Final Response to CMA WACC Consultations

27 January 2021

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1. Introduction

1.1 Overview

1.1.1 Further to YWS's initial responses to the CMA's Cost of Capital Working Papers[1] on 13 and 18 January 2021, this submission represents YWS's final response to the CMA's consultation (the **Consultation Response**).

1.1.2 This Consultation Response, together with its supporting Papers, is focused on the key issues arising from the Cost of Capital Working Papers and the cost of capital roundtable on 20 January 2021 (the **Roundtable**). It has a particular focus on areas which YWS considers will, if replicated in the CMA's Final Determination, result in a significant shift in the balance of risk and return beyond a reasonable range for the notional company.

1.1.3 At the Roundtable, YWS noted that it was approaching the anniversary of its Board's decision to seek a referral to the CMA after assessing Ofwat's final determination (**FD**) against long-term resilience challenges and the financeability of the notional company. Ofwat's approach to its FD was viewed as untenable, resulting in significant long-term detriment to both YWS and its customers.

1.1.4 The CMA's Provisional Findings (**PFs**) represented a step forward in recognition of these points as summarised in its press release last September:

"*We have sought to ensure that our provisional findings 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.*"[2]

1.1.5 Although the PFs were finely balanced, the financeability assessment recognised the primary role of WACC in ensuring an efficient firm can

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[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 **Point Estimate Working Paper**), and Water Redeterminations 2020 – Cost of Debt – Working Paper (the **Cost of Debt Working Paper**) (all 8 January 2021) (together, the **Cost of Capital Working Papers**).

[2] Kip Meek, Chair of the CMA Inquiry Group, 'Provisional findings published in CMA review of water price controls' (29 September 2020), available at: https://www.gov.uk/government/news/provisional-findings-published-in-cma-review-of-water-price-controls.

finance its functions and moved away from discredited solutions adopted by Ofwat that relied upon changing the timing of cashflows.

1.1.6 The better-balanced position achieved by the PFs has now been upturned by the recent Cost of Capital Working Papers issued by the CMA. These proposed changes are unprecedented in scale and timing, and so naturally demand a high level of scrutiny.

1.1.7 YWS has serious concerns about the recent approach taken in the Cost of Capital Working Papers, the remaining time to address its materially changed point estimate and the opportunity to engage on the broader consequences. As YWS noted in its response to the PFs, "*the pragmatic and targeted approach that YWS has adopted in response to the PFs, based on its consideration of the package in the round, does not imply that YWS agrees fully with the CMA's detailed approach in all other areas. Moreover, it is also predicated on the assumption that the CMA will not materially alter its PFs in any other area in its final determination.*"[3]

1.1.8 **YWS believes firmly that the updated point estimate of WACC lacks sound economic rationale; undermines the logic underpinning the CMA PFs; and does not appear to have taken account of credible evidence submitted by YWS on risk asymmetry.**

1.1.9 **Moreover, were the approach in the Cost of Capital Working Papers (together with the working papers on leakage and 19/20 data) to be adopted in the Final Determination, an updated Monte Carlo analysis attached to this submission concludes that it is highly likely that YWS is unfinanceable on a notional basis, inconsistent with the CMA's statutory duties**.[4]

1.1.10 The Cost of Capital Working Papers demonstrate a high level of engagement with Ofwat's submissions, as was recognised by Kip Meek in his letter of 25 January 2021 that, "*[i]n terms of the focus of the working papers, since Ofwat provided extensive comments and criticisms of certain aspects of the Provisional Findings, it is to be expected that the matters we wish to consult on are to some extent informed by the issues raised in Ofwat's response.*" On the contrary, the Cost of Capital Working Papers demonstrate a regrettable lack of engagement with YWS's evidence. In accordance with YWS's previous

[3] YWS, Response to the CMA's Provisional Findings of 29 September 2020 (27 October 2020) (the **PFs Response**), paragraph 1.1.15.

[4] Annex 1 to Paper 4 and Section 4 below.

correspondence with the CMA,[5] given the seriously detrimental consequences to YWS were these proposals to be included in the Final Determination, it is clearly of the utmost importance, which YWS believes to be common ground, that the CMA ensures that the basic requirements of effective and fair consultation are fulfilled, including that conscientious consideration is given to any response before a decision is made.

1.1.11 In light of all the above, it was therefore apt that the CMA concluded the Roundtable by recognising that a great deal is at stake in relation to WACC,[6] with which YWS fully agrees. This is also evident from the responses received from investors to the Cost of Capital Working Papers which demonstrate the understandable levels of concern in the investor community.[7]

1.2 Approach taken for Consultation Response

1.2.1 YWS understands the purpose of the Cost of Capital Working Papers is limited to those specific elements of the WACC on which the CMA wished to have further submissions, and that the CMA is not consulting again on all elements of the cost of capital.

