CMA PROVISIONAL FINDINGS FOR WATER COMPANIES

Our Assessment of the Key Issues and implications

Client note | October 2020

Economic Insight

In March of this year, Ofwat referred its PR19 price determinations for Anglian; Bristol; Northumbrian; and Yorkshire Water to the CMA (following those companies choosing to reject Ofwat's own proposed price limits). On September 29th, the CMA published its Provisional Findings (PFs), for the four companies, awarding them materially higher revenues than those set by Ofwat. Whilst the key issue at the PFs may appear to be the WACC (which the CMA set 50bps higher than Ofwat) we suggest a more fundamental concern about Ofwat's determinations not being consistent with the financing duty lies at the heart of the CMA's provisional decision. Put simply, once the package as a whole was considered, Ofwat's allowed revenues were insufficient, requiring significant remedy. Of the options available to the CMA, an increase in the WACC appears appropriate and pragmatic. Economic Insight is advising Yorkshire Water on its redetermination.

1. Overview

Before addressing the main issues raised by the CMA's PFs, it is helpful to summarise the overall financial impact of the redetermination, relative to Ofwat's PR19 position. As shown in the table below, the CMA concluded that the companies required significantly higher average bills than those awarded by Ofwat. In Yorkshire's case, the CMA went as far as restoring average bills back to the level the company itself proposed in its April Business Plan. In £m terms, we estimate that the CMA's provisional decision would result in the companies receiving an additional C. £600m, relative to Ofwat's FD. Assuming the CMA largely retains its position in its own FDs, this will make it one of the largest awards granted in a regulatory appeal process.

Table 1: Impact of CMA's PFs on company bills

Company	Average bills (£s)		
	Ofwat's FD	CMA PFs	% change
Anglian	£386	£400	3.6%
Bristol	£160	£166	3.8%
Northumbrian	£323	£335	3.7%
Yorkshire	£364	£379	4.1%

Source: CMA Provisional findings

The above raises an obvious question: *why did the CMA disagree with Ofwat's determinations to such a large degree?* The 'practical' answer to this lies in examining the two areas in which the CMA reached a materially different decision to Ofwat: enhancement totex; and the WACC, which we address in the next sections. However, in our view, the main explanation lies in the financing duty and the fundamental need to ensure overall allowed revenues are sufficient to meet this.

2. Totex

2.1 Base costs

On base costs, the CMA was broadly supportive of Ofwat's econometric relative efficiency modelling, although it did rely on a slightly different set of cost assessment models. The CMA further rejected proposals by the companies to account for differential performance against outcomes targets within cost assessment models. However, the CMA disagreed with Ofwat's late change in approach to set the cost efficiency benchmark at the 3rd and 4th ranked firms, and instead set the efficiency challenge at the upper quartile. Other key points on base costs are as follows:

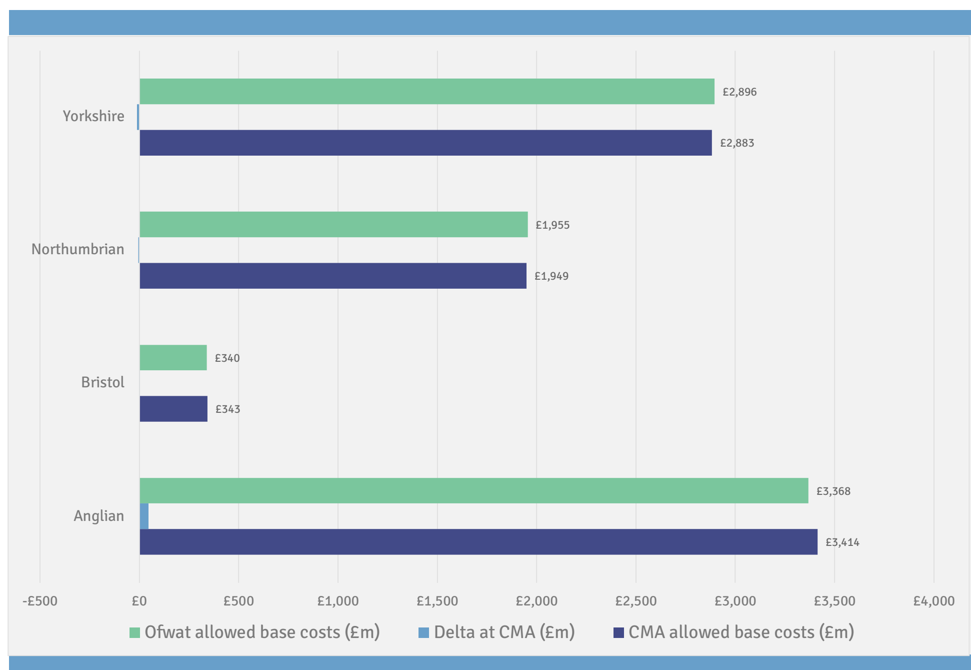
- The CMA set a slightly less stringent frontier shift (ongoing productivity) related efficiency challenge than Ofwat (1.0% pa versus 1.1% pa). Interestingly, the analysis presented by the CMA seems to support a somewhat *lower* figure; but the CMA was perhaps influenced by the fact that some companies had themselves proposed values close to Ofwat's assessment.

