Making a positive difference
for energy consumers

Kip Meek
Inquiry Chair, Ofwat Price Determinations
Competition and Markets Authority
The Cabot
25 Cabot Square
London
E14 4QZ

waterdetermination2020@cma.gov.uk

Direct Dial: [redacted]
Email: [redacted]

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Dear Mr Meek

Water Determinations 2020: Cost of Capital Working Papers

1. Thank you for the opportunity to respond to the CMA's working papers published on 8 January 2021 on the cost of capital in the above determinations. Ofgem previously responded to the call for submissions from third parties in our letter of 11 May 2020[1], attended a hearing with the CMA on 3 June 2020, responded to the CMA's Provisional Findings on 29 October 2020[2], and attended a further hearing with the CMA on 25 November 2020. We are not responding on the leakage, cost models or Elsham working papers.

2. We welcome the CMA's updated position that the Final Re-determination will set separate point estimates for the cost of debt and the cost of equity. We also welcome the introduction of cross-checks for both the cost of debt and cost of equity parameters.

3. Having said that, our previously expressed views that the Panel's estimation of cost of equity parameters may be upwardly skewed remain, although we note no specific updates on these parameter ranges in the consultation. This, along with the CMA's proposal to also then explicitly aim up on the cost of equity, could be perceived as altering the balance of risk and return in favour of investors, to a level beyond what is reasonable based on market evidence. The result is likely to be a substantial transfer of value from consumers to investors in the water sector, without clear benefits in terms of deliverable outputs and standards of service.

4. We set out below our observations on the CMA's updated thinking on the cost of debt, cost of equity and on financeability, which the CMA may find helpful.

Cost of Debt

5. We welcome the introduction of actual water company average sector costs as a cross-check to the cost of debt point estimate and are of the view that this provides confidence that the point estimate is a fair and reasonable allowance.

[1] https://assets.publishing.service.gov.uk/media/5ebebdc1e90e071e2a937fce/Ofgem_Redacted.pdf
[2] https://assets.publishing.service.gov.uk/media/5fa298d88fa8f57896ad0276/Ofgem_response_to_PR19_Provisional_Findings_291020_Redacted.pdf

6. We note that actual debt costs are likely to be sector-specific and as we do not have access to all relevant data for the water sector, we are unable to comment on the details of the embedded debt point estimate or calibration of the benchmark used. We agree with the CMA's suggestion that a benchmark approach is preferable to using individual company actual debt costs and that "there would be little to no incentive for companies to ensure that their debt costs were as low as possible if there were a 'cost-pass-through' mechanism in place"[3]. We therefore agree with the CMA's suggested cross-check of sector average debt costs rather than individual company debt costs.

Cost of Equity - Aiming Up

7. We understand the CMA's main reasons for aiming up relate to the following three areas:

- A concern that investors may be unwilling to invest to identify, plan and fund specific and large future investments;
- The risk of investors seeking to remove capital and risk to investment beyond the current price control; and
- Overall package asymmetry.

We discuss each in turn below.

Ensuring capital availability for future specific investments

8. The CMA notes that there is substantial uncertainty over the actual cost of equity, as recognised in the wide estimated ranges around the cost of equity[4]. However, we note that the CMA's range of 2% is substantially wider than Ofwat's estimates[5] and that this is at least in part due to the inclusion of data points at the top end of the parameter ranges which may be inappropriate. The narrower ranges identified in footnote 19 of the CMA's working paper would indicate that this uncertainty may be closer to a 1% range between high and low estimates.

9. The CMA also notes that there is "uncertainty around the optimal level of investment ….but with a material probability that companies will need to design and invest in an enhanced capital programme in the coming periods, in particular to meet the challenges raised by climate change"[6].

10. However, the CMA goes on to "recognise that if the cost of capital is set too low, this may only have a limited effect on investment in the short term"[7] but that it remains concerned that "the cost of capital today may have a knock-on impact on investment planning during AMP7" and that "expectations of insufficient investment returns based on the current cost of capital may discourage companies from identifying and proposing otherwise desirable investment projects". This suggests that the CMA are of the view that an equity return allowance higher than the true cost of equity would *encourage* companies to complete greater investment and/or to identify and propose desirable investment projects.

