Initial Response to CMA WACC Consultations

18 January 2021

1. Executive summary

1.1.1 In advance of the roundtable discussion on 20 January (the **Roundtable**), this initial response to the CMA's Cost of Capital Working Papers[1] (the **Initial Response**) addresses the two following areas:

(a) overarching points relating to risk/return and asymmetry, which are important for framing the Roundtable discussion (see **Section 2** below); and

(b) the key issues that YWS considers have to be addressed during the Roundtable discussion (see **Section 3** below).

1.1.2 In order to assist the CMA with its preparations for the Roundtable, this Initial Response has been kept targeted and concise.[2] YWS will submit a fuller response on 27 January 2021, covering issues raised in the Cost of Capital Working Papers and at the Roundtable.

2. Overall balance of risk and return

2.1 Importance of the WACC to the overall price control

2.1.1 The Cost of Capital Working Papers propose a material decrease to the WACC of approximately 0.3% at a late stage in the CMA's investigation.[3] It is common ground between the CMA and YWS that such a change cannot be considered in isolation and must include an "in-the-round" assessment of the overall package.[4] There is a detrimental impact on the overall risk/reward imbalance without it.

[1] CMA, Water Redeterminations 2020 – Cost of Capital – Working Papers Executive Summary, Water Redeterminations 2020 – Choosing a point estimate for the Cost of Capital – Working Paper (the **WACC Point Estimate Working Paper**), and Water Redeterminations 2020 – Cost of Debt – Working Paper (the **Cost of Debt Working Paper**) (all January 2021) (together, the **Cost of Capital Working Papers**).

[2] For completeness, the preliminary response that YWS submitted to the CMA on 13 January 2021 (the **Preliminary Response**) identifying an error in the CMA's Cost of Debt Working Paper has been annexed to this Initial Response (Annex 1) – this error is also referred to below in Section 3 as one of the items for discussion at the Roundtable.

[3] CMA, Cost of Debt Working Paper, paragraph 32. In the CMA's Provisional Findings of 29 September 2020 (the **PFs**), the CMA set a provisional estimate for the cost of capital of 3.50% (i.e., marginally above the mid-point of its range for appointee WACC of 2.82%-3.99%). See CMA, PFs (29 September 2020), paragraphs 82-83.

[4] CMA, PFs, paragraph 98: "*This is a determination of a whole package 'in the round', and our provisional decision is that this package secures compliance with all our duties*."

2.1.2 As the CMA noted in the PFs, "*the WACC is the primary factor in the redetermination ensuring that an efficient firm can finance its functions*"[5]. YWS strongly agreed with the CMA's recognition of the importance of the WACC to the financeability of the wider package, as well as with the CMA's (important) acknowledgment of the risks of setting the WACC too low.[6] In line with the CMA's acknowledgement that a sufficient level of return is central to its ability to discharge its statutory duties,[7] the CMA will therefore need to reconsider the implications of the revised position it takes in the Working Papers in its Final Determination.

2.2 The CMA has underestimated the level of asymmetry

2.2.1 The CMA has correctly identified that the right conceptual approach to considering the extent of any asymmetry of risk and reward is to evaluate whether the various components of the price control represent the likely outcome for an efficient firm.

2.2.2 In this context, YWS recalls Ofwat's stated intent that the price control should represent a "step-change",[8] pursuant to which it set PR19 targets that were much more demanding than in the past.

2.2.3 Ofwat's evidence in support of the PR19 targets relies on highly selective spot examples of performance during PR14. Contrary to regulatory best practice, there is no consideration of the overall package of targets, and there is an inherent disconnect between the targets that Ofwat has set and the evidence of what is achievable by an efficient company. This is clearly manifested in Ofwat's assertion that the most likely result (the P50) is identical to the target itself.[9] There is no basis for such an assertion, and it allows the regulator unfettered freedom to set targets that are divorced from the practical reality of delivery, and the associated efficient funding required. Such an approach will significantly undermine investor confidence in the regulatory regime.

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[5] CMA, PFs (29 September 2020), paragraph 10.58.

[6] YWS, Response to the CMA's provisional findings of 29 September 2020 (27 October 2020) (the **PFs Response**), section 3.2.

[7] CMA, PFs (29 September 2020), paragraphs 7, 10.58 and 10.93

[8]See, for example: Ofwat, Delivering Water 2020: Our final methodology for the 2019 price review (December 2017), page 14: "*Companies will need to deliver a step change in efficiency to provide more for customers and the environment, while reducing bills*".

[9] Ofwat, PFs Response (Risk and Return), paragraph A2.19.

