottom Line

Following the generous settlement of PR04, uncorrected in PR09 and PR14, for water companies, water customers have been overcharged for many years. The use of a weighted cost of capital when companies raised capital by borrowing added to excess returns.[4]

In consequence, water companies have been allowed high returns for a low risk activity. In PR19, Ofwat have now corrected this, ensuring a progressive transfer of excessive returns to customer through lower price limits. Since then, in the wake of Covid 19, bond yields, returns to equity and customers' incomes have all fallen.

It would seem perverse for the CMA to increase the allowed rate of returns for the companies who have appealed against Ofwat's' final

[3] Daiky Telegraph 21 October 2020
[4] See NAO review of PR09

determinations. This would risk misreading market evidence or failing to consider the full range of evidence

The introduction of a price/dividend sliding scale would be a convenient and transparent way of ensuring the sharing of financial innovation, as well as greater operating efficiency, with customers.

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