18th January 2021

GIIA CMA Water Price Determinations Provisional Findings

Cost of Capital and Cost of Debt Consultation Response

Global Infrastructure Investor Association (GIIA) is the membership body for the world's leading institutional investors in infrastructure. Our members operate in 55 countries across 6 continents and are responsible for over US$800bn of assets under management globally, with over a third of that value invested in the UK. GIIA members have stakes in 10 of the privately held regional water companies in England and Wales, supplying over 50% of the UK population's water supply.

GIIA members have drawn our attention to the CMA working papers on Point Estimate for Cost of Capital and Cost of Debt, published 8th January 2021, and we are keen to express the perspective of institutional investors in infrastructure. This letter therefore acts as a high-level position statement on behalf of the investor community on the issues raised by the findings. By way of background, many of GIIA's members are active across various markets in many sectors, including in energy networks, transport, telecoms and social infrastructure and not exclusively the water sector in the UK.

Opening remarks

GIIA believes that it is fundamentally important for regulation to ensure that consumers pay a fair price for their utilities, whilst at the same time making sure that the UK is able to attract the level of investment required to build resilience against climate change impacts and to meet the legally binding commitment to achieve Net Zero carbon emissions by 2050. It is also important that the regulatory system enables the water sector to make the investment required to meet resilience challenges, which will increase in coming years due to a combination of growth pressures, changes to drought and flood risk associated with climate change[1] and through the Environment Agency making reductions to the amount of water that companies are allowed to extract from rivers. This is supported by the fact that customers consistently place a high priority on ensuring that their services remain resilient to the challenges of climate change and growth in demand and can be relied upon now and in the future.

Delivering this resilience will require extensive investment in the UK's infrastructure over the coming years and decades. The associated costs must be fairly allocated to ensure inter-generational equity between current and future consumers of UK utility services. GIIA's recent joint report with PwC on private infrastructure investment for Net Zero finds that around £40bn per annum on average is required to be invested across key infrastructure over the next 10 years. This level of investment will need to be sustained beyond 2030 in order to reach Net Zero by 2050 – and it is all the more urgent in the water sector given the sector's commitment to reach Net Zero by 2030[2].

In our submission to the consultation on the CMA's provisional findings (PF's) on water price redeterminations submitted on 26th October 2020, we were clear that the approach the CMA had taken at that point was better aligned with the interests of customers both now and in the

[1] Environment Agency, Water Supply and Resilience and Infrastructure (2015), URL
[2] Water UK (December 2019), URL

future, compared to the approach taken by Ofwat, and more conducive to enabling the investment required to build resilience into the UK water networks, which, as noted above, is a key priority of UK water customers. We also agreed with the CMA's broader conclusion in its PF's which state that ensuring that UK infrastructure sectors remain an attractive investment proposition is highly important due to the fundamental role infrastructure will play in delivering on the government's 'Build Back Better' and climate resilience agenda.

GIIA also welcomes the approach that the CMA has taken to the water price redetermination process in a broader sense. We feel that the CMA has demonstrated a clear level of independence and sound judgement in upholding core principles such as a rigorous approach to financeability and the need for 'aiming up', while rejecting questionable new Ofwat principles such as the gearing outperformance sharing mechanism which is at odds with established regulatory precedent, principle and theory.

Weighted Average Cost of Capital

However, the improved confidence created by the CMA's provisional redetermination has been negatively impacted with the CMA's revised proposal towards two aspects of cost of capital (the Weighted Average Cost of Capital and Cost of Debt) in the two working papers published on 8th January 2021. The revised approach to the WACC in particular will act to significantly dampen the incentive to invest in the UK, at the precise moment when global investors' perception towards the UK is at a point of heightened sensitivity following the UK's departure from the European Union, and whilst there is a pressing need to redefine the investment proposition for UK Plc more broadly in the context of a new international trading regime and as a means to support the recovery to the Covid-19 crisis and associated economic downturn.

The CMA's change in thinking is much less aligned than with the Government's strategic objectives for investment as outlined within the recently released National Infrastructure Strategy, which states "…the government remains strongly committed to supporting private investment and maintaining the UK's status as a leading global destination for private investment"[3]. It also undermines the message that the newly established Office for Investment intends to send out to the international investor community that the UK is serious about attracting higher levels of investment to support the delivery of the Government's strategic priorities in the years ahead[4].