- The CMA applied the above frontier shift to the totality of base costs unless (and by exception) companies could show it was already accounted for.

- On real price effects, the CMA supported Ofwat's position that it was only appropriate to include an allowance relating to labour costs.

Overall, however, the impact of the CMA's decisions as regards base costs were relatively immaterial. Across the four companies, base allowances were increased by just 0.4% on average, with both Northumbrian and Yorkshire actually receiving slightly *lower* allowances under the CMA's redetermination (see Figure 1 below).

Figure 1: Base costs under CMA PFs versus Ofwat FDs



Source: CMA Provisional Findings

ENGINEERING INPUT WAS A KEY SOURCE OF EVIDENCE FOR THE CMA IN ASSESSING ENHANCEMENT COSTS.

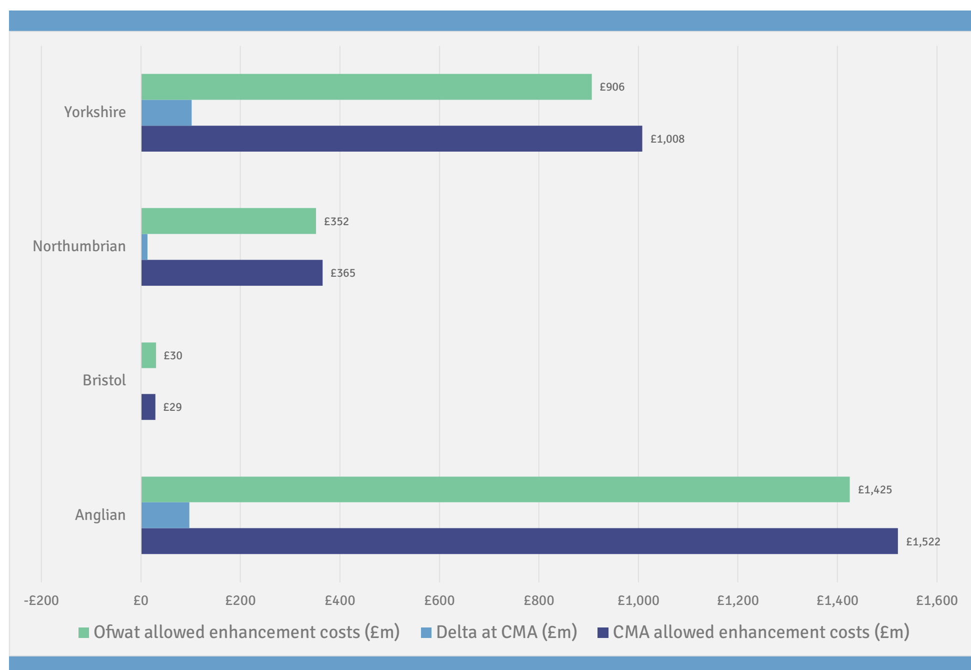
2.3 Enhancement costs

On enhancement costs (spending to increase capacity or service quality beyond base) the CMA adopted the same broad approach as Ofwat, making use of both benchmarking models (that compare company costs), but also reviews of company specific proposed investments. Key points on enhancement are as follows:

