South East Water

CMA submission

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1. Introduction

This submission is presented in response to the CMA provisional findings of the review of price determinations for Anglian Water, Northumbrian Water, Bristol Water and Yorkshire Water, published on 29th September 2020,

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2. Executive Summary

Overall we welcome the conclusion that there is a need to rebalance risk in Ofwat's final determinations to ensure the continuing investability of the sector. This will protect the interests of customers in the long and medium terms.

The CMA has recognised an asymmetry which Ofwat built into the Final Determination, and chosen to rebalance risk and reward by choosing to aim up in elements of the WACC. We understand the approach CMA has taken in compensating for this asymmetry through the WACC, especially given the number of appellants and the complexity of the ODI regime and cost assessments, however, we believe that a better approach would be to make adjustments to the relevant building blocks. In particular, we think that Ofwat's conclusions on resilience, ODIs and growth justify such changes.

We would not wish to the see the principle established that utility regulators should be unbalanced in their approach to individual components of a price control and then to compensate for that lack of balance by aiming up in the WACC. In our view this makes Price Reviews less predictable and therefore will erode investor confidence.

As outlined in our third party submission although we did not request that the Final Determination for SEW was referred to the CMA, it should not be assumed that we do not have significant concerns or that there are not superior approaches to those adopted by Ofwat in their determination.

Although we did not appeal, this was an incredibly tough decision for our Board to make. We had to weigh up the costs of disrupting our business through an appeal against the losses that we expect to make in AMP7 as a result of the Final Determination, and the risks associated with an uncertain process. As such, we welcomed these appeals as we believe that they raised some key points about the future of the water industry.

Overall, we feel that the CMA's provisional findings could have created stronger signals to encourage the regulator and the industry towards creating a more sustainable future in which higher performance and control of bills remain important, but due consideration is also given to ensuring there is adequate investment so that water systems are resilient both to current and future needs.

We consider that the CMA has established important principles for the financeability assessment which can serve as binding cross-checks on the calibration of future price controls.

We welcome the evidenced based approach to setting the WACC. In particular, by extending the trailing average and removing the so-called outperformance wedge adjustment, the CMA recognises the importance of long-term financing for the sector and the risk inherent in policies that encourage shorter tenor issuances. We also welcome the CMA's recognition of the higher financing costs faced by small companies, although note that the CMA suggests that the need for such an adjustment may be decreasing – we consider that a number of the factors driving it continue to be relevant.

The remainder of this paper addresses seven particular areas where we have comments that we would like the CMA to consider further. We think it would be helpful if the CMA could clarify those recommendations which it thinks Ofwat should be mindful of at PR24, and that such clarifications may help to avoid widespread appeals at PR24.

1. Resilience
2. Growth
3. Cost of service improvements
4. Risk and Return
5. Financeability
6. Gearing Outperformance Sharing Mechanism
7. Cost Sharing Rates

We offer comments across these seven areas to assist the CMA in its redeterminations and to also highlight the necessary improvements that we believe are required to the regulatory regime in the future.

3. Detailed Points

3.1 Resilience

Resilience was a key focus for many stakeholders and for the industry at PR19 to ensure that there is adequate investment when considering the needs of both current and future customers. This was a key part of our business plan and one where customers supported stable bills over 5-10 years, rather than a bill reduction, in order to deliver the necessary investment to improve resilience. Adequate investment in the short term protects future customers against substantial bill increases or significant service deterioration in the longer term.

A significant number of our enhancement schemes to improve resilience were rejected or significantly underfunded by Ofwat at the Final Determination. We note that this approach was replicated across the industry with reductions made to many resilience proposals made by companies. Throughout the process it was unclear how Ofwat assessed the acceptability of resilience schemes, and it appears to us that there was no clear policy objective or targeted outcomes on which these decisions were based. We believe that all of the schemes we presented demonstrated clear resilience benefits for customers now and in the future.

We note that the CMA has taken some steps to partially address this problem in its provisional findings. However, we recognise that a CMA appeal is not necessarily the right place to tackle this problem.

We would like the CMA to be clearer on solutions to this problem at future periodic reviews. This area particularly requires more clarity on how resilience is set, what the objectives are and how proposed schemes will be assessed against those objectives.

We interpret the CMA's findings as an appropriate message to Ofwat and the wider industry that this subject should be addressed comprehensively and systematically at PR24, and we support that message.