2.2.4 The result of the above is clear asymmetry which the CMA has also recognised in its analysis. YWS considers, however, that the CMA, while accepting the existence of asymmetry, has underestimated its extent. YWS refers to its previous asymmetry analysis in this context,[10] which explains why the CMA's asymmetry range of 0.1%-0.2%[11] is insufficient.[12] An appropriate WACC cannot be considered in isolation from these asymmetry concerns but, in YWS's view, the Cost of Capital Working Papers fail to do so, resulting in material errors of fact and assessment.

2.3 Resilience, investability and long-term cost

2.3.1 YWS's Business Plan supported Ofwat's key themes for PR19 of great customer service, affordable bills, resilience in the round and innovation, and YWS created a Business Plan that was in the best interests of its customers and the environment.[13] However, Ofwat's Final Determination set an efficiency challenge that an efficient firm could not meet, meaning YWS would have to step away from its Business Plan, causing material harm to YWS and its current and future customers.[14]

2.3.2 YWS found that the CMA's PFs achieved a better balance than Ofwat's Final Determination between delivering a good deal for today's customers in the form of bill reductions, and a fair settlement for future generations by encouraging investment in long-term resilience. Moreover, the PFs were also much closer to the preferences expressed by customers than Ofwat's FD.[15] However, the benefits of the PFs are now at risk as a result of the CMA's proposals in the Cost of Capital Working Papers and the interests of both existing and future consumers are no longer adequately protected, inconsistent with the statutory consumer duty.[16]

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[10] Annex 1 (PFs Response), Economic Insight, Financeability of the Notionally Efficient Firm: a Bottom-Up Analysis (21 October 2020).

[11] CMA, WACC Point estimate Working Paper (January 2021), paragraph 83.

[12] See, for example: YWS, PFs Response (27 October 2020), paragraphs 2.4.9-2.4.15 and paragraphs 6.4.1-6.4.4; and Annex 1 (PFs Response), Economic Insight, 'Financeability of the Notionally Efficient Firm: a Bottom-Up Analysis' (21 October 2020).

[13] YWS, Statement of Case (2 April 2020) (the **SoC**), paragraphs 71-73.

[14] YWS, SoC (2 April 2020), Chapter H.

[15] YWS, PFs Response (27 October 2020), foreword.

[16] See section 2(2A)(a) and 2(5A), Water Industry Act 1991.

3. Roundtable agenda

3.1.1 The following section lists the issues which YWS considers must be discussed at the Roundtable, with a brief explanation of why each is important.

3.2 Cost of debt

3.2.1 Key issues include:

(a) **Notional benchmark**: Contrary to the position in the PFs, YWS notes that the CMA has moved to a collapsing average and reduced the trailing average period from 20 years to 15 years, therefore arriving at a significantly lower embedded cost of debt of 4.52%.[17] However, the basis for these changes in approach that have such a material impact on the embedded cost of debt is unclear and YWS is concerned that the notional approach has, in fact, been unnecessarily "actualised".

(b) **Trailing average period for notional benchmark:** One of the primary reasons for the CMA's decision to move from a trailing average period of 20 years to 15 years appears to be the apparent match to the weighted average maturity data for the sector reported in APRs.[18] As outlined in YWS's Preliminary Response of 13 January (included as Annex 1 to this Initial Response),[19] YWS has identified a material misinterpretation in the CMA's Cost of Debt Working Paper regarding "weighted average years to maturity" and "average maturity". Consequently, there is a genuine concern the notional approach to setting the cost of debt allowance does not have a sound economic rationale.

(c) **Adjustments to the notional benchmark**: As explained to the CMA previously,[20] YWS considers that there is no need for potential "actualisation" adjustments to notional index data. Notwithstanding this position:

(i) YWS is concerned that the CMA appears to be of the view that the cost of debt allowance ought to be set ~40bps

[17] CMA, Cost of Debt Working Paper (January 2021), paragraphs 80, 81 and 200.

[18] CMA, Cost of Debt Working Paper (January 2021), paragraph 78.

[19] YWS, Preliminary Response (13 January 2021).

[20] YWS, Post-Hearing Submission (17 December 2020), paragraph 2.3.2.

below an iBoxx-based notional benchmark.[21] This ~40bps estimate significantly overstates any potential adjustment due to factors such as: overstating the proportion of floating debt within the sector, double counting floating rate EIB debt, overstating the quantum of EIB debt and the discount achieved on EIB debt.

