WESTERN POWER DISTRIBUTION
Serving the Midlands, South West and Wales

waterdetermination2020@cma.gov.uk

Avonbank
Feeder Road
Bristol
BS2 0TB

Telephone 0117 933 2203
Email pbranston@westernpower.co.uk

Sarah Fox
PR19 Regulatory Redeterminations
Competition and Markets Authority
The Cabot
25 Cabot Square
London
E14 4QZ

Our ref *Your ref* *Date*
27 October 2020

Dear Sarah,

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

I am writing on behalf of Western Power Distribution (South Wales) plc, Western Power Distribution (South West) plc, Western Power Distribution (East Midlands) plc and Western Power Distribution (West Midlands) plc – collectively Western Power Distribution (WPD). WPD is the electricity distribution network operator for the Midlands, South West and Wales. We deliver electricity to 7.9 million customers over a 55,500 square kilometres service area.

On 29 September 2020 the CMA published its Provisional Findings (PFs)[1] for the four water and sewerage companies that sought referrals of Ofwat's PR19 Final Determinations (FDs). We welcome the opportunity to provide comments in response to the CMA's PFs and this letter sets out targeted comments on a range of issues which may assist the CMA as it finalises its decision.

WPD is a member of the ENA and supports additional submissions from the ENA in response to the CMA's PFs. We have carefully reviewed the PFs and make a number of observations and comments in relation to these in this document. Our comments and observations are collated under three main headings:

1) Estimation of allowed returns;
2) Principles of 'aiming up'; and
3) The approach to assessing financeability.

The rest of this letter expands on these topics.

[1] CMA provisional findings: Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, 29 September 2020.

Estimation of allowed returns

The CMA provides critical safeguards for the regulation of WPD as well as for the water sector. We are therefore encouraged that the PFs go some way towards addressing material errors in Ofwat's estimation of the allowed cost of capital in its FD. We present our comments on the parametric estimates of the CAPM and cost of debt below.

Risk-free rate and Total market returns

When deriving the risk-free rate, the CMA has placed weighted on both UK ILGs and AAA UK corporate bonds to account for the gap between corporate and sovereign risk-free financing rates – we agree with this general approach which is aligned with submissions made by the ENA.[2] However, the CMA appears to have stopped short of applying forward rate uplifts to spot risk-free rate estimates which we consider is merited on the basis of best practice corporate finance principles.

In estimating the total market returns (TMR), the CMA has continued with its practice of placing most reliance on the historical ex-post approach and applied a range of averaging techniques over 10 and 20 year holding periods. Importantly, the CMA has acknowledged that an arithmetic average is most suited to approximate a discount rate (assuming returns in each year are independent) – we welcome these clarifications from the CMA on what has been a contentious issue.

The CMA has acknowledged that the CED/CPI series has significant flaws and has placed some weight on TMR estimates derived using the CED/RPI – whilst we support the CMA's views on the inherent flaws with the CED/CPI series, we note that the CMA has not placed equal weight on both inflation series. This does not reflect the CMA's own analysis and discussion of the issue. A more balanced view of the evidence on this issue would better align the TMR estimate with the overall principles underpinning the CMA's approach to estimating the cost of equity in the PFs.

Cost of debt

The CMA has not included an adjustment for the so-called 'outperformance wedge' on the cost of new or embedded debt. In line with the position set out in the ENA submission[3], the CMA considers that it is necessary to control for rating and tenor. The CMA also noted that the wedge could provide inappropriate signals to shorten tenor and increase refinancing risk. We welcome the CMA's consideration of the economic theory of incentives and whether the methodology for setting the cost of debt promotes the right behaviours. In our view, it establishes an important principle for future price controls across regulated sectors in the UK by recognising the long-term nature of assets and financing requirements in these sectors.

In particular, by extending the trailing average period from 15 to 20 years to reflect the timing of issuance for the sector, the CMA has recognised the importance of long-term financing of long term regulated infrastructure in line with asset lives and the remaining maturity of the benchmark indices selected. This is critical to capture market conditions when debt was raised across the sector.