[3] https://assets.publishing.service.gov.uk/media/5ff72645e90e07639fd8d469/Cost_of_Debt_Working_Paper_---_-.pdf, para 13
[4] CMA Point Estimate for Cost of Capital working paper, para 42(a)
[5] Summarised in footnote 19 of the CMA Point Estimate for Cost of Capital working paper, page 14
[6] CMA Point Estimate for Cost of Capital working paper, para 42(b)
[7] CMA Point Estimate for Cost of Capital working paper, para 47

11. However, PWC's submission for Ofwat[8] suggests that an increase in the positive differential between allowed returns and required returns does not increase expenditure or investment above regulatory targets. PWC suggests that instead, this would be more likely to channel increased dividend payments and maintain Market-to-Asset Ratios (MARs) markedly above 1.0x. We agree with PWC that an allowed return on capital that materially exceeds the cost of capital does not appear to be an effective or targeted method of securing higher investment, particularly in the absence of agreed or specified investment(s).

12. In the National Audit Office (NAO) report into RIIO-1 published in 2020, the NAO concluded that Ofgem had aimed up in ex ante cost of equity allowances[9]. The experience from RIIO-1 outturn is that – rather than this leading to higher investment levels – licensees have consistently underspent their allowances. We discussed one important reason for this in our RIIO-2 Draft Determinations[10]: once a price control is set, the totex incentive tends to dominate the cost of capital in governing levels of spending by networks. For instance, it is possible to show that in order to counteract a totex incentive rate of 50% at the margin (in other words, to encourage a network company to spend more than it needs to in order to meet its licence obligations and quality of service targets, just so that it can add to its Regulated Capital Value or RCV), that it would take many years for the surplus earned under aiming up (say 0.5% above the cost of capital) to outweigh the benefit of underspending, as remunerated through the incentive. A simplistic example implies a payback of 100 years (50%/0.5%). We stated at Draft Determinations that we doubted the effectiveness of aiming up to promote investment in the context of this analysis assuming 50bps aiming up on WACC. The CMA's proposed level of aiming up (0.25% on equity or 0.1% on WACC) would imply a 500-year payback period at a 50% incentive rate[11] (50%/0.1%), which may be even less likely to incentivise additional spend/investment effectively.

13. We recognise that the CMA's concern may be that companies faced with a powerful totex incentive may inefficiently underspend (i.e. not invest enough) during AMP7 in ways that cause consumer detriment if the cost of capital is set too low (e.g. in a bid to avoid increments to the RCV). However, given that the consumer interest is protected by quality of service targets and licence obligations, it is difficult to see how this could happen without companies facing high fines or penalties from breaching their obligations and targets. It is theoretically possible for the allowed (or expected) return to be set so far below the true cost of capital that it becomes rational for companies to risk exposure to penalties and fines rather than to spend to meet their obligations in order to minimise short term losses. However, the calculation above suggests that this differential is beyond the scale of aiming up being considered by the CMA, and it may be difficult to argue from the evidence that aiming straight rather than aiming up in setting allowed returns could undershoot the true cost of capital to this extent.

14. The CMA refers to the New Zealand Commerce Commission (NZCC) 2014 decision to aim up to the 67th percentile on energy regulation WACC allowances[12] in support of its suggestion that it can be appropriate to aim up to mitigate "the risk of under-investment relating to service quality generally, and of under-investment contributing to major supply outages in particular"[13]. However, the introduction of Output Delivery Incentives (ODIs) at PR14 and the subsequent expansion of these incentives at PR19 provides targeted incentives for discretionary investment in the long term interests of customers. In addition, ODIs that are linked to metrics that measure the underlying