(ii) As the CMA notes in the Cost of Debt Working Paper,[22] the discussion on possible overlays has often been negatively skewed. If the CMA were to consider an adjustment to the notional benchmark, then positive factors – such as those listed in paragraph 122 of the Cost of Debt Working Paper – should also be properly investigated.[23]

(d) **Ancillary costs:** The cost of carry and CPIH issuance / basis mitigation allowance costs, as included by Ofgem, should also be more fully considered.[24]

(e) **Use of actual costs as a cross-check:** It is common ground that care must be taken with the use of actual costs as a cross-check to a notional cost of debt.[25] The CMA has sought to address this point by taking a range of datapoints, including different averages and medians, and coming at the necessary adjustments for the impact of revolving credit facilities and floating rate debt in different ways.

This approach inevitably produces a wide range for the cost of embedded debt, and the CMA settles on a point estimate at the lower end of the CMA's cross-check range. YWS is concerned that there are problems with the CMA's position. In particular, by specifically referencing a point estimate at the lower end of the cross-check range, the CMA is essentially adopting an actual approach, rather than the notional benchmark approach for which it advocates.

[21] CMA, Cost of Debt Working Paper (January 2021), paragraph 121.

[22] CMA, Cost of Debt Working Paper (January 2021), paragraph 123.

[23] For example, the issuances of bonds with a longer than 20-year maturity in order to match a long asset-life project.

[24] N.B., Ofgem's RIIO-2 allowance for issuance/liquidity costs is 25bps.

[25] CMA, Cost of Debt Working Paper (January 2021), paragraph 190; YWS, Post-Hearing Submission (17 December 2020), paragraph 2.3.2.

As YWS has previously noted, actual data should serve solely as a cross-check for the notional benchmark approach (otherwise the approach essentially becomes an "actual" one). If the chosen notional benchmark is within the actual data cross-check range, then there should not need to be further adjustments to achieve certain positioning within that actual range.

Notwithstanding the above, YWS also notes the following specific issues with selecting a point estimate at the bottom of the range:

(i) *WASCs and large WOCs:* The lower end of the CMA's range is based on WASC-only data. YWS considers it is inappropriate to exclude large WoCs from this dataset.

(ii) *Impact of gearing:* The CMA has stated that water companies carry more gearing than the notional company,[26] and that this is one reason for using the lower end of the range. This is unsound: evidence previously provided by YWS[27] has shown that higher gearing has no impact on weighted average interest figures.

(iii) *Introduction of a collapsing average:* The introduction of a collapsing average has addressed the CMA's point on falling debt costs, and Ofwat's evidence has shown actual costs will not materially fall across the period.[28] Therefore, it is not reasonable to expect that the point estimate should sit at the lower end of the range for 'actual' costs, which is more due to the reduced trailing average period selected by the CMA for the cost of embedded debt.

(f) **Proportion of new debt and embedded debt:** As set out in YWS's Preliminary Response, the CMA has misinterpreted "average number of years to maturity" data, which appears to have resulted in the overstating of the proportion of new debt at 20%. Correcting for this error would result in a notional range for new debt of 11% to 12%.

(g) **Approach to new debt:** The six-month period of data used by the CMA was highly impacted by Covid-19, for which some

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[26] CMA, Cost of Debt Working Paper (January 2021), paragraph 197.

[27] YWS, Post-Hearing Submission (17 December 2020), section 2.3.5(b)(ii) and Annex 07 (Response), Centrus, Yorkshire Water Debt Portfolio Review (May 2020).

[28] Ofwat's PFs Response – Risk and Return (November 2020), Table A1.1. WASC data shows average AMP7 rate 2bp-3bp lower than the rate at March 2020.

forward adjustment would be appropriate. Alternatively, the CMA should use pre-Covid-19 figures for the six months to March 2020. The approach adopted is also inconsistent with the CMA's assumptions on inflation.

(h) **Inflation:** The CMA continues to use unrealistic inflation assumptions of 2% for CPIH and 2.9% for RPI. As YWS has submitted previously,[29] current expectations for AMP7 indicate that inflation is unlikely to recover to meet this assumption on an average basis for the five years of the price control period. Therefore, there is no reasonable expectation that a notional company could recover the full nominal cost of its debt. The CMA has suggested previously that Ofwat could address this point during AMP7.[30] However, there is no established mechanism to do so, nor is there any indication that Ofwat would consider one. It is therefore incumbent on the CMA to reach a reasoned and reasonable view on this matter.