Indeed, foreign direct investment (FDI) levels into the UK have been on a downward trend for several years. The House of Commons Library shows that by 2019, FDI had fallen for the third year in a row since 2016, having peaked at £192.6bn in 2016, to £35.6bn in 2019[5]. At the same time, global flows of FDI increased by an average of 3% over the same time period to $1.5tn in 2019, demonstrating the pace at which the UK has fallen behind competitors in the race for global capital investment[6].

That is why GIIA, as the representative body for the world's leading international investors in infrastructure, is firmly of the view that the revised approach that the CMA is proposing to the cost of capital and cost of debt significantly increases the risk of new and existing investment being diverted away from the UK in future, directly contradicting the stated intention by the CMA in its PF's to set the cost of capital at a level that ensures continued investment in the sector.

[3] HM Government, National Infrastructure Strategy, (November 2020), URL
[4] Office for Investment, (November 2020), URL
[5] House of Commons Library, FDI Statistics, (December 2020), URL
[6] Ibid

We also note that the CMA has released a further working paper on 13th January '*2019/20 data for base cost models*' suggesting they do not intend to reflect 19/20 cost data in their cost modelling for the final determinations. This raises questions regarding the CMA's methodology for selecting data/evidence to include and which to exclude in the exercise. It seems to be the case that some evidence submitted post-PF's has been accepted which has resulted in a proposal for a lower cost of capital, but that 19/20 cost data, which has a direct correlation in determining higher costs for companies is excluded. It is unclear why that should be the case and appears to be based on judgement rather than a substantial change in the evidence base. We are concerned that the CMA's position on 19/20 costs and now the partial reversal of its decision on leakage costs will further exacerbate downside risks for investors and, unless this is rectified in the FD's, the WACC should incorporate a greater degree of aiming up not less.

Cost of debt

In addition to the revised WACC, the two working papers also propose a very significant reduction in the cost of debt, driven largely by a major change to the assessment as to how embedded debt should be assessed. The move away from a 20-year trailing average now creates a scenario where the costs of older, more efficiently incurred debt are now effectively unfunded. This introduces hindsight to the assessment of efficient debt, as the CMA approach implies that companies should have anticipated that debt costs would fall significantly in the future, and thus should have taken out shorter tenor debt in the early 2000's. Such a judgement would not be reflective of the regulatory guidance of the day when those long-term financial decisions were made, nor is it consistent with the principles of better regulation.

Indeed, it is clear from remarks made by Ofwat executives in the early 2000's that the regulator expected water companies to take prudent long-term debt at the time. In 2001, Philip Fletcher, then Director General said: "The key here is how efficient the company has been in structuring and managing its finances…Given the exceptionally long lives of system assets, this would suggest the need for a relatively long average duration and an interest rate structure aimed at maintaining a broadly stable real interest cost over time"[7].

In a discussion paper issued in 2011, Ofwat also set out that it was clearly comfortable with the refinancing and restructuring trends between 2004 and 2007: "The refinancing trend began following the 1999 price review. Between 2004 and 2007, the pace of this increased, largely because the companies were able to take advantage of long tenor debt available at very cheap rates. While the availability of this cheap debt allowed the companies to outperform our assumptions at the 2004 price review, customers benefit from this cheaper financing over time through the price setting process"[8]. The revised approach as outlined in the working paper on cost of debt is therefore retroactive in denying the costs of this efficiently incurred debt now. Moreover, to do so would create perverse incentives for companies to take short tenor debt in future. The PF's position presented an already significant challenge as it still left companies underfunded for the cost of debt. That gap would significantly increase if the CMA's change of position in its consultation remains unamended.

It is unclear why the CMA has shifted position on these two measures so substantially and in a relatively short period of time following the release of the PF's in September 2020. The proposal appears not to be based on a substantial change in the evidence base during that time, but instead on a judgement made that the CMA had overestimated the level and impact of 'capital flight' during the PF's stage. We are mindful of the considerable public pressure put

[7] Oxera report for Ofwat, The Capital Structure of Water Companies, (2002), URL
[8] Ofwat, Financeability and Financing the Evidence Base, Discussion Paper (2011), URL

on the CMA by Ofwat during this period which is unprecedented in our experience, and are concerned that Ofwat's views on the risk of 'capital flight' may not be impartial.