1.2.2 In this Consultation Response, YWS has therefore chosen not to substantively revisit territory that has already been covered in its previous submissions in detail. The same decision has been taken in respect of the long list of points in Table 1.1 of Ofwat's Initial Response, which have been the subject of YWS's written submissions on numerous previous occasions.

1.2.3 Instead, YWS brings to the CMA's attention specific issues relating to the WACC arising from the Roundtable and Cost of Capital Working Papers, particularly where there has/have been:

(a) fundamental errors of fact and/or assessment;

(b) failure to take account of key evidence; or

(c) no evidence for the position advanced, or where a coherent rationale is lacking.

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[5] Letter from Liz Barber to Kip Meek (20 January 2021).

[6] Cost of Capital Hearing Transcript (20 January 2021) page 154.

[7] See GIIA, Response to Cost of Capital Working Papers (January 2021).

1.3 Outline of this paper

1.3.1 The Consultation Response is structured as follows:

(a) **Section 2:** YWS has drawn out two major aspects from its review of the CMA's Cost of Capital Working Papers, both regarding the cost of debt, which are material to the point estimate set for WACC. These have been highlighted distinctly for attention since YWS believes the CMA's analysis is flawed and unevidenced. YWS's analysis is summarised in section 2 below and supported by two standalone papers as follows:

(i) **Paper 2(A)** on the cost of embedded debt; and

(ii) **Paper 2(B)** on the proportion of new debt to embedded debt.

(b) **Section 3:** YWS sets out further relevant points regarding WACC and gearing, including those discussed at the recent Roundtable. These include material issues not considered to date in the Cost of Capital Working Papers, or where there appear to be errors of fact and/or assessment in the CMA's analysis.

(c) **Section 4:** YWS presents its concerns on the omissions in evidence used to support the CMA's views on risk asymmetry and the conclusion of the updated Monte Carlo analysis that shows that it is highly likely that YWS would not be financeable in the event that the proposals from the January Working Papers are carried over to the CMA's Final Determination. These are supported by **Paper 4** and **Annex 1 to Paper 4**.

(d) **Section 5:** YWS provides further comments on the remainder of this redetermination process.

2. Cost of debt analysis

2.1.1 YWS would like to make the following key observations about the cost of debt:

(a) Cost of embedded debt

2.1.2 The CMA stated a very definite preference in its PFs and in the Cost of Capital Working Papers for a benchmark-led approach to setting the allowed cost of embedded debt. Having settled on this position, it is vital that the CMA's chosen benchmark is now genuinely a benchmark – i.e., a realistic characterisation of the mix of debt that an efficiently financed company would have taken into the AMP7 regulatory period.

2.1.3 There is no rationale that YWS can conceive of for a 15-year collapsing debt portfolio which cuts off all pre-2005 data, and which progressively loses all memory of pre-2009 interest rates. As YWS explained in its submission on 13 January 2021 (**13 January Response**), the CMA appears to have arrived at this benchmark in error because it misconstrued the anchoring that it should take from the "average number of years to maturity" data presented in companies' APRs.[8]

2.1.4 In Paper 2(A), YWS sets out an improved methodology that the CMA should use in its Final Determination. This approach expands the CMA's PFs benchmark to include recognition of floating-rate debt, EIB debt and index-linked debt, thus addressing the CMA's concern that it may not have adequately captured the full range of instruments that water companies utilise.[9] YWS also shows that this proposed benchmark passes a cross-check to the actual industry cost of debt.

(b) Weights for embedded debt and new debt

2.1.5 The mistake that undermined the calibration of the embedded debt allowance also affects the CMA's revised calculation of the weights for embedded and new debt in the Cost of Debt Working Paper. YWS explains in Paper 2(B) that the CMA has significantly overstated the speed with which existing debt will mature, leading to an equal and opposite overstatement of the new debt that would be issued during AMP7.

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[8] YWS, 13 January Response.

[9] CMA, Cost of Debt Working Paper (January 2021), paragraph 76.

2.1.6 The analysis in Paper 2(B) explains that the correct weighting for embedded and new debt is in the range of 11% to 15% and not 20% as appears in the Cost of Debt Working Paper.[10] This manifest error has led the CMA to materially overstate the proportion of new debt and, consequently, understate the cost of debt allowed for the notional company – this error cannot be left uncorrected.