- The CMA considered that in wastewater, Northumbrian and Yorkshire required additional funding relating to phosphate removal (P removal). This amounted to an additional £13m of allowed costs for the two companies.
- The CMA's most material additional funding allowances related to 'deep dive' reviews of specific company proposed investments. In total, the CMA allowed an additional £81m of costs relating to these. This was primarily because, in a number of instances, the CMA took a different view to Ofwat as to the need for, or efficiency of, specific investments. Here, independent engineering input appears to have been an important evidence source for the CMA.
- Yorkshire Water was allowed an additional £93m of enhancement totex relating to leakage (this is discussed further in relation to the CMA's approach to outcomes incentives).

Across the four companies, the CMA increased enhancement cost allowances by £212m, equivalent to a 7.8% increase, relative to those allowed by Ofwat under its FD (as summarised in Figure 2 below).

Figure 2: Enhancement costs under CMA PFs versus Ofwat FDs



Source: CMA Provisional Findings

4. The WACC

'The CMA has provisionally set a materially higher WACC (3.50%, appointee CPIH) relative to that proposed by Ofwat (2.96%).

The CMA has provisionally set a materially higher WACC (3.50%, appointee CPIH) relative to that proposed by Ofwat (2.96%). Table 2 provides a comparison of the CMA and Ofwat positions for each parameter; and in the bullets below the table, we briefly highlight our observations regarding the most material parameters.

Table 2: Comparison of CMA proposed WACC relative to Ofwat's

Parameter	WACC range (Appointee, CPIH)			
	Ofwat's FD	CMA low	CMA high	CMA decision
TMR	6.50%	6.20%	7.21%	6.95%
Risk free rate	-1.39%	-1.40%	-0.81%	-0.96%
Equity risk premium	7.89%	7.59%	8.00%	7.91%
Unlevered beta	0.29	0.27	0.32	0.31
Debt beta	0.125	0.00	0.15	0.04
Equity beta	0.71	0.65	0.80	0.76
Cost of new debt	0.53%	0.21%	0.52%	0.37%
Cost of embedded debt	2.42%	2.76%	3.16%	2.76%
Proportion of new debt	20%	21%	13%	17%
Issuance and liquidity	0.10%	0.10%	0.10%	0.10%
Pre-tax cost of debt	2.14%	2.32%	2.92%	2.45%
Post tax cost of equity	4.19%	3.56%	5.60%	5.08%
Gearing	60%	60%	60%	60%
Appointee WACC	**2.96%**	2.82%	3.99%	**3.50%**

Source: CMA Provisional findings

Our observations on the CMA's provisional decisions relating to specific WACC parameters are as follows:

- In relation to the **total market equity return** (TMR), the CMA set a value of 6.95%, relative to Ofwat's proposed 6.50% (CPIH). The CMA's higher estimate mainly reflects it: (i) placing some weight on RPI (rather than just CPI) deflated historical returns; and (ii) using a broader mix of averaging techniques to those used by Ofwat. Interestingly, this puts the CMA's estimate for TMR above the midpoint of its range for the NATS inquiry (6.50%, CPIH), with the CMA indicating that in the water appeals, it revised its view on the appropriate interpretation of historical inflation series.

- In relation to the (unlevered) **beta,** the CMA's slightly higher estimate (0.31) relative to Ofwat's (0.29) reflects the CMA using a mixture of time periods and data frequencies, whereas Ofwat relied on 2-year daily data. The CMA also took into account the impact of different 'cut-off' points for the time period over which beta was estimated. This issue is pertinent to the CMA's FD, given the potential impact of COVID on more recent market data.

- In relation to the **debt beta** (0.04), the CMA has provisionally set this materially below Ofwat's proposed figure of 0.125. Consistent with the NATS inquiry, the CMA has taken the view that: (i) both direct (econometric) and indirect (decomposition) methods are valid, but Ofwat only relied on the latter; and (ii) in

any case, Ofwat's application of the decomposition method led to an overstatement.