However, we do have two concerns with the CMA's estimate of the cost of debt – first, the CMA's estimate is based on the A rated iBoxx index only and this is not consistent with the target rating for the notional company; second, in selecting a point estimate, the CMA has 'aimed down' (discussed in further detail below) which appears contrary to the

[2] Ofwat Price Determinations: Submission by Energy Networks Association, 1 June 2020
[3] Ibid.

arguments and principles the CMA sets out with regards to attracting capital and allowing for estimation error. We would urge the CMA to reconsider these aspects in setting the overall allowance for cost of debt.

Equity and debt beta

We consider it appropriate for the CMA to have taken a more involved and expansive approach to estimate the raw equity beta. The CMA has also put more weight on the higher end of the range in the selection of a point estimate for beta recognising that the CAPM may not fully reflect the impact of political and regulatory risk. As a result, the CMA has made efforts to mitigate the risk of the CAPM understating returns required by investors in companies with significant exposure to such risks.[4]

The CMA has also considered all evidence available when setting an appropriate range for the debt beta. As a result, its range is more closely aligned to the 0.05 estimated by Oxera for the ENA.[5]

Overall, we consider the CMA's approach to setting allowed returns as more reflective of the data and evidence. In particular, the CMA's overall approach attempts to take a more holistic view to setting allowed returns by seeking to: (a) anchor these in the financeability criteria (see section on financeability below) for the water companies and (b) to ensure a more balanced risk-reward settlement given the asymmetry in the design of various regulatory mechanisms. We believe that while the CMA has gone some way in addressing key issues relating to the balance of risk and reward and financeability, taking further cognisance of the concerns raised above could better align the overarching principles cited by the CMA with the outcomes delivered for the sector.

Approach to 'aiming up'

In relation to arguments on 'aiming up' while setting the point estimate of allowed returns, the CMA has considered:

- Aiming up to promote investments during AMP7 and more widely in the water sector;
- Overall risk-reward balance and whether there is any asymmetry in returns; and
- Cross checks on the overall level of the WACC.

At the outset, we agree with the principles for 'aiming up set out by the CMA. This is consistent with historical regulatory precedent in the UK and other jurisdictions where regulators have routinely set point estimates well above the 50th percentile of the estimated range. In particular, the CMA's emphasis on promoting investment over the longer-term horizon (and not just specific investments over AMP7) is particularly welcome given the recent trend of regulators not giving due weight to well-established arguments that underinvestment caused by a cost of capital being set too low damages the overall welfare of consumers (and potentially the wider economy) materially more than the welfare lost through bills that may be marginally high.

However, the CMA's implementation of the principles cited above appears mixed in setting the provisional point estimates for both the cost of equity and cost of debt.

The CMA has sought to 'aim up' on the cost of equity in response to the inherent uncertainty in setting allowed returns and the asymmetric risk exposure on ODIs (as an efficient notional company would expect, on average, to face penalties due to the calibration of the ODI package). We agree that this is required in principle and also agree

[4] Ofwat Price Determinations: Submission by Energy Networks Association, 19 June 2020
[5] Ibid.

that estimation uncertainty is likely to be greater for the cost of equity than the cost of debt.

Upon reviewing the CMA's approach to setting the cost of equity point estimate, it is not clear that the CMA has successfully 'aimed up' on cost of equity. For example, the point estimate for TMR is likely closer to reflecting the midpoint of the range when the CED/RPI and CED/CPI series are given equal weight. Additionally, the CMA also excludes non-overlapping returns and the 1-year arithmetic average while estimating the TMR – both of which merit reconsideration.

More generally, we are concerned that the CMA may not have 'aimed up' sufficiently to price asymmetric risk exposure. This is because: (1) it is unclear to what extent the CMA has actually 'aimed up' based on the evidence analysed by the CMA for each CAPM parameter; (2) the CMA's estimate of the expected penalties may be understated given that the PFs continue to imply a very significant performance challenge; and (3) the CMA only takes into account expected penalties from ODIs and may under-estimate exposure arising from totex including asymmetric cost sharing rates.

This suggests that further analysis of asymmetry is warranted and could justify amendments, including potentially introducing additional aiming up to price in asymmetry equal and opposite to the expected loss.