3.3 Aiming up

3.3.1 On aiming up, key issues include:

(a) **Quantum of aiming up:** YWS disagrees with the arbitrary reduction of the extent of aiming up from 50bps to 25bps. Consistent with YWS's previous submissions,[31] YWS considers that the characterisation in the PFs of the original 50bps aiming up as '75th percentile' was not a fair reflection of the point estimate selected and has been used to introduce unnecessary statistical analysis solely around this aspect of the cost of equity.[32] YWS also considers that any assessment of aiming up needs to be undertaken alongside a review of the appropriate positioning of the upper and lower bounds of the risk-free rate, TMR and beta ranges.

YWS notes the CMA has at times cited Ofgem's views on aiming up as relevant evidence in the WACC Point Estimate Working

[29] See, for example: YWS, SoC (2 April 2020), paragraphs 242-244; YWS, PFs Response (27 October 2020), paragraphs 3.3.3-3.3.8; and YWS, Reply to Ofwat's PFs Response (16 November 2020), paragraph 2.3.5.

[30] CMA, PFs (29 September 2020), paragraph 9.28.

[31] YWS, PFs Response (27 October 2020), paragraphs 3.3.14-3.3.18 and Table 1.

[32] See, for example, the analysis in Anglian Water, Response to the CMA's provisional findings of 29 September 2020 (27 October 2020), paragraph 392.

Paper. However, these views would not take into account all aspects of a price review, e.g. comparing approaches to setting expenditure and target levels, the design of incentive regimes and setting the level of allowed return. Therefore, Ofgem's views must be taken with caution in these circumstances.

(b) **Investor interest:** YWS strongly disagrees with the characterisation of the risk of exit from the sector and underinvestment in AMP7 as being "*relatively low*".[33] As YWS has highlighted in its previous evidence,[34] the level of return plays a crucial role in investor confidence. Reducing the WACC in the CMA's Final Determination risks materially reducing the attractiveness of water companies to potential investors at a time when investment is critical to the ultimate success of the sector.

(c) **Asymmetry of ODIs:** In relation to ODIs, the CMA continues to assume that the downside skew arises only in relation to structural matters, and that performance risk is symmetrical (i.e., that Ofwat's targets actually do represent a P50). While YWS agrees there is no straightforward way to identify the likely or P50 outcome for an efficient firm, the fact that Ofwat's targets are "stretching" is not a proper basis on which to conclude that they are a more reasonable assessment than YWS's. Moreover, there are other areas of the price control that embed downside skew, which provides a further reason for the CMA to take care in determining the uplift relating to asymmetry.

3.4 Procedural significance of the Roundtable

3.4.1 The CMA no doubt recognises the procedural importance of the Roundtable, and the need to take full and proper account of all representations made during the Roundtable and subsequently.

3.4.2 The CMA will also appreciate YWS's concern in relation to the materiality of the changes proposed in the Cost of Capital Working Papers (and, indeed, the other working papers recently published by the CMA), and the impact that this will have on the overall balance of the price control as well as issues of intergenerational fairness and resilience.[35] In light of

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[33] CMA, WACC Point Estimate Working Paper (January 2021), paragraph 108.

[34] YWS, Reply to Ofwat's PFs Response (16 November 2020), section 2.2.

[35] As noted in YWS's PFs Response, YWS welcomed the CMA's desire to ensure that the PFs "*strike the right balance between bill reductions and the interests of current and future customers in resilient infrastructure, particularly in the face of climate change*" and that

these developments, it is essential that YWS is provided with a proper opportunity to be heard, not least as Ofwat has already had ample opportunity to do so since the PFs.[36]

3.4.3 Furthermore, given the extensive changes to the PFs indicated in the CMA's Working Papers and the various errors of fact and assessment to which they give rise, the priority now should be that any changes from the PFs are carefully considered and supported by compelling evidence, consistent with the statutory framework.[37] Therefore, there is a clear requirement for the CMA to reflect thoroughly on all representations made in the Roundtable and subsequently.

3.4.4 YWS will provide a further submission on **27 January** containing more detail on the above and other points. In the meantime, YWS looks forward to discussing these important issues at the Roundtable.

"*companies need to be provided with more revenue to secure continued investment in the sector*" – see CMA, Press release (Provisional findings published in CMA review of water price controls) (29 September 2020), see https://www.gov.uk/government/news/provisional-findings-published-in-cma-review-of-water-price-controls.

[36] Ofwat had two half-day hearings on 30 November 2020 and 2 December 2020, the first of which was dedicated to finance issues (although Ofwat's arguments on finance and cost of capital are consistent across each of the four redeterminations). For water companies, finance issues were addressed as part of each of the companies' one half-day hearing.

[37] In carrying out its redetermination, the CMA is subject to both (i) the primary and secondary duties which apply to Ofwat, as set out in section 2 of the Water Industry Act 1991, and (ii) the principles of best regulatory practice.