(*c) Impact on financeability cross check*

2.1.7 The observations set out above raise serious questions as to the economic rationale supporting the CMA's point estimate for the cost of embedded debt being set at 4.52% and assuming a 20% weighting to new debt. Given the analysis presented in Papers 2(A) and 2(B), YWS believes firmly that this would result in the funding for a notional company's debt cost not being commensurate with the costs that it would reasonably expect to incur in AMP7.

2.1.8 Consequently, it is clear that there would be a negative impact on the range of interest cover metrics used as a reference for the notional financeability assessment. This is critical since it is the cross check for the CMA's point estimate of WACC, incorporating a 4.52% cost of embedded debt set and 20% weighting to new debt. This negative impact would result from cashflows in interest cover calculations including a lower amount of allowed return in respect of cost of debt than would be included in interest costs.

2.1.9 Therefore, unless these points are addressed, YWS believes it would not be possible for the notional financeability cross check to confirm that the CMA's point estimate for WACC would be consistent with a strong investment grade rating of Baa1/BBB+.

[10] CMA, Cost of Debt Working Paper (January 2021), paragraph 260.

3. Further WACC and gearing considerations

In addition to the material cost of debt points noted in Section 2, YWS requests the CMA gives full consideration to the following points:

3.1 Notional gearing

3.1.1 The CMA indicated that it may consider calculating the WACC for a notional company with a gearing of 55%. YWS would be strongly opposed to such a move since the existing notional gearing level of 60% already sits below the gearing of all shareholder-owned water companies in the sector.

3.1.2 Any further decrease would result in a wholly unrealistic characterisation of a notional water company, including, but not limited to, the financeability challenges that companies currently face. It would therefore be a misguided approach giving rise to a distorted assessment unrepresentative of the sector.

3.2 Cost of debt – liquidity and issuance costs

3.2.1 YWS highlighted within its SoC that Ofwat's FD allowance of 0.10% was understated.[11] YWS refers the CMA to its PR14 Bristol Water redetermination allowance of 0.20% to 0.30% and Ofgem's recent RIIO2 FD allowance of 0.25% as clear examples that the current allowance is understated.[12]

3.3 Cost of equity

(a) Risk-free rate

3.3.1 YWS has nothing to add to the helpfully lucid discussion of the risk-free rate at the Roundtable.

(b) TMR

3.3.2 YWS has previously expressed concern that the positioning of the CMA's PFs range for the TMR is inconsistent with the CMA's very clear findings about the caution that needs to be shown before placing reliance on CPI-deflated measures of historical stock market returns.[13]

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[11] YWS, Statement of Case (**SoC**) (2 April 2020), paragraphs 229-231.

[12] CMA, Bristol Water plc – A reference under section 12(3)(a) of the Water Industry Act 1991: Report (6 October 2015), Table 10.2; Ofgem, RIIO-2 Final Determinations – Core Document (8 December 2020), paragraph 6.9.

[13] See, for example: YWS, PFs Response (27 October 2020), paragraphs 3.3.15-3.3.18 and 3.4.12; YWS, Reply to Ofwat's PFs Response (16 November 2020), paragraph 2.7.2.

YWS has also noted that the bottom end of the TMR also appears to be unduly influenced by a single outlier value.[14] YWS expects that the CMA will want to revisit the precise calibration of its TMR range in light of these issues ahead of its Final Determination.

(c) Equity beta

3.3.3 Empirical estimates of betas come with large standard errors. Consistent with YWS's submissions throughout the CMA's redetermination,[15] the CMA should be very cautious about the weight that it gives to to short-term spot estimates of beta, especially after: (i) the turbulence in financial markets during the last 11 months; and (ii) the continued company-specific "noise" that there has been in the SVT and UU share prices during 2020, as companies and investors have got to grips with what the PR19 FDs mean for profitability and dividends.

(d) "Aiming up"

3.3.4 The CMA's so-called "aiming up" erroneously conflates: (i) allowed revenue that the CMA proposes to give companies to offset the expected losses caused by asymmetry in ODI design; and (ii) genuine aiming up on the cost of equity parameters. If one correctly separates out the 10-20 basis offset for expected ODI losses, the Point Estimate Working Paper only actually provides for an aim up of between 5 and 15 basis points on the mid-point cost of equity, or the equivalent of 2 and 6 basis points on the overall WACC.

3.3.5 By any standard, this constitutes a *de minimis* adjustment to a ~5.5% mid-point nominal WACC. YWS asks the CMA to consider if this proposed calibration gives proper effect to the statements that the CMA has made about the importance of securing long-term investment in the sector and financeability, consistent with the statutory framework.