Net Zero and resilience

With regards to the delivery of climate resilience and Net Zero in particular, it is worth noting that investors have, up until recently, been working closely with Government Ministers on proposals for a programme of additional investment during Asset Management Period 7 (AMP7) to support the green recovery following the COVID-19 crisis through the 'green recovery investment programme'. Investors have hitherto been supportive of the initiative, working on the premise that while the WACC and cost of debt levels proposed by Ofwat at PR19 were not sufficient to make the required investment attractive, it was hoped that the CMA's decision on the WACC would provide a viable basis to unlock this additional investment and bring a much-needed boost to regional economies across the UK.

However, if the CMA's final decision on the WACC remains at the level implied in the two working papers, then we understand that investors are unlikely to be able to support these enhanced levels of investment.

Customer bills

As part of their 2020-25 Business Plans, water companies undertook some of the widest ranging customer engagement exercises ever recorded in the sector. For example, Anglian's business plan reflected more than half a million interactions with customers across 38 channels, a ten-fold step up in engagement since AMP6[9]. Following this engagement process, Anglian concluded that more than 8 in 10 of its customers are willing to pay a slightly higher bill if that delivers outcomes such as increased demand management, improved measures to decrease leakage, takes care of customers in vulnerable circumstances and, perhaps most importantly, brings forward the investment needed to meet climate change challenges. Similarly, Yorkshire Water engaged with over 30,000 customers in its 2020-25 business plan, reporting that 86% of those surveyed found the bill costs set out in the Yorkshire Water Business Plan to be 'acceptable'[10].

The approach the CMA has taken in its working papers on the WACC and cost of debt does not appear to give sufficient weight to this clear customer view, expressed in far-ranging and extensive engagement exercises, which consistently places greater emphasis on ensuring investment to address growing and urgent climate change impacts, rather than focussing on a further, relatively minor, reduction in annual water bills.

These stakeholder engagement exercises seem to have been afforded little weight in the CMA's recent conclusions, and this risks customer's priorities not being met. The movement of 30 bps in the revised approach equates to only a further c 1.5% reduction on an average customer bill (so if that bill were £400 per annum it would mean a further saving of c.50p a month). The cumulative impact of that movement is, however, profound at the investment decision level. At the CMA's previous position, a better balance had been struck with the settlement still able to offer consumers a substantial reduction in average bills, whilst, crucially, also enabling the investment they signalled they wanted.

The final point in relation to the revised approach set out in the working papers is on the increased levels of uncertainty that arise as a consequence for investors. It is not clear from the working papers whether the CMA also intends to revise the range of other measures included in the price redeterminations, including on outperformance, leakage, operational

[9] Anglian Business Plan, 2020-25, (September 2018), URL
[10] Yorkshire Water Business Plan, 2020-25 (2019), URL

stress and capex expenditure. Without clarity on whether or not these are likely to be revised following the PF's stage, decisions for investors will be made increasingly difficult. The very significant changes between the PF's and the consultation document are consequently a source of concern, both in relation to the WACC and cost of debt, as well as the uncertainty surrounding the remaining measures within the PF's.

Concluding remarks

GIIA supports many aspects of the approach that the CMA sets out in its WACC consultation, including:

a) Recognition of the risk of setting cost of equity too low and principle of aiming up;
b) Recognition of the asymmetry of risk and return within the overall PR19 settlement and that the downside skew needs to be taken into account in the CMA's final decision.
c) Acknowledgement of the importance of the financeability duty and that this needs to be assessed alongside the WACC – however, as outlined above, it is difficult to provide a view on how well this has been done as we are unable to determine the position that the CMA has reached on the wider issues.

On Cost of Equity: whilst the CMA quite rightly recognises the risks attached to setting WACC too low and the impact on investor appetite, it has made a significant and, we feel, not well-evidenced change from its PF's in how these risks should be mitigated. Much of this change seems to be based on changes in judgement, rather than any material change in the evidence base. This reduction will drive a marginal reduction in customer bills, but it raises the risk of a material reduction in investment coming forward, exactly the risk that the CMA identified it wished to avoid in its PF's.

On Cost of Debt: The CMA has made a very significant reduction in its consultation, driven largely by a major change to the methodology for how embedded debt should be assessed on an historical basis and introducing an unwelcome retrospective aspect to water regulation. Again, this shift seems mainly to result from changes in judgement, rather than any change in the underlying data and evidence.

Many private investors in UK infrastructure are committing to deploy long term capital. They are seeking regulatory stability, as well as a clear policy framework that incentivises investment alongside a fair and merits-based appeals system. GIIA feels that the optimum balance has not been successfully struck in these revised proposals and would urge the CMA to reconsider the approach taken in the two working papers that currently deviate from that taken at the PF's stage.