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27 January 2020

Dear CMA PR19 Panel,

Consultation - Cost of Capital Working Papers

Citizens Advice welcomes the opportunity to respond to this consultation as part of its statutory role to represent domestic and small business energy consumers in Great Britain. Our response is not confidential.

We welcome that the CMA has given ground in its updated position on the cost of capital. We note the CMA says that Ofwat's determinations for the four disputing companies would lead to around 12.5% reduction in bills over the period of the price control relative to those applying in the 2015 to 2020 period. The provisional findings would have seen bills fall by an average of 9.3% while the revised proposals are much closer to Ofwat's determinations, with around an 11% fall in average customer bills.

In particular, we welcome the CMA's updated view, subsequent to its provisional findings, that it had previously overestimated the cost of capital of the water companies. Given the pressing statutory deadline in March for the CMA to provide a final determination, we recognise the time pressures on the consultation and the choice of an efficient update to the provisional findings by consulting only on the point estimate and cost of debt for the cost of capital. However, it is problematic to respond to these in full without also knowing how the CMA is responding to the further evidence provided on the other main components of the cost of capital, the risk-free rate (RFR), Total Market Return (TMR), and particularly, beta.

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Charity registration number 279057 VAT number 726 0202 76 Company limited by guarantee Registered number 1436945 England
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Citizens Advice notes the CMA's working paper proposal has set a point estimate for the cost of equity of 0.25% above the CMA's mid-point of that range, subject to the CMA's financeability analysis. We welcome this reduction in the point estimate, but we nevertheless strongly disagree with the need for any "aiming up" above the relevant mid-point estimate.

In particular, we disagree with the CMA's concerns about risks to long-term investment and capital availability should the cost of capital be set "too low" – resulting in "benefits" from choosing a point estimate for the cost of equity above the middle of the range – and that the CMA's approach will therefore result in an appropriate balance of risk "in the round".

On the contrary, setting the cost of equity at the mid-point of the cost of equity range will not create a material risk of the cost of capital being too low – and this risk should be addressed by regulators by more appropriate price control mechanisms, such as requiring delivery outcomes, reconciliation adjustment processes and forms of enforcement. Setting the cost of equity above the mid-point and aiming up on the cost of capital creates a certain – and unacceptable – ~£40 cost to the average water customer if applied across the sector for the price control period.

We have previously provided the CMA with evidence of stretched consumer budgets due to COVID-19 which present a material risk to consumers ability to pay, which continues to worsen[1]. This winter 24% of consumers - equivalent to almost 7 million households - expect to struggle to pay their energy bills. As of November 2020, there were 1.72 million unemployed with a fivefold increase on the same period a year earlier[2]. Ability to pay will have weakened and not setting an efficient cost of capital will lead to consumer detriment. Ofwat states that an overestimated mid point on equity (40 basis points) and then aiming up (25 basis points) on top would cost customers at PR19 c.£1 billion. Providing a rationale for aiming away from the midpoint without reflecting both the impact of additional consumer costs alongside consideration of investor risk is highly

[1] Citizens Advice (2020) Ruin, or Recovery?
[2] ONS (2021) Labour market overview, UK: January 2021

asymmetric. As is not recognising the impact of the opportunity for companies to try and correct any apparent underfunding via reopener processes.

Asymmetry, in part, appears driven by the CMA preferring to stagger reductions in the allowed cost of equity possible based on the available evidence, preferring a slow fall over multiple price controls[3]. There is not the same opportunity to graduate a correction if market factors increase the cost of capital so as to avoid the risk of spikes in consumer bills. Ofwat has also gone to great lengths to signpost the correction over the course of PR14 minimising the rationale for any surprise. The efficacy of this process is evident in market cross checks we have previously highlighted, including investor expectations on the PR19 cost of capital.

We recognise of course that there has been a history of regulators, including Ofwat, setting the cost of capital from the top half of an underlying range. That approach, however, led to a persistent and large over-remuneration of investors at the expense of customers, as is now widely accepted. The most formidable evidence for this was the aggressive historic leveraging of the water companies (i.e. gearing up with maximum debt) – following previous regulatory determinations (especially PR04 and PR09) – in order to extract large rewards to shareholders. Such leveraging, and equity withdrawal, enabled the upfront capitalisation and extraction of future excess profits, on the assumption that regulators would continue to set such generous returns on an indefinite basis.

The CMA agrees that expectations of future excess returns will tend to be capitalised in current share prices: "*A high return on existing assets may result in a premium for current shareholders, if it is expected to continue over multiple periods*."[4] In any event, maintaining investors' confidence that the UK water sector will continue to generate excessive returns is of course not a legitimate objective or consistent with Ofwat and the CMA's financing duty. Investors must be confident merely that they will receive a rate of return equal to a robust – and central – estimate of the cost of capital (and therefore that their investments will not be appropriated) but no more than this. Consumers must similarly

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[3] CMA (2020) Point estimate for cost of capital working paper, suggests there is an issue with "responding too quickly to market fluctuations" para 103

[4] Water Redeterminations 2020: Choosing a point estimate for the Cost of Capital – Working Paper, para. 38.

have confidence that regulators will protect their interests, in accordance with regulators' primary duty.

Accordingly, the regulatory approach of setting the cost of capital from the top half of a range – along with multiple other conservative assumptions – has now been discredited, following the historic experience, and as documented in various reports by the UKRN[5] and NAO[6], among others.