[8] https://www.ofwat.gov.uk/publication/pwc-review-of-the-relationship-between-financing-allowances-and-water-company-performance/
[9] https://www.nao.org.uk/wp-content/uploads/2020/01/Electricity-networks.pdf#page=37 (e.g. para 2.12)
[10] https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_finance.pdf, para 3.146
[11] Water company incentive rates vary according to licensee and can be different for underspend and overspend. We have used 50% for illustrative purposes.
[12] Commerce Commission New Zealand, (2014), Amendment to the WACC percentile for price-quality regulation for electricity lines services and gas pipeline services
[13] CMA Cost of Capital working paper, para 12

health of the asset base provide incentives on companies to adequately maintain and improve their asset base. Therefore, it seems aiming up on WACC in the UK water sector is unnecessary and unlikely to be as effective as mechanisms already in place to incentivise investment in a targeted manner.

15. We also note the more recent NZCC decision in the telecoms sector, which stated that its "final decision is not to apply an uplift to reflect asymmetric consequences of under-investment as we consider that doing so, would not best give effect to the purpose of Part 6 in s 162, nor promote competition for the long-term benefit of end-users of telecommunications markets."[14]

16. This more recent NZCC decision considered that there are tools other than a WACC uplift that can address under-investment concerns. They quote their expert panel as follows:

> *"….before departing from the FCM [Financial Capital Maintenance] principle, it is important first to ask if adjusting the expected NPV is the most direct and the best way of redressing what would otherwise be a regulatory failure. If this is not the case, the regulator could probably avoid unintended consequences and find it easier to calibrate the intervention by going to the proximate cause than by adjusting the NPV"*[15]

17. The NZCC conclude that they "agree that more targeted tools are potentially available….to the extent concerns on under-investment prove substantive, a WACC uplift appears a comparatively expensive way to address these concerns for end-users"[16].

18. We are of the view that more recent decisions such as this better reflect current experiences of whether or not aiming up has been effective in increasing investment, improving reliability, and/or simulating competition for the long term benefit of consumers.

19. In relation to the CMA's view regarding planning and identification of desirable investment projects for subsequent price controls, we agree that this is more difficult to measure. However, as regulated utility companies have in the past achieved additional return through outperforming totex allowances and/or incentive targets, we suggest that any expectations they have around this source of additional return may also be relevant to planning and identifying desirable projects. In addition, expectations about future price control ODI requirements could influence planning and identification of desirable investment projects for future price controls. Therefore, it is not just their expectations of the allowed return on equity that would influence their behaviour.

20. If identification of future investment projects remains a material concern for the CMA then we suggest that a more targeted approach to incentivise planning and identification of projects would be more appropriate than an adjustment to the allowed return.

21. We would also note that the CMA's role relates to a re-determination of AMP7 and does not extend to what might be an appropriate allowance for AMP8. In our view, there are multiple factors that could influence investors' expectations in relation to

[14] https://comcom.govt.nz/__data/assets/pdf_file/0022/226507/Fibre-Input-Methodologies-Main-final-decisions-reasons-paper-13-October-2020.pdf , 6.861
[15] Martin Cave & Ingo Vogelsang, Financial capital maintenance and its role in fibre regulation in New Zealand, May 21, 2019, paragraph 4.4.
[16] https://comcom.govt.nz/__data/assets/pdf_file/0022/226507/Fibre-Input-Methodologies-Main-final-decisions-reasons-paper-13-October-2020.pdf, 6.837

WACC allowances for future price controls and these will be influenced at the time by not only the current price control allowances but also by:

- Market conditions and updated market data at the time;
- Updated analysis from their own regulator during early consultation stages;
- Relevant analysis of other relevant regulators at various stages of their price control setting processes; and
- International comparisons.

Risk of investors removing capital over time

22. The CMA states that a potentially more important risk "is that a low WACC over multiple periods will lead to an opex bias and a gradual reduction in investment, with limited RCV growth"[17].

23. It further states that "[w]here the cost of capital is low, the preference will be to withdraw capital rather than to increase the level of invested capital over time. This might be achieved, for example, through a high dividend pay-out policy"[18].

