# Enhancing the bottom line

As part of its Risk Based Review framework for PR14 Ofwat has had to determine the financial value of offering companies 'enhanced' status. This Insight examines whether Ofwat has got the balance of incentives right, or whether the companies might have been better off seeking higher returns from the Competition and Markets Authority.

## Overview

For PR14 Ofwat has implemented its new Risk Based Review (RBR) framework for assessing companies' business plans. A key element of this is that companies whose plans are judged to be 'enhanced' will receive a number of benefits, designed to help incentivise and reward high quality, customer-focused, plans:

- financial benefits – initial rewards and enhanced cost menus;
- reputational incentives – public recognition of high-quality plans; and
- early draft determinations – draft determinations by April 30th.

In addition to the above, Ofwat has committed to a *'do no harm'* principle with regards to enhanced companies. This means that any changes in capital markets, which might affect Ofwat's assessment of risk and reward, or any changes in policy or the assessment of new data, will ultimately be reflected in the determinations received by enhanced companies (so that they are not disadvantaged relative to companies that do not receive an early price determination).

On March 10th Ofwat announced the results of its initial RBR assessment of companies' plans and determined that both Affinity Water and South West Water had pre-qualified as being of enhanced status. Ofwat commented that South West demonstrated a *"strong focus on engagement and balancing the need to keep customers' bills affordable."* Regarding Affinity the regulator stated that both its: *"plan and company vision (to be the UK leading community-focused water company) are innovative."*[1]

Whilst the reputational benefits associated with enhanced plans are somewhat intangible and subjective, the financial benefits can be quantified and traded-off against the potential upside from challenging Ofwat's determinations. This is the issue we examine in the remainder of this *Insight.*

## Enhanced value

Ofwat has set out two financial benefits associated with companies obtaining enhanced status: (i) an 'initial reward' amount; and (ii) an enhanced cost sharing menu. In relation to the initial reward amount Ofwat has indicated that this can either be recovered in full during the 2015-20 period, or added to the RCV and recovered over time. With regard to the potential upside from cost sharing, Ofwat has set an enhanced menu rate at 5% above the standard menu (where the current assumption is that the standard menu has a sharing rate of 50%, meaning that the enhanced rate is 55%). Ofwat has specifically offered:

- For South West, an initial reward of £11m and an estimated benefit of £6m over PR14 arising from cost sharing.
- For Affinity, an initial reward of £4m and an estimated benefit of £3.3m over PR14 arising from cost sharing.

The value of the enhanced cost menu is, of course, uncertain. This is because Ofwat has not yet published its actual cost baselines or cost-sharing incentives for its standard menus. In addition, one cannot objectively determine whether a company's 'central expectation' would be one of outperformance against the menu (i.e. the benefits published by Ofwat only arise if the companies do outperform the baseline. If they do not, then the enhanced cost sharing rate means they would actually incur a larger downside than had they not been enhanced).

## Making the trade-off

For the companies prequalifying as enhanced, this status (and thus the estimated financial benefits) can only be secured if they also accept Ofwat's guidance on 'risk and rewards.' This means the companies must commit to a wholesale vanilla weighted average cost of capital (WACC) of 3.7%; and retail margins of 1.0% and 2.5% in the household and non-household markets. In practice, both South West and Affinity chose to accept Ofwat's guidance, and so confirmed their enhanced status.[2] The question this raises, however, is whether the financial benefits of being enhanced (as outlined above) are sufficient to make acceptance of Ofwat's allowed returns worthwhile. The answer to this turns on:

- by how much higher could returns be if companies challenged Ofwat at the Competition and Markets Authority (CMA); and
- what the probability of success might be.

To analyse the trade-off more closely we examined the published business plans of South West and Affinity and estimated the expected value they might receive from securing a wholesale WACC above Ofwat's indicated 3.7% and compared this to the lost value of rejecting their enhanced status (companies could also potentially secure higher retail margins via the CMA, but for the purpose of our analysis we have focused on the wholesale WACC, as it accounts for the vast majority of total value).

As the probability of securing a higher wholesale WACC at the CMA is uncertain, we multiplied the benefit of this by an assumed probability, ranging from 10% to 70%. Netted off against this was the 100% probability of surrendering the value benefit of being enhanced (i.e. losing the initial reward