By linking performance incentives to specific outcomes, consumers are better protected from networks receiving windfall gains. Equally, totex reconciliation and performance monitoring provide appropriate mechanisms for ensuring the right investments are made. Aiming up on the cost of capital to protect investment, would - if linked at all to additional investment - only enable networks in their preferred investments, which does not always ensure a positive consumer outcome. There is growing evidence in multiple sectors that networks respond positively with investment to Outcome Delivery Incentives (ODIs) to the benefit of consumers and networks. For example, in the energy sector, investment and returns by the Data Communications Company or by the Electricity System Operator are highly dependent on performance incentives. ODIs and other forms of delivery checks lower the risk of under-delivery and have become a more substantial element of prospective investor returns. This should be reflected when setting the cost of capital.

Indeed, as evident from PR19 (and all previous water reviews) the greater problem that Ofwat faces is not exit of capital from the water sector, but too much capital, namely, that the Regulatory Capital Value (RCV) "*may also contribute to a bias towards capital-intensive solutions where they may not be optimal*"[7]. This can contribute to investment behaviour that does not protect customers and environmental objectives. Where allowed, companies' add to their RCV, allowing receipt of further returns in excess of the cost of capital. As the CMA notes: "*a higher cost of capital [...] provides incentives for existing investors to put in new equity or forego dividends and grow the RCV*"[8].

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[5] UKRN (2018) Estimating the cost of capital for implementation of price controls by UK Regulators
[6] NAO (2020) Electricity Networks
[7] Ofwat (2015) Financeability and the asset base, p17
[8] Water Redeterminations 2020: Choosing a point estimate for the Cost of Capital –Working Paper, para. 38.

This is evidence alone that the allowed return on capital materially exceeds the cost of capital and that the companies expect it to stay that way.

Citizens Advice also strongly disagrees that there is a "*structural asymmetry in the overall [PR19] determination*" against investors. On the contrary, there is a large structural asymmetry throughout the whole UK economic regulation regime in favour of investors, which PR19 has further enhanced, such as by indexation of debt servicing costs. Such asymmetry should principally be reflected in the equity beta, namely, the measure of non-diversifiable risk facing the companies, rather than ad hoc adjustment to the cost of equity, such as "aiming up".

We remain concerned therefore by the CMA failing to acknowledge elements of Citizens Advice's previous submissions[9] (prior to and following the CMA's Provisional Findings) on the profile of risks faced by water company investors, either in the Provisional Findings or in the CMA's Cost of Capital Working Paper consultation now. We, therefore, restate Citizens Advice's position, in summary, again.

First, water is a fundamentally non-cyclical industry, generally impervious to the wider economy and to other economy-wide economic shocks, with neither revenues nor costs likely to vary materially, or at all, with wider economic conditions.

Furthermore, from the perspective of the typical global investors in the UK water companies – global banks, asset management firms, private equity funds, along with major pension funds, and/or other global institutional investors and multinational corporations – virtually all risk facing the UK water companies is diversifiable.
Second, the underlying feature of the England & Wales water regulation regime – and UK economic regulation more generally – is that non-diversifiable risk is almost entirely borne by customers, rather than by investors. The large majority of diversifiable risk is also borne by customers rather than investors.

Third, PR19 adds a series of new uncertainty mechanisms that further shift risk from investors to customers, in particular, the indexation of debt servicing costs, as well as other material and/or highly uncertain performance commitments. In addition, the CMA

[9] Both prior to and in response to the CMA's Provisional Findings (June 2020 and October 2020 respectively).

itself proposes a further reduction in companies' exposure to financial risk, such as the proposed "deadbands". Betas estimated using historic share price data from previous price control review periods will of course not reflect such structural reduction of non-diversifiable risk.

Fourth, estimating regulated companies' equity betas based on short-term share price movements is likely to result in substantial over-statement of firms' underlying non-diversifiable risk. This is because short-term share price movements reflect the risks borne by short-term investors, not those borne by the long-term investors that characterise the large majority of investors and which the regulatory regime is intended to encourage.

Accordingly, on the basis of the lower longer-run water company raw equity betas presented in the 2018 UKRN cost of capital report of 0.3-0.5, Ofwat's final determined asset beta should have been 0.21-0.30 (rather than 0.36), notional equity beta should have been 0.33-0.55 (rather than 0.71). This would have meant a lower overall allowed rate of return by between 0.5%-1.2%-points on all inflation measures. The CMA was, therefore, wrong to provisionally determine an equity beta even higher than Ofwat's.

Citizens Advice also disagreed with the CMA's assessment of the TMR and RFR. In particular, we said that to be fully consistent with the CAPM – the TMR should not just be based on the average returns on UK equities, but on the average returns on a wider and more diversified asset portfolio, including bonds, property, infrastructure, private equity, and other such assets that are readily available to the typical investors in UK water companies. This would mean a lower TMR than proposed by Ofwat and the CMA. We also said that the cost of borrowing by low-risk investors, as proposed by the CMA, is not just "another" way of estimating the return on a zero-beta asset. On the contrary, it will always lead to an over-estimate the return on a zero-beta asset, i.e. the RFR.

We are not specifically commenting on the CMA's Cost of Debt working paper. However, we note that neither Ofwat nor the CMA appears to follow Recommendations 8 and 9 of the UKRN report, namely, that for consistency with the definition of the CAPM-Weighted Average Cost of Capital (WACC) as an expected return, cost of debt estimates that feed into estimates of the CAPM-WACC should include an adjustment to corporate bond

yields to convert these into expected returns, i.e. by correctly adjusting for default risk. This is a further reason why Ofwat's and the CMA's cost of capital estimates are likely to be too high.

Hence, overall, we do not accept that the CMA's current position that the alleged benefits of setting the cost of equity above the mid-point of the CMA's cost of equity range would "*more than outweigh*" the costs to consumers. On the contrary, they do not outweigh the costs to consumers at all.

Kind regards

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