- In relation to the cost of **embedded debt**, the CMA set a higher allowance (2.76%) than Ofwat (2.42%). Here, the CMA agreed with Ofwat that the cost of embedded debt should be estimated with reference to an average of the A and BBB 10+ indices. However, the CMA disagreed with Ofwat on the need for an outperformance wedge downwards adjustment to the cost of debt. The CMA considered that this was because evidence submitted by the companies 'strongly suggests' that there is no evidence of historical outperformance, once differences in debt tenor and ratings are taken into account.

- The CMA set a lower cost of **new debt** than proposed by Ofwat. This mainly reflects movements in market data, rather than issues of methodology. As per embedded debt, the CMA rejected Ofwat's application of an outperformance wedge.

- As regards the **risk free rate**, the CMA has set this at -0.96%, compared to Ofwat's figure of -1.39%. The CMA disagreed with Ofwat that the RfR should be estimated based on the real yield on Index Linked Gilts (ILGs) alone. Instead, the CMA placed weight on both ILGs and deflated nominal gilts.

THE CMA 'AIMED UP' ON THE WACC. IN OUR VIEW, THIS WAS PRIMARILY DRIVEN BY A FUNDAMENTAL CONCERN AROUND FINANCEABILITY.

Having arrived at what it considered to be a 'reasonable range' for the WACC, the CMA had to determine 'where' in that range to set its point estimate. The CMA's proposed WACC of 3.50% sits someway above the midpoint of its range (3.41%). The CMA's reasoning for setting the WACC above the midpoint is as follows:

1. The harm to customers arising from 'underinvestment' (as a result of the WACC being 'too low') is greater than the reverse, especially over the longer term. Thus, the CMA was concerned that 'too low' a WACC would place too much weight on the welfare of current customers, over future customers.

2. That if the expected return is below the allowed return, there is a further justification to explicitly 'aim up' on the WACC. Here the CMA highlighted that ODI financial risk remains skewed to the downside under its determination.

3. The CMA considered the WACC to be central to financeability. In particular, it made it clear that if allowed revenues (and associated cash flows) are not consistent with an efficient firm being able to meet investment grade status, an obvious remedy is to increase the WACC. This is because, as the CMA notes, *"the WACC is the main driver of expected financial ratios."*

In our view, the first and third issues above seem to have influenced the CMA most materially. In relation to issue 2, the CMA considers there to be only a 'slight' asymmetry under its determination; hence, this might imply this was a less critical consideration. We consider the third issue (financeability) to be central to the CMA's thinking and is also the most pertinent to future price controls (and related appeals).

Finally, the CMA rejected Ofwat's proposed gearing outperformance sharing mechanism, on the basis that the benefits Ofwat claimed companies enjoy from 'gearing up' may not exist (although the CMA agreed there were legitimate reasons for Ofwat to be concerned about high levels of gearing).

6. Outcomes incentives

Overall, the CMA was generally supportive of Ofwat's outcomes framework. This included: (i) supporting the use of comparative information to set outcomes targets; (ii) intervening in company plans to amend incentives (including in place of customer evidence); and (iii) that there was not a simple cost / outcomes trade-off on an 'in principle' basis.

Notwithstanding the above, the CMA recognised that for 'efficient' firms, there *was* a cost / outcomes trade-off and that large improvements in performance likely required funding (in addition to that provided in base costs). The CMA further recognised that company-specific (or regional) factors could impact both the achievability of targets and the associated funding required to meet them. Finally, whilst the CMA considered it reasonable for Ofwat to include some outcome delivery incentives (ODIs) that were asymmetrically skewed to the downside, it was concerned with the degree of asymmetry under Ofwat's FD. As such, in its PFs, the CMA's main changes were as follows:

- It implemented a number of refinements that, in the round, somewhat de-risked the outcomes package for the companies.

- It slightly reduced the amount of asymmetric downside risk exposure. Specifically, on its own assessment, the CMA found that the differences between the 'high case' level of performance and 'low case' level of performance[1] across the companies was around -1.2% of RoRE under its PFs. This compared to a figure of -1.4% RoRE under Ofwat's FD. Overall, the CMA considers under its FD the *'expected'* performance of firms in relation to ODIs translates to underperformance of around -0.2% RoRE. However, we note that the CMA's analysis excludes performance risk, and so may significantly understate the expected downside under its PFs.