3.4 Retail margin

3.4.1 In its closing remarks, Northumbrian Water noted that there was no discussion during the Roundtable of the retail margin adjustment. YWS continues[16] to believe that the CMA has not considered the full amount

[14] YWS, PFs Response (27 October 2020), Table 1.

[15] See, for example: YWS, SoC (2 April 2020) paragraphs 225-226; YWS, PFs Response (27 October 2020), Table 1; and YWS, Reply to Ofwat's PFs Response (16 November 2020), Annex A.

[16] YWS, PFs Response (27 October 2020), Table 1.

of financial capital that companies need in order to support the provision of retail activities. The suggestion that a stand-alone retail business can finance itself with a margin of just 0.2% – i.e. well below the margin that low-risk, asset-light businesses typically earn[17] – is not credible.[18]

3.4.2 This is supported by the error within the calculations that Northumbrian Water identified within its response to the PFs.[19]

3.5 Inflation assumptions

3.5.1 YWS notes that there was no discussion of the treatment of inflation during the Roundtable despite YWS's multiple submissions on the issue.[20] YWS struggles to understand why this issue has received such low prominence during this redetermination. The inflation forecasts published by the OBR in November 2020 indicate that companies will have to contend with a cumulative shortfall of more than 2 percentage points relative to the long-term inflation/RCV indexation assumptions that the CMA used in its cost of capital computations in the PFs. Absent any belated recognition of this shortfall, there is no realistic prospect that companies will be able to recover their cost of capital in full.[21]

3.5.2 Even if it is not now possible for the CMA to reflect the real-world inflation outlook in its line-by-line estimates of the cost of debt / WACC parameters, it is incumbent on the CMA to recognise this downward bias when evaluating its proposed level of return in the round.

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[17] YWS, PFs Response (27 October 2020), Table 1.

[18] YWS explained in its response to the PFs that a 0.2% margin fits incongruently with the profits earned by other businesses that manage risks around revenue collection and associated costs – see YWS, PFs Response (27 October 2020), Table 1.

[19] NWL, PR19 CMA Redetermination, Response to Provisional Findings (26 October 2020), paragraph 7.7.

[20] See, for example: YWS, PFs Response, paragraphs 3.3.3-3.3.8; YWS, Reply to Ofwat's response to the CMA's provisional findings of 29 September 2020 (16 November 2020) (**Reply to Ofwat's PFs Response**), paragraph 2.6.4; YWS, Post-Hearing Submission (17 December 2020), paragraph 2.3.8-2.3.13; YWS, Initial Response of 18 January 2021 to the Cost of Capital Working Papers (the **18 January Response**), paragraph 3.2.1.

[21] YWS, PFs Response (27 October 2020), paragraph 3.3.6.

3.6 Gearing and GOSM

3.6.1 The following points are noted by YWS solely as a consequence of their inclusion and discussion at the Roundtable.

(a) Actual gearing

3.6.2 YWS reiterates[22] its position that there is no correlation between higher gearing and higher cost of debt and/or poor operational performance. Such repeated suggestions by Ofwat have not been supported by credible evidence. It is overly simplistic to assume that different gearing levels are solely responsible for different costs of debt when comparing companies in the water sector nor use this suggestion as part of an explanation that the cost of debt for a notional company would be lower than the sector average.[23]

(b) GOSM

3.6.3 YWS did not see value in including GOSM on the CMA's agenda for the Roundtable given that discussions indicated there were no new matters to consider and that Ofwat had continued with its changing justification for GOSM by describing it as an incentive to reduce gearing.

3.6.4 Should it decide not to include the GOSM in the Final Determination, the CMA will have discharged its responsibility to make a determination under Condition B of the licence, and there is no additional obligation upon the CMA to consider and potentially redesign the wider regulatory framework under which companies operate. If Ofwat wants to introduce a new mechanism in the future, it should do so outside of this redetermination process. It should also explain much more clearly why the existing tools (e.g. the regulatory ring-fencing licence provisions) are not sufficient and then adopt an evidence-based approach, including a full cost-benefit analysis, for any such proposal.[24]

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[22] YWS, Response to PFs (27 October 2020), paragraph 4.3.2; YWS, Post-Hearing Submission (17 December 2020), paragraphs 2.3.19-2.3.22.

[23] As indicated by para 197 of CMA, Cost of Debt Working Papers.

[24] YWS, Response to PFs (27 October 2020), paragraph 4.5; YWS, Reply to Ofwat's PFs Response (16 November 2020), section 3; YWS, Post-Hearing Submission (17 December 2020), paragraph 2.4.

