Mr Kip Meek, CMA Panel Chair
cc Dr Andrea Coscelli, CMA Chief Executive

By email

27th October 2020

Dear Mr Meek

Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations: Provisional Findings

Following publication of the CMA Panel's Provisional Findings (PFs) with regard to the above price determinations, a number of UKRN members have discussed the CMA's broad approach to regulatory determinations through the UKRN Cost of Capital Group[1], and identified specific concerns around the Panel's approach to determining the cost of capital. We set out below our overall position on these matters. Individual regulators may make their own representations to the CMA, but this letter reflects the broad position of the regulators and the UKRN.

We strongly support the CMA's role as an independent regulatory appeals body. We understand that providers of both debt and equity finance take significant comfort from having independent appeals on the merits of a price control or licence modification and the confidence that this provides supports licensees' access to financial markets in a way that is cost effective and efficient. This helps avoid undue upward pressure on the cost of capital, means consumers have value for money access to essential services and supports the proper funding of investment programmes.

We also recognise the challenges that the CMA faces in undertaking this role. The processes that are currently in place require the publication of the Panel's findings after a relatively short time from the point that the CMA first receives details of an appeal. Over time, the CMA's task has also been made more difficult by the increasing complexity of economic regulation and the greater volume of evidence that is available – both in relation to the specific sector that is the subject of the review but also the wider comparator information that is now available, including from other regulated sectors. We also note that while the CMA's use of different panels for different inquiries has advantages in terms of drawing on a wide range of expertise, this will also create challenges in terms of consistency and learning from experience.

[1] UKRN Cost of Capital Group comprises CAA, Ofcom, Ofgem, Ofwat and Utility Regulator Northern Ireland.

Notwithstanding this context, the UKRN has a number of specific concerns arising from the PFs. Our response below is centred around three main issues: (1) the benefits of stability and predictability, and the importance of changes in the CMA's broad approach being supported by a full range of evidence, proper explanation and appropriately wide ranging consultation; (2) the PFs' approach to aiming up in regulatory decision making; and (3) the use of adequate cross checks to financial parameters.

We have concerns that in estimating the cost of equity parameters and by applying a mechanical approach to aiming up, the Panel places significant weight on the ends of the cost of equity parameter ranges. It is not clear whether the Panel has adequately considered the appropriateness of this approach, which has resulted in a cost of equity estimate that it recognises includes elements that are above market expectations. As a result, the UKRN is concerned about the precedent this could create for UK regulation.

The UKRN is keen to engage with the Panel to ensure its methodology and use of data is as robust as possible and appropriately consistent with previous decisions. We would also ask the Panel to take into account the broader impact its decisions could have on future regulatory decisions and certainty.

The importance of stability and predictability

The UKRN is of the view that a stable and predictable regime is at the core of UK regulation and that it has resulted in it being highly regarded around the world. However, in a number of areas the PFs appear to depart from established regulatory approaches or to be inconsistent with previous CMA decisions, including ones made relatively recently. The UKRN recognises that the CMA may wish to evolve or develop its thinking, but we would suggest that such evolution should be properly explained and supported by a broad range of evidence.

The PFs deviate from previous approaches to estimating cost of capital in a number of areas, for example the top end of the risk-free rate range uses corporate bonds as a proxy[2], which is a departure from regulatory and previous CMA decisions and would ordinarily be expected to require wider consultation.

From the PFs, we consider it is unclear how the Panel has determined the ends of the range for its total market return based on the evidence it has considered. We note that the Panel has decided to exclude evidence which would support an extended lower range without providing reasoning to explain why less weight should be placed on this evidence. In addition, the Panel appears to have been inconsistent in its criteria for excluding outlying data points in its estimation of debt and equity beta.

[2] CMA PFs Para 9.137

The PFs' approach to aiming up in regulatory decision making

The framework for assessment of aiming up[3] is different to that used in the CMA's recent NERL decision, where the CMA concluded that aiming up was not appropriate. Different criteria were used, for example whether there was a clear bias in the WACC. The CMA reached a different conclusion on asymmetry, taking account of cost incentives and past performance which it does not appear to have done in water.[4] As a result, different conclusions were reached. Whilst we recognise that sector differences in this area can be appropriate, we are concerned at the change in methodology over a short period of time. These are aspects of policy that are of importance across a number of sectors and so the CMA should clearly explain how and why its position on these matters has changed since the CMA's final determination for NERL's price controls was issued in July 2020.

In our view the PFs do not sufficiently explain the Panel's concerns about the need to aim up to promote investment in the sector more broadly or justify the conclusion that this is required[5]. The brief reference to aiming up as a regulatory concept is unsupported by references to theory or prior decisions[6], and the UKRN see this area as more complex and nuanced than implied in the PFs. Given that it involves a significant departure from previous CMA decisions, it is important that any change is strongly supported by evidential and policy justification, and would ideally have been signposted and subject to broader consultation. We recommend that this is considered in more detail.

The method used to aim up in the PFs appears too mechanistic. In aiming up to 75th percentile for each cost of equity parameter, the Panel places significant weight on ends of the range for each parameter. We consider this requires substantially better evidence on the rationale for choosing the upper and lower bounds for each parameter, as well as careful consideration of the probability distributions within the ranges and the degree to which they are correlated.

Use of adequate cross checks to financial parameters

With the exception of financeability, the PFs appear not to take the full opportunity to use additional financial data as a cross check to decisions in the PFs. For example, whilst we are supportive of the Panel adopting a notional company framework, the PFs explicitly choose not to look at balance sheet cost of debt[7], potentially resulting in a debt cost allowance that cross-subsidises equity returns, that could be alleviated using this cross check. In addition, it appears limited weight is placed on listed company Market-to-Asset Ratios to cross check the resulting allowed equity return, and an assessment of practitioners' view of expected market returns is not used to cross check the total market return range. The Panel indicates these parameters face estimation error, and hence the use of cross checks can be a valuable approach for regulators in certain cases.

[3] CMA PFs Para 9.665(b) and 9.667-9.670
[4] CMA NATS (En Route) Plc / CAA Regulatory Appeal Final Report Para 13.290 and 13.292
[5] CMA PFs Para 9.665(b) and 9.667-9.670
[6] CMA PFs Para 9.667
[7] CMA PFs Para 9.340-9.342

The UKRN recommends that the Panel explicitly assesses its findings by looking to balance the overall risk-to-return proposition for companies. The fact the PFs have a cost of capital higher than three of the four companies requested in their revised business plans, along with not using the above cross checks, suggests that this may not have been done for the PFs.

We hope this submission is useful to the Panel and would be happy to discuss any aspect of it in further detail if helpful. Given the importance of these matters to properly protecting consumers and the appropriate discharge of our statutory duties we are also copying this letter to Dr Andrea Coscelli.

Yours sincerely

PP. [redacted]

[redacted]

Attricia Archer
UKRN Director

Simon Wilde
Chair of UKRN Cost of Capital Group