24. Our understanding of the CMA's argument is as follows: faced with expected returns that were repeatedly set in multiple price control periods by a regulator below the true cost of capital, investors would rationally choose to withdraw capital from the sector, and one would observe "capital flight". Companies would do everything they could to minimise spending, or – with a given level of spending – to minimise what is added to the RCV by proposing opex solutions that lower the capitalisation rate (i.e. increase the proportion of fast money). Over time, this would lead to chronic under-investment in the water network, and cause significant consumer harm.

25. If that is the correct reading of the CMA's argument then we agree that those conclusions *may* follow (although not *necessarily* so – on which see paragraph 26 below). However, in our view, the question is: why would a regulator set returns in such a way that expected returns were repeatedly below the true cost of capital in multiple price control periods? A regulator that is aiming straight could monitor the effects of its price control decisions on on-going appetite to invest by looking at market cross-checks to its determinations, and make corrections as it goes along by re-setting values. If it is genuinely aiming straight, in some periods, it may *ex ante* overshoot the true cost of capital; in others, it may *ex ante* undershoot them. But over time, investors in a regime that is aiming straight should expect to earn their cost of capital. In contrast, investors in a regime that has a stated policy of "aiming up" will actually expect to earn excess retuns over time due to this explicit bias in the regulator's methodology.

26. We also do not think it *necessarily* follows that if the expected return is below the true cost of equity, investors will withdraw capital by adopting a high dividend payout policy. A long-term investor may also consider the impact a high dividend pay out policy may have on the company credit rating, future access to capital, cost of capital (including the cost of debt), and the remaining risk associated with their investment. We consider it more likely that if it were the case that allowed returns were 'too low' for one price control that this may be reflected in a trading implied market to asset ratio below 1 (when adjusted for any other sources of actual outperformance) and that this would provide cross-check evidence that a regulator could appropriately respond to in future price controls.

27. We also do not necessarily agree with the implication that capital from new investors would necessarily be at higher cost (as implied by paragraph 42(c)(i) of the Cost of Capital

[17] CMA Cost of Capital working paper, para 48
[18] CMA Cost of Capital working paper, para 48(b)

Working paper). If one investor decides to remove capital or sell their investment because they consider the return too low, it is not necessarily the case that a new investor would have the same view and that the cost of capital would be higher. If the new investor did have a higher cost of capital than they expected to receive under the price control this may lead to licensees being sold at a discount to RCV, which would provide evidence the regulator could consider for future price controls. However, this may not necessarily be the case. Indeed, with an increasing number of investors and volume of capital seeking Environmental, Social and Governance (ESG)-related sustainable investments, water companies, particularly if they involve specific investments to tackle climate change or sustainability, may attract new capital at lower cost.

28. In the absence of clear evidence to the contrary, we suggest a better strategy may be to 'aim straight' and to observe whether any exits of capital do occur and, if so, whether new investment has come at a premium or discount to RCV.

29. Building on this point we suggest that the nature of periodic price controls is to adjust cost of capital allowances to reflect prevailing expectations. By allowing these resets, it avoids the need to aim up.

30. We note the CMA's suggestion that they "continue to be concerned that there needs to be an appropriate level of caution in making significant changes to the cost of capital."[19] We suggest that aiming up in order to create a glide path for changes could only be expected to be negative for consumers because it is unlikely that it would be considered acceptable to regulated companies to provide lower cost of capital allowances than indicated by market data in order to transition upwards if we were in a rising rate and return environment.

Overall package asymmetry

31. While we agree with the CMA that asymmetry can be relevant to considerations of where to set allowed returns on equity, we believe it would be more transparent to consider this by differentiating between the assessed *cost of equity, the expected return on equity* and the *allowed return on equity*. This is the approach suggested by the UKRN[20] and adopted by Ofgem in our RIIO-2 Final Determinations for the gas and electricity transmission and gas distribution sectors[21]. This is distinct from using asymmetry as a reason to land at a particular point in the range for the assessed *cost of equity*.

