The voice for water consumers
Llais defnyddwyr dŵr

Water Redeterminations 2020:

CCW's response to the Competition & Market Authority's working paper on the Cost of Capital

January 2021

CCW response to the Competition and Markets Authority (CMA) working paper on the cost of capital.

1. Introduction

1.1 We welcome the additional scrutiny that CMA has given to its approach to the WACC. However, we remain concerned about the approach on the cost of equity and remain of the view that we do not think the CMA has struck the right balance between customers and investors. However, we welcome the reduction signalled since CMA's provisional findings.

1.2 Much will depend on CMA's final findings and the decision it takes on the appropriate ranges for the CAPM parameters and subsequent mid-point. We would be concerned if there was effectively double counting through the estimation of the individual parameters and the decision to aim-up. We are also concerned about the rationale underlying CMA's decision to aim-up. This relates to:

- Risk of setting the WaCC too low
- ODI asymmetry
- Financeability

It is also worth reiterating the points we made at November's Hearing:

- In our view, it is hard to see how consumer views were taken into account when setting the WACC. The decision appears over generous to companies at the expense of customers and delivers no material benefits to consumers.
- There is a wider historical context in the water industry with decades of outperformance, driven in part by an overgenerous WACC, which essentially has been a windfall for companies. This can negatively impact consumers' perceptions of the water industry, in particular perceptions of "value for money" and "fairness of bills", both of which have lagged far behind views of other areas of service.
- It important to note that 13 companies have accepted Ofwat's Final Determination (FD), so they've made a decision they can finance their commitments to their customers and the environment
- Further to accepting the FD five of these 13 companies are proposing additional investment in 2020-25 under the "Green Recovery" initiative. This suggests that the settlement cannot have been so tight as they are capable and willing to do more. In particular, it signalled no lack of appetite to invest under the PR19 assumption.
- Companies remain at investment grade according to the ratings agencies, and share prices of the listed companies did rather well after Ofwat's FD.

2. Debt

2.1 Cost of new debt

2.1.1 We note CMA's decision to not make any adjustments to its assessment of cost of new debt for an outperformance wedge/matching adjustment or a forward rate adjustment. We agree that with regard to the latter the true-up mechanism for the cost of new debt in AMP7 means that this need not be included.

2.2 Embedded debt

2.2.2 There is a lot we welcome in the consultation such as the reduction in the proportion of embedded debt from 83% to 80%; the move to a 15 year collapsing average from 20 year straight average approach and a 31 March 2020 cut off for embedded debt to avoid any overlap/double counting of new debt. We are also supportive of the use of actuals as a cross check.

2.2.3 However, we do not agree that there's insufficient evidence to support Ofwat's contention that water companies can consistently raise debt at lower than benchmark yields when measured on a like-for-like basis. While CMA indicates that its cross check to actuals suggests that a 'matching adjustment' (Ofwat's outperformance wedge) is not required, we note that CMA is reserving judgement on this matching adjustment for its final findings. We welcome that CMA has not ruled out further consideration of this issue.

3. Cost of equity

3.1 We recognise that CMA is considering its estimation of the individual CAPM parameters in the light of new market evidence and in the context of responses to its provisional findings.

3.2 On the back of the consultation the proposed approach (0.25% aim-up based on the mid-point of range) would, all other things equal, lead to a cost of equity 0.6% higher than Ofwat's FD. We are concerned with this variance and do not agree with the rationale CMA has provided to support its decision to aim up as we set out in sections 3.2.1 to 3.2.3 below.

3.2.1 Risk of setting the WaCC too low

3.2.1.1 CMA notes and considers that there is low risk of both exit of capital from the sector and underinvestment in AMP7 should the WaCC be set too low. It nevertheless suggests aiming up is warranted to address these risks in the context of a sharp reduction since AMP6.

3.2.1.2 We agree with Ofwat that the level of investment is determined as part of the price review process rather than a response to the allowed return.

3.2.1.3 We do not consider that you have addressed Ofwat's point that the regulatory framework encourages optimal level of investment and incentives for companies to invest, and limit the ability to over-invest. As Ofwat noted in its response to the provisional findings, suboptimal investment would be best addressed by amending the regulatory framework rather than aiming up.

3.2.1.4 We find CMA's argument on this to be no more than an assertion with little in the way of empirical evidence to back it up. The recent evidence of companies expressing interest in the Green Recovery initiative, which would have been underpinned by the WaCC set in Ofwat's Final Determination, signalled no lack of appetite to invest.

3.2.1.5 Overall we do not consider that you have demonstrated the case that either investor exit or that suboptimal investment would occur in the event of too low a WaCC or, even if it could be demonstrated, that aiming up provides the right solution.

3.2.2 ODI asymmetry

3.2.2.1 We note that the decision to aim up is in part due to CMA's assessment of ODI asymmetry. We do not agree with CMA's approach on this this, as it seems to devalue the incentive regime and effectively offer companies protections against underperformance. This is not in the customer interest. The regulatory framework allows companies who deliver in line with Ofwat's FD to earn a return in line with Ofwat's WaCC.

3.2.2.2 We agree with Ofwat that if expected asymmetric performance is a concern, it is appropriate to adjust incentive mechanisms rather than 'aim up' the allowed return.

3.2.2.3 Moodys has recently commented on ODIs noting that:

> "Given increased potency of performance incentives following Ofwat's 2019 price review, companies are placing added focus on meeting outcome delivery incentive targets, with many reporting good progress in the first half of the current financial year to March 2021, despite Covid-19".

3.2.3 Financeability

3.2.3.1 We note that the CMA has assessed that it does not need to adjust PAYG or run-off rates to secure the financeability of the four companies. As we stated in our initial submission, Ofwat used financeability levers for 12 of the 17 companies in its Final Determination. We are concerned that using the WaCC to secure financeability could result in customers paying more than if a case-by-case basis of assessment of financeability that is resolved through some other mechanism.

3.2.3.2 Our concern is that CMA's approach could boost companies' financial metrics above and beyond those modelled in Ofwat's Final Determinations to the cost of the customer. If CMA persists with this approach in its final findings, we ask that it is transparent about the financial metrics that would result from a 'pure' financeability approach (Ofwat) versus the intention behind aiming up. There are alternative approaches available to financeability that are NPV neutral over time.

3.2.3.3 In addition, the strong outperformance shown by Severn Trent, United Utilities and South West Water in their interim results and the scale of the investment companies have proposed as part of the Green Recovery initiative, does not indicate an industry that is struggling to be financeable under Ofwat's Final Determination.

3.2.4 Range for each CAPM parameter

3.2.4.1 In the context of aiming-up the cost of equity, it is critical that there is no upward bias in the range of the individual CAPM components, which is then compounded by the approach to aiming up. As you are aware, we are concerned with the ranges adopted for each of the CAPM parameters from the provisional findings and that CMA should review its approach to aiming up in the context of its consideration of each of the individual elements.

We welcome the CMA's consideration of this important aspect of the price setting methodology. We would be happy to provide any further clarity necessary to inform CMA's decisions.

Enquiries

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