3.2 Growth expenditure

The funding of growth expenditure has always represented a challenge over many price reviews. This is highlighted by the fact that the same approach has never really endured for more than one 5 year cycle and indeed was changed by Ofwat a number of times during the PR19 process. This is a particularly important subject for companies that operate in areas of high housing growth such as South East England, and that a failure to properly address and fund this issue demonstrably disadvantages such companies and leads to lower levels of resilience for customers.

The CMA has decided that it could not make any more substantial redeterminations in this aspect of the price control, due to a lack of appropriate data (page 209). We raised this data issue with the CMA and are pleased they also recognise it is an area that needs addressing to allow a move away from an imperfect integration of growth and base costs. We believe this is a key area that needs addressing at PR24. In particular, this will require the collection of additional annual data throughout the current AMP, relating to drivers such as capacity, as well as costs of growth and the costs of delivering both above and below ground capacity.

We would encourage the CMA to be more prescriptive in their findings and recommend to Ofwat that they work with the industry to address this issue as part of their considerations for PR24.

3.3 Cost of Service Improvements

The provisional findings largely accept Ofwat's approach to the cost of service improvements. We do not agree with the CMA in their findings on this issue.

We note that leakage is the major exception to this where the CMA has acknowledged that there is a cost associated with reducing leakage beyond current levels. It is unclear why leakage, predominantly a maintenance issue is singled out for this treatment when other related issues such as burst mains and interruptions are not.

The link between cost and service improvement is not a simple question. For example, pressure management (which costs very little) can improve performance in both leakage and mains repairs. But there are only so many gains that can be made from pressure management (the low hanging fruit). Some companies may have already done as much as possible, in which case only innovation or mains renewals can improve the situation. Innovation is possible, but not a guaranteed solution and mains renewal is extremely expensive.

Supply interruptions is another example. It is certainly true that effective management action and good processes are required in order to improve performance on this ODI. However, such improvements also require: more technicians on standby out of hours; investment in equipment such as tankers; improved modelling capability; static tanks; overland supplies and rapid response vehicles. All of these are very expensive on the scales required to make the significant improvements needed to achieve the targets for this measure.

Whilst we are pleased that the CMA has recognised that there is a cost associated with improved leakage performance, we think that it has been inconsistent in its treatment of other service improvements which clearly cannot be delivered without incurring additional cost.

We believe this area needs further scrutiny by the CMA to determine whether the cost models developed by Ofwat adequately allow for the level of service improvements needed.

Challenging the industry to improve its performance is commendable and necessary, but we maintain that if performance commitments and ODIs are set without any link back to operating conditions or customer preferences, it creates unsustainable risk – not just financial but reputational for individual companies and the industry too.

If these models do not sufficiently allow for this cost then the result is that companies will have to effectively absorb these types of costs on top of the efficiency assumptions that have already been assumed in the totex.

3.4 Risk and return

The provisional findings suggest a number of changes to the calculation of the allowed cost of capital. The CMA has adopted a more balanced approach to evidence which should be retained going forwards to support the financeability of the sector and its ability to attract capital.

Whilst we are broadly supportive of the CMA's point estimate for the allowed cost of capital, we note that when taken in the context of previous regulatory settlements this allowance represents a material reduction and continues to remain challenging.

<u>Cost of Debt</u>

On the cost of debt, we welcome the CMA's recognition of the importance of long-term financing for the sector and share its concerns that Ofwat's approach could encourage issuance of shorter tenor debt, increase refinancing risk and under-finance efficient financing costs. Such an incentive would be inconsistent with Ofwat's own requirement for companies to maintain investment-grade ratings.

As detailed in our Draft Determination response, the use of a 20 year trailing average for embedded debt reflects the tenor at issue for debt that was efficiently procured at the time of issuance. The timing of debt issuance across the sector, is consistent with the economic useful life of assets, as well as the long-term remaining maturity of the benchmark indices.

We agree with the CMA that the so-called outperformance wedge should be removed. This adjustment is not supported by robust evidence when the comparison with the index is on a like-for-like basis, and controls for tenor and rating. This is consistent with our position in the Draft Determination response.