THE CMA's MAIN INTERVENTIONS IN OUTCOMES RELATED TO LEAKAGE FUNDING.

- In relation to reducing leakage, the CMA considered funding was required for the companies. In terms of base costs, the CMA took the view that there *was* implicit funding for leakage for firms 'at or below' the upper quartile performance level.[2] However, for firms already at or beyond the upper quartile on leakage (Anglian and Bristol), the CMA awarded a base cost allowance determined by the '%' by which they outperformed the upper quartile in 2019/20. In relation to enhancement costs, the CMA considered that the 'magnitude' of the performance improvement the companies were required to make at PR19 was such that funding was required (distinguishing leakage from other performance commitments). The CMA set allowed costs based on the incremental enhancement funding companies proposed in their plans, adjusted for efficiency. This resulted in Yorkshire being allowed significant (£93m) additional revenues. Northumbrian was not allowed any additional revenues, as it had not proposed enhancement spend for leakage.

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[1] *Defined as the P90 and the P10.*

[2] *Note, the implication of this is that the CMA considers UQ performance on comparative ODIs 'is' implicitly funded. Interesting this appears contrary to its position during the Bristol Water PR14 redetermination.*

8. Financeability

In relation to financeability, the key points arising from the CMA's PFs are as follows:

- The CMA recognised that the price control settlement 'as a whole' determines allowed revenues; and whether firms are able to finance their functions. Consistent with this, the CMA highlighted that it had addressed financeability pressures through setting a higher WACC (and other interventions).

- In relation to the calculation of financial ratios used to inform financeability testing, the CMA favoured the calculation methods used by the ratings agencies (Moody's and Standard & Poor's), rather than Ofwat's own calculations. The main issue here being that Ofwat included the impact of 'fast money' (i.e. bringing forward cash through the 'pay-as-you-go' – PAYG - totex rate), whereas, in line with the ratings agencies, the CMA also calculated ratios excluding this effect. Relatedly, in making its determinations, the CMA adopted company assumed PAYG rates, rather than Ofwat's.

- The CMA recognised the need for risk analysis in assessing financeability; and so examined key ratios following a downside scenario of -1.0% RoRE, relating to ODI performance. As discussed in relation to outcomes, we consider it possible that the CMA has understated potential ODI related RoRE risk.

9. Our assessment of the CMA's position and implications

'Whilst from the PFs, one might conclude the debate is 'all about the WACC', in practice, we suggest it goes to something more fundamental: the need to set sufficient allowed revenues in total to meet financing duties.'

Stepping back from the details, our assessment of the key issues is as follows:

- In our view, the PFs primarily reflect the CMA taking a view that the package should be assessed 'as a whole' and that, on this basis, Ofwat's determination was not consistent with an efficient firm being financeable. The CMA further took the view that this problem was sufficiently material that the remedy required a significant increase in allowed revenues (i.e. minor changes, or a reprofiling of revenues, could not resolve the problem).

- An increase to the WACC was an appropriate and pragmatic remedy for the CMA to implement to address the above (i.e. because the WACC is a large driver of allowed revenues and is central to financeability). Therefore, and of relevance to future price controls and those in other industries, we do not think this necessarily sets a precedent for distinguishing between 'allowed' and 'expected' returns (i.e. this is about a practical solution to a fundamental financeability concern).

- The above might also mean that one should not draw overly strong inferences from the CMA's decision to make less material interventions in relation to Ofwat's outcomes framework. That is to say, whilst the CMA did make some changes, ODIs are a complex area and the CMA noted that it was not possible to collect new customer evidence or analyse each ODI in detail. The uncertainty around ODI performance perhaps also makes interventions in this area a less practical remedy to a financeability concern relating to insufficient revenues.

In short, whilst from the PFs, one might conclude the debate is *'all about the WACC',* in practice, we suggest it goes to something more fundamental: the need to set sufficient allowed revenues to meet financing duties.

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