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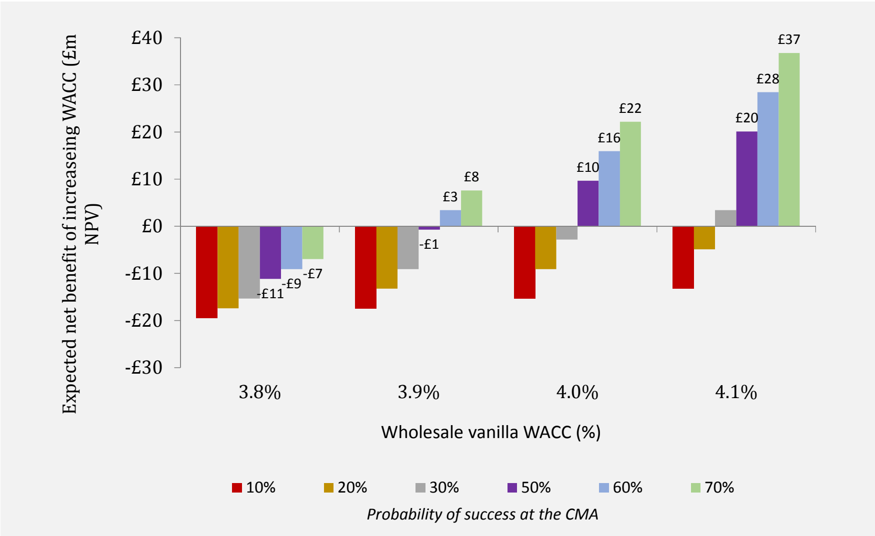
[1] *'Pre-qualification decisions – conference call 10 March 2014.' Ofwat (March 2014).*

[2] *See Pennon Group press release: 'South West Water accepts Ofwat's Risk and Reward Guidance.' (March 17th 2014); and Affinity Water press release: 'Affinity Water accepts Ofwat's Risk and Reward Guidance.' (March 17th 2014).*

and Ofwat's estimate of the cost sharing benefit), were the companies to reject this in favour of going to the CMA. The figure below shows the expected net value (in NPV terms over PR14) of securing a higher WACC at the CMA, based on the combined data for Affinity and South West.

**Figure 1: Expected NPV from achieving higher WACC at the CMA**




*Source: Economic Insight Analysis*

While the above results are based on a number of assumptions (in particular, we have assumed that Ofwat's assessment of the financial benefit arising from enhanced cost sharing represents an appropriate central expectation) they do raise some interesting implications for South West and Affinity:

» Even if South West and Affinity had a high chance of success, merely increasing the wholesale WACC to 3.8% at the CMA is unlikely to be sufficient to offset the rejection of enhanced status.

» The companies would need to have an expected probability of success of at least 60% for an increase in the WACC to 3.9% to be sufficient to offset the value loss associated with rejecting their enhanced status.

» If the WACC could be increased to 4.0%, however, a 50% probability of success at the CMA would be sufficient to make rejecting enhanced status rational.

» Finally, if a WACC of 4.1% could be secured, a 30% probability of success would be enough warrant the rejection of enhanced.

Put another way, the decision of South West and Affinity to accept Ofwat's offer of enhanced status is consistent with them believing there was less than a 50:50 chance of securing a WACC of 4.0% or more at appeal.

## No enhancement, nothing to lose?

For companies that have not pre-qualified, the trade-off of going to the CMA is, in a purely financial sense, less complex. For them the direct financial cost simply relates to the fees paid to legal advisors and external consultants; and the associated internal time costs. These costs can be traded-off against the expected benefits of potentially securing higher returns from the CMA. In relation to the direct cost of going to the CMA, the Government (as part of its consultation on streamlining the process for regulatory and competition law appeals) published an Impact

Assessment, in which it estimated the average cost of appealing a price control to be £0.32m, with a high estimate of £0.8m.[3]

At face value, the low direct costs of appealing (relative to the potential benefit arising from securing higher returns) might appear to give quite a strong incentive to appeal. However, in practice the trade-off is somewhat trickier, as issues such as the strength of the regulatory relationship and perceived external credibility – though more subjective – are also of vital importance.

## Striking the right balance

Our analysis suggests that Ofwat has broadly got the balance right in relation to the financial benefits from securing enhanced status in relation to South West and Affinity. In particular, in each case shareholders would need to be pretty confident of success at the CMA for the rejection of enhanced status to be commercially rational – and a single basis point increase in the wholesale WACC would almost certainly be value destroying even if they succeeded.

As this is the first time the RBR framework has been applied within the sector there will almost be some ex-post learnings on both sides. In particular, the actual benefit of the enhanced cost sharing rate will only be known once: (i) the menus are published; and (ii) companies' actual out or underperformance is observed at the end of the control period. Whether, with the benefit of hindsight, the companies would have been better or worse off (in expected value terms) going to the CMA than accepting enhanced status would, for example, most likely influence Ofwat's assessment of these incentives next time around. For now, based on what is publically known at least, Ofwat's calibration of these incentives seems to be appropriate – as does the decision of South West and Affinity to accept the risk and reward guidance.

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## Further information

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[3] *'Impact Assessment: Streamlining Regulatory and Competition Appeals.' HM Government (June 2013).*