With respect to the cost of debt, we note that the CMA has actually 'aimed down' on the cost of embedded debt. The CMA argues that its approach takes into account the cost of debt falling mechanically over the price control. We consider this to be unjustified particularly as the CMA has set the allowance based on the A rated iBoxx only. This means that the cost of debt is not consistent with the target credit rating (Baa1/BBB+) achieved by the notional company based on the PFs. This inconsistency of the credit rating between the allowed debt funding and credit metrics is not captured by the CMA's financeability assessment, which suggests that an efficient notional company which has raised Baa1/BBB+ debt in the past will not be able to recover efficient costs.

In our view it would be helpful for the CMA to consider modelling how debt would mature for the notional company based on the average of the A/BBB iBoxx indices. This would be consistent with the target rating for the notional company and closer to the midpoint of the range estimated by the CMA based on a 20Y trailing average period.

Furthermore, the CMA considered that certain financial instruments such as swaps can be complex and difficult to analyse. Therefore, it has not set the cost of embedded debt based on these instruments, in line with its focus on a benchmark index. Given that derivatives are a standard risk management tool used extensively by regulated companies and form inextricable parts of their debt portfolios, the CMA's approach might have implications for companies' financing policy in the future. The exclusion of swaps, where actual costs are used to calibrate the cost of debt allowance, could under-state actual financing costs, and could deter companies from using synthetics to hedge risk exposures implied by the regulatory regime.

Overall, while the CMA's rationale for aiming up is well intended, considers all the right principles, and is well grounded in the economics of incentive based regulation, our view is that its execution falls somewhat short of its stated intent. The 'aiming up' of the cost of equity is offset by the 'aiming down' on the cost of debt resulting in a WACC at the 58th percentile. We believe the CMA ought to target a higher percentile while setting the WACC point estimate. Targeted amendments as outlined above could result in an outcome which better addresses the overall risk-reward balance of the regulatory package, boosts

investor confidence by providing the necessary incentives to investors and protects long-term consumer welfare.

Approach to the financeability assessment

We consider that – consistent with the core principles of corporate finance – investments will be undertaken only if investors believe that they will make a reasonable return. This is closely related to the necessary condition for financeability whereby investors expect to earn their required returns.

This can only be achieved when the price control represents a "fair bet" for regulated utilities and network companies. A fair bet is one where the firm making an investment should, in expectation, be allowed to earn a return equal to the investment's cost of capital. That is, for an investment to be a fair bet, the firm should be allowed to enjoy some of the upside benefit (i.e. be allowed returns higher than the cost of capital) in order to balance the probability that it could earn returns below the cost of capital. Where the prospect of downside risk outweighs any reasonable expectation of upside returns, the fair bet principle is violated and the business in question cannot be considered financeable.

The CMA's approach to financeability provides welcome clarification on the approach to assessing financeability. It underpins a number of critical principles and corrects for several issues with Ofwat's financeability analysis.

In particular, the CMA applies the financeability assessment as a meaningful, binding cross-check on the calibration of key price control parameters. It adopts a market-based approach to debt financeability using methodologies adopted by the rating agencies, carries out downside scenario testing and considers whether an efficient notional company can earn its required return on average. We note that these principles and tests adopted by the CMA are fundamentally different in practice to the approach adopted by Ofwat in its FDs.

Perhaps most importantly, the CMA recognises that the WACC is the key determinant of ensuring that an efficient firm can finance its functions.6 As a result, it corrects for methodological errors in the WACC prior to assessing financeability.7 Additionally, the CMA also recognises that credit ratio analysis plays an important role by helping provide cross checks to consider whether the allowed return is, in practice, high enough to be consistent with the target investment-grade credit quality.

This interpolation of inferences between calibrating the point estimate of the WACC and assessing financeability is an important principle. In contrast, the Ofwat approach implicitly assumes a complete disconnect between the discretion it applies in setting allowed returns and financeability constraints identified. We believe that the CMA's approach establishes an important precedent in regulatory best practice of assessing financeability of companies and provides much needed clarity.

The CMA also acknowledges that whilst the use of asymmetric or penalty only incentives may be appropriate in certain circumstances, where this results in residual financial risk for investors, it needs to be explicitly factored into the calibration of WACC to ensure the company is financeable. We fully agree with the CMA's reasoning on this.