We note that the CMA has 'aimed down' on the cost of embedded debt by selecting a point estimate based on the A rated iBoxx only to reflect CMA's expectation that average embedded costs of debt for the notional company are likely to fall mechanically over the price control. However, this does not reflect the mechanics accurately and CMA should either explicitly model how embedded debt would mature across AMP7 or 'aim straight'. The CMA's approach to aiming down means that the cost of debt (based on A-rated iBoxx only) is not consistent with the target credit rating (Baa1/BBB+) achieved by the notional company based on the PFs.

We welcome the CMA's recognition that small companies have higher financing costs and that these should be taken into account when calibrating the cost of debt, not least to support financeability. Our economic advisers estimated a small company adjustment of c. 30bps[1]. We note the CMA's provision finding that the premium required may be less significant than in the past. We see no evidence that this has changed materially.

We consider the CMA's weightings given to embedded versus new debt to be more realistic and to reflect the amount of new debt likely to be drawn in AMP7. However, in our own case we expect the ratio to be 97-3, even higher than the 83-17 which the CMA has applied.

Cost of Equity

On the risk-free rate the CMA has concluded that an estimate based on long-term real gilts would not reflect the rate that market participants can borrow and lend at and has placed weighted on both UK ILGs and AAA UK corporate bonds to derive its range. As set out in our Draft Determination response[2], we do not consider it appropriate to rely only on ILGs or use short-run market data, therefore we agree with the inclusion of corporate bonds as well as the CMA's focus on instruments with a remaining maturity of 20 years – consistent with its 20-year investment horizon – and use of a longer 6-month trailing average.

We agree with the CMA on the potential presence of 'noise' in short term beta estimates, such as the 2-year betas used by Ofwat, and the CMA's approach to also estimate betas using longer time windows. However, we do not consider that the point estimate reflects the 75th percentile. At the Draft Determination response, our economic advisers estimated an overall beta range of 0.36 to 0.38.[3]

We welcome the more balanced approach that the CMA has adopted to averaging and the appropriate inflation series for deriving TMR, although we note that the CMA has not placed equal weight on both inflation series which does not reflect the CMA's own analysis of the issue.

The CMA states that, in principle, it 'aims up' on the cost of equity parameters in order to (1) account for the inherent uncertainty in the estimates and (2) compensate companies for the fact that an efficient notional company would expect, on average, to face penalties due to the calibration of the ODI package. The CMA has estimated the latter as commensurate to 0.1-0.2% of RoRE. Whilst we believe regulation should strive for a package with symmetry of risk and return across all elements of the determination, we welcome the important principle that asymmetry in the price control package needs to be explicitly taken into account when setting the allowed returns.

However in practice it is not clear that the CMA has actually 'aimed up' as point estimates for each cost of equity parameter are in our view closer to reflecting the midpoint of the ranges based on the evidence considered by CMA – in particular, when the ranges are adjusted to reflect only the most robust and likely estimates.

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[1] South East Water Draft Determination Response – Aligning risk and return, 30th August 2019, p. 13

[2] Ibid., p. 11

[3] South East Water Draft Determination Response – Aligning risk and return, 30th August 2019, p. 11

As expressed earlier, we believe the sustainable approach is to address risks in the area they occur in the provisional findings. There is a risk that – if in practice the CMA has not aimed up on individual parameters – the asymmetry recognised by the CMA is not actually priced in. Furthermore, it is not clear how the CMA has estimated the expected loss arising from asymmetry but we consider the 0.1-0.2% of RoRE to be low, given the downside skew on ODIs alone.

Overall we welcome the CMA's decision to take account of the investability of the sector in its deliberations. We think that this sets an important precedent for PR24, and will help enhance the long-term prospects of the industry. However we think that the CMA should have confidence in its technical corrections. Adjustments to account for risk should be made in the appropriate building blocks and not compensated for by adjusting the WACC.

3.5 Financeability

We welcome the key principles set out by the CMA for assessing financeability, which reaffirm that financeability tests should be meaningful, binding cross-checks on the calibration of key price control parameters. We note that these principles are significantly different to those applied under Ofwat's FD methodology. The CMA has:

- Acknowledged that the cost of capital is the key determinant of financeability and first lever to address financeability constraints. The CMA stated that *"if the WACC is set too low, notionally geared companies would not be able to retain strong investment grade ratings."*
- Recognised that if the allowed return is set at a reasonable level, the price control should be financeable from debt and equity perspectives.
- Recognised the role of credit ratio analysis which can cross-check whether allowed returns are in practice sufficient to support the target credit rating and assess whether other aspects of the determination, such as the amount of cash generated from regulated activities, are consistent with rating agency expectations.
- Applied a market-based approach to debt financeability which calculates the ratios consistent with the rating agency methodologies.
- Carried out downside scenario analysis to stress test notional company projections (although we consider that the 1% RoRE scenario which CMA considers to represent a severe downside may not fully reflect the risk exposure of the notional company under the PFs).
- Recognised asymmetry in the price control package and sought to address this by 'aiming up' on the cost of capital.
- Applied appropriate remedies for the financeability constraint identified – the increase in cost of capital (including the principle of 'aiming up') and targeted interventions to reduce risk on ODIs and Totex sharing factors.

Overall, we consider that CMA has established important principles for the financeability assessment which can serve as binding cross-checks on the calibration of future price controls.

However, we note that the financeability position remains finely balanced given the risk exposure implied by the PFs and the limited headroom above minimum thresholds for key credit metrics – the disputing companies are only just able to achieve the minimum required AICR for a Baa1 rating.

We also note that it is not clear whether the CMA has actually 'aimed up' as point estimates for each cost of equity parameter are in our view closer to reflecting the midpoint based on the evidence considered by CMA – this suggests that asymmetric risk may not be priced under the PFs and it would be helpful if CMA could consider this further. Moreover the magnitude of the unpriced exposure is contingent on the CMA's analysis of asymmetric risk exposure, which seems low notwithstanding the amendments made by the CMA to cost sharing rates.

3.6 Gearing outperformance mechanism

Ofwat proposed a gearing outperformance mechanism which introduces a penalty where actual gearing exceeds the notional gearing assumed, with the penalty based on the difference between the allowed return on equity and cost of debt.

We do not believe that the mechanism is in customers' interest and we fundamentally disagree with this penalty:

- Customer bills are based on an allowed WACC for a notionally efficient company, irrespective of companies' actual capital structures. As a result companies with gearing higher than the notional level assumed do not accrue any benefits associated with higher gearing.
- Ofwat considers that shareholders enjoy benefits from higher gearing, but there is no evidence to support this assertion in theory or in regulatory practice. Mainstream corporate finance theory shows that a company's cost of capital is independent of its capital structure. The only benefit associated with higher gearing is the reduction in companies' tax liabilities which is already fully passed through to customers under the existing regulatory rules.
- The mechanism can, as recognised by the CMA, undermine the financial resilience of highly geared companies by leaving them with lower resources available for risk management.
- The mechanism does not take into account company specific factors. Firstly, it does not take into account non-appointed activities and the gearing associated with these activities. Secondly, companies are penalised when the actual return on equity is below the allowed cost of equity due to unfunded debt costs due to higher embedded debt.

The CMA acknowledges that there may be legitimate concerns around financial resilience that the GOSM is trying to address in principle. However Ofwat has not demonstrated that companies which exhibit gearing above notional levels are not resilient or that its existing toolkit is not sufficient. The fact that even highly geared companies were able to navigate the global financial crisis of 2008/09 without evidence of financial distress or impact on customers further evidences that companies are financially resilient.

As a result we fully support the CMA's decision to disapply this mechanism and would request it is recommended to Ofwat that a review is needed as to whether the application of the Gearing Outperformance Sharing Mechanism for 2020-25 is appropriate for the industry.

We welcome that the CMA has established a high bar for the introduction of an alternative mechanism and agree that the GOSM fails to meet the key criteria outlined by the CMA, including that such a mechanism should:

(1) take into account other, non-gearing related, factors that can influence financial resilience;

(2) be consistent with corporate finance theory;

(3) not represent a significant break from well-established approach;

(4) be accompanied with an assessment of the risks of miscalibration and of the time and cost required to implement; and

(5) be well evidenced and justified.

We fully support the CMA's finding that Ofwat's GOSM is not an appropriate mechanism and we believe that existing reputational regulatory tools can be used to address any financial resilience concerns.

3.7 Sharing rates

Whilst not being against the principle of the quality of a company's business being linked to cost sharing rates, we welcome the CMA's rejection of Ofwat's approach to this as the sharing rates applied were too simplistic and based on highly subjective judgements (some of which the CMA has not accepted).

We agree with the CMA conclusion that standard sharing rates are more appropriate and we think that this should be a specific recommendation to Ofwat for PR24.

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