4. Risk asymmetry

4.1.1 YWS's response to the CMA's PFs explained that YWS was financeable on a notional basis but with limited headroom. This was based on a range of evidence, including a Monte Carlo risk analysis,[25] which modelled variation in outturns for a range of key price control parameters. The analysis showed a much more material downside RORE skew than that reported by the CMA in its PFs (the CMA reported a downside skew of just -0.1% to -0.2%). The CMA's downside skew was understated because: (i) in relation to ODIs, the CMA's estimate ignored asymmetry relating to performance risk; and (ii) the CMA assumed other parts of the price control were symmetrical.

4.1.2 There has been limited engagement by the CMA on evidence presented by YWS regarding risk asymmetry beyond the CMA's downside RORE range of -0.1% to -0.2%, which shows clearly there has been a material underestimation of the downside skew. More fundamentally, the CMA has not undertaken any analysis of its own that would allow itself to reach any conclusions that either PCLs, or other elements of the price control, represent a P50 for an efficient firm.

4.1.3 YWS has explained the nature of this omission in detail in **Paper 4**, which highlights the following key points:

(a) the CMA has not explicitly acknowledged the principle that PCLs should be set where marginal cost is equal to marginal benefit. Furthermore, there is a failure to explain why, despite Ofwat's PCLs not being set on this basis, the CMA has come to the conclusion that its targets are appropriate in representing a P50 position for an efficient firm;

(b) the CMA must address this notable omission in order to explain how it has determined its targets are appropriate and demonstrating clearly that it has taken into account evidence presented by YWS on this issue; and

(c) the CMA should clarify how any downside asymmetric risk has been adequately addressed in its Final Determination.

[25] Annex 1 (PFs Response), Economic Insight, 'Financeability of the notionally efficient firm, a bottom up analysis: update to reflect CMA provisional findings' (21 October 2020).

4.1.4 Furthermore, **Annex 1 to Paper 4** expands upon previous evidence submitted by YWS,[26] and provides an updated Monte Carlo analysis to reflect the impact of the proposed changes set out in the Cost of Capital Working Papers, together with the working papers on leakage and 19/20 data (the **CMA January Working Papers**). This analysis now shows that YWS would highly likely not be notionally financeable, were the CMA to retain its position in the CMA January Working Papers its Final Determination.

4.1.5 Therefore, YWS requests that the CMA, in line with its statutory duties, addresses the omissions highlighted above and rectify this imbalance in order to reach sound conclusions on asymmetry of risk and financeability.

[26] Appendix F1 (YWS's Financeability Draft Determination Representation (August 2019)), Economic Insight, 'Financeability of the notionally efficient firm, a top-down analysis' (August 2019).

5. Procedure and next steps

5.1.1 As YWS stated in recent correspondence with the CMA,[27] in the event that the major changes to the PFs implied by the Cost of Capital Working Papers are replicated in the Final Determination, YWS has no clear view of the 'in the round' assessment that the CMA is undertaking in order to determine an appropriately balanced package consistent with its statutory duties. Moreover, the Cost of Capital Working Papers have now created considerable uncertainty as to how the CMA will be able to present a balanced package 'in the round'.

5.1.2 As a result this gives rise to material concerns as to whether the Main Parties are in a sufficiently informed position to respond adequately to the CMA's consultation. More fundamentally, however, it also gives rise to the highly likely outcome that the notional firm would not be financeable on a notional basis, a proposition that is not discussed at all in the Working Papers and which is critical given that it relates to the CMA's ability to satisfy its statutory duties. YWS awaits the CMA's proposals as to how this highly material omission is to be considered and addressed.

5.1.3 Given the wide-reaching impacts that the CMA's Final Determination will have, it is critical that the CMA ensures that adequate time is given for consideration and response, and that conscientious consideration is given to the submissions at the recent Roundtable and the written submissions before making its final decision.

5.1.4 With that in mind, YWS understands that the CMA's amendment to its target date from mid-February to late-February recognises the need to spend further time considering responses to the January Working Papers – YWS would indeed encourage the CMA to **make further use of the full statutory timetable**. Since Ofwat has confirmed that its charges will be spread over three years rather than four, there is no longer any meaningful consumer benefit to the CMA issuing its Final Determination earlier rather than later, and – given the materiality of the changes to the PFs proposed by the Cost of Capital Working Papers, in addition to the other changes proposed in the leakage and 19/20 data papers – the priority should be ensuring the issues raised in response to the consultations (including the fact that the notional firm is highly unlikely to be financeable if these proposals are adopted) have

[27] Letter from Liz Barber to Kip Meek, 20 January 2021.

been properly considered and addressed before the CMA makes its Final Determination.