We also note that the CMA's practical approach to assessing financeability is better aligned with market methodologies than the Ofwat approach. In particular, the CMA assesses

[6] CMA provisional findings: Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, 29 September 2020.
[7] Ofwat Price Determinations: Submission by Energy Networks Association, 1 June 2020

debt financeability using current rating agency methodologies by recognising the importance of accounting conventions and underlying definitions of ratios for core financial metrics. As a result, it does not apply PAYG adjustments or other cash forwarding measures to remedy financeability constraints. In our view, the CMA rightly outlines concerns with the principle of Ofwat's approach to using higher PAYG rates to address financeability constraints. The CMA also carries out downside scenario analysis to stress test notional company projections, although it is unclear whether the 1% RoRE scenario assessed by CMA represents a severe downside scenario given the scale of the risk exposure implied by the regulatory framework.

We consider that the overall assessment of financeability and credit rating requires an element of judgement. It needs to form an opinion on the overall quality of credit with respect to a broad range of factors. Indeed, while financial ratios are important, rating agencies do not apply these mechanistically or in isolation from a wide range of other relevant factors. In this regard we note that the CMA has exercised due caution in its financeability assessment by not over- emphasising the importance of any particular ratio.

While we are supportive of the CMA's general approach to assessing financeability, we would like to make some observations for further consideration.

First, we note that projected metrics do not include a margin above the minimum credit rating thresholds for the target rating. For instance, our initial assessment indicates that for at least one of the companies, the AICR remains at the bottom of the range that is currently considered consistent with a Baa1 credit rating. Both Moody's and Fitch advise targeting the 'middle' of the range (i.e. 1.60x) for Baa1. Targeting the middle of the range would allow for some headroom for unforeseen shocks at the target rating and is particularly important when a price control package leads to asymmetric downside risk. As a result there is a real risk that the notional company would not be able to achieve a stable Baa1/BBB+ rating – especially if the CMA updates its cost of debt estimates to 'aim straight' and includes expected ODI penalties in projected metrics.

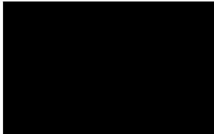
Second, we continue to remain concerned that risk is exacerbated by the negatively skewed price control package. The 'base case' financeability analysis is conducted on the assumption that the notional company meets its regulatory cost allowances and performance targets (i.e. there is no outperformance or underperformance). The extent to which this is financeable in practice depends on the likelihood that the price control package is achievable. If the cost allowances and performance targets are unachievable, then the cash flows and credit ratios of the notional company under the 'base case' scenario will not provide a meaningful indication of actual financeability on an expected basis. This is particularly important when the design of key elements of the regulatory package such as performance commitments and cost sharing rates are negatively skewed and asymmetric.

Third, in our view, the PFs appear to over-state the financial resilience of the notional company. It is important that regulated companies have sufficient financial headroom to absorb downside shocks that are outside the company's control and to withstand estimation error by the regulator in setting the price control. This is particularly important given the uncertain macroeconomic environment due to COVID-19 and Brexit and the challenging operational targets (totex, ODIs). Given how tough the AMP7 package is, we have material concerns about what this means for financeability and attracting new capital. As a matter of principle, companies' financial headroom should be sufficient to bear reasonable downside risks without encountering financial difficulties. The CMA has at this stage only published its analysis of one downside scenario. In light of limited financial resources available to the notional company for risk and corporate financial management, further analysis is needed in respect of a wider range of realistic but severe

downside scenarios – where financeability challenges are identified, amendments may be needed.

Lastly, we note that the CMA has presented limited analysis of equity financeability. The CMA's equity financeability assessment considers the impact of the calibration of the ODI package on the notional company's expected returns. Whilst this is a marked improvement from Ofwat's approach – which gave limited consideration to equity financeability – there may be room for further improvement. For instance, it is not immediately evident if the CMA's analysis of the estimated impact of RoRE for water companies fully accounts for the totex gap or the expected ODI penalties. This risk is exacerbated by the 'aiming down' of the point estimate on embedded debt and the presence of material unpriced asymmetric risk exposure. We would welcome the CMA to consider a more involved and balanced analysis of equity financeability and whether expected returns to equity holders satisfy the above-stated fair bet principle.

Yours sincerely,



Paul Branston
Regulatory & Government Affairs Manager