32. If, for example, the CMA assesses that overall package asymmetry leads to an expected return of [-Y%] from incentives and totex allowances, then we would suggest the CMA state the assessed cost of equity and expected return at X% but that due to asymmetry in the overall package, the allowed return on equity could be set at X%+Y%.

33. Ofwat will be better placed than us to comment on the CMA's statement that they "expect negative ODI-related returns on average"[22] and on the magnitude of that expectation. However, we remain of the view[23] that consideration should be given to asymmetries that may exist in other aspects of Ofwat's PR19 price control package

[19] CMA Cost of Capital working paper, para 105
[20] See page 14 and section 5 (page 64 onwards) of the UKRN Study: https://www.ukrn.org.uk/wp-content/uploads/2018/06/2018-CoE-Study.pdf
[21] https://www.ofgem.gov.uk/system/files/docs/2020/12/final_determinations_-_finance_annex.pdf, Chapter 3, Step 3 discussion starting at 3.122, see Table 11 also
[22] CMA Cost of Capital working paper, para 82
[23] https://assets.publishing.service.gov.uk/media/5fa298d88fa8f57896ad0276/Ofgem_response_to_PR19_Provisional_Findings_291020_Redacted.pdf, paras 60-62

(and whether other aspects are expected to be neutral, or lead to outperformance or underperformance).

34. There appear to be some differences of view between Ofwat and the CMA regarding the ex ante assessment of asymmetry. We suggest that, to the extent the CMA still considers an ex ante adjustment to the allowed return on equity is warranted in its final re-determination, it may wish to consider an ex post adjustment mechanism to protect consumers against error in its ex ante assessment of a negative skew on incentives and overall package.

Financeability

35. We note the CMA's view that "[t]he overall determination, in the round, needs to include a consideration of whether the WACC assumptions are consistent with the credit rating assumed."[24] However, we suggest that even if the CMA wanted to focus solely on WACC assumptions (which we disagree with for the reason set out in paragraph 36), this consideration should at least extend to *all* of the WACC assumptions, i.e. not just the cost of debt and cost of equity point estimates but also on the notional gearing level and on the appropriateness of the inflation measures used and their impact on the 'inflation gap' present in certain ratios. We were unable to identify in the working papers specific consideration of whether the notional gearing level, or the inflation measures used in PR19 WACC allowances are contributing to perceived notional financeability pressure and/or whether there are trade offs to be considered in this regard.

36. However, as noted above, we disagree that the WACC assumptions are the only relevant considerations for determining whether the price control in the round is consistent with the credit rating assumed. In our view, all other policy decisions that influence revenue and cashflow are relevant to an in-the-round assessment of whether the price control assumptions are consistent with the credit rating assumed.

Other Observations- Cost of Equity Parameters

37. We note that the CMA has neither sought views on the cost of equity parameters nor provided updated thinking on point estimates or ranges. However, we note the statement that "outside of TMR there may be a mild bias for the assumptions that indicate a higher cost of equity than suggested by the midpoint of our stated range"[25]. We remain of the view that some of the ranges in the Provisional Findings appear to be skewed to the high side. For further detail we refer you to our response to the Provisional Findings[26] which discusses the following with regards to the cost of equity parameters:

- Risk Free Rate[27]: our view is that the range is biased upwards by the inclusion of AAA corporate bond index yields.
- TMR[28]: our view is that the range has been shifted upwards, and that the evidence points to a range of 5% to 6%.
- Unlevered and equity beta[29]: our view is that the CMA's approach may have introduced a degree of upwards bias, by taking averages of different estimation windows and oversampling the same data.

[24] CMA Cost of Capital working paper, para 97
[25] CMA Cost of Capital working paper, para 73
[26] Ofgem response to PR19 provisional findings
[27] Ibid, 19-28
[28] Ibid, 29-39
[29] Ibid, 41-43

38. We hope the above information is useful to the Panel and would be happy to discuss any aspect of it in further detail if that would be helpful.

Yours sincerely

Simon Wilde

Director of Analysis and Assurance