

Wessex Water Services Ltd Response to Ofwat's PR19 Draft Determination – August 2019

Representation reference: Risk and Reward R3

Representation title: Cost of capital

Summary of issue

Ofwat's draft determination has used an allowed cost of capital of 2.19%. It has also suggested that market evidence since its cut-off date in February 2019 may lead to a further reduction in the allowed cost of capital to 1.82% at its final determination.

Neither value in our view is appropriate as they are inconsistent with:

- other parameters in Ofwat's determination, therefore threatening the long-term resilience of the sector
- regulatory precedent without sufficient new evidence to warrant this material change
- reasonable cross checks on the cost of equity that would support a value at the upper end of a range calculated on a bottom-up basis.

Further, we do not agree that updated market evidence between February and July supports a lower cost of capital allowance.

Change requested

That Ofwat reassesses its allowed cost of capital at the final determination considering the items above.

That it confirms it will continue to use the traditional approach to the EV/gearing adjustment when assessing appropriate asset beta.

Rationale (including any new evidence)

We have commissioned two reports related explicitly to the cost of capital since we submitted our revised plan and we include both reports as appendices to this document.

Frontier Economics (FE) has provided its own estimate of the WACC that should apply within the water industry and has suggested a value of 2.78% using data equivalent to Ofwat's 2.19%. FE has updated this estimate to 2.77% (range 2.31%-3.01%) using market evidence since 28 February.

The Wessex Water business plan used a figure of 2.4% for the Appointee WACC which is therefore at the bottom end of the range proposed by FE. We note that in FE's view is that there is good reason, in the context of the PR19 determination, wider economic risk factors and cross checks, to choose a number in the higher end of this range.

Economic Insight (EI) has provided us an analysis explaining how the WACC calculations do not allow for a downside skew in returns and estimating the impact of this on the required cost of equity and conclude that there should be a small uplift of 5-7 bp to any traditional CAPM-style calculation of the equity return

Consistency with the rest of the determination including other economic parameters

In its totality we find that Ofwat's assessment of the cost of capital is inconsistent with the other elements of its price determination. This could undermine financial resilience.

In our March submission we provided a report from EI that showed that Ofwat's choices on RPEs, productivity improvements and the cost of capital did not form a coherent package in that they suggested an economy where economic growth was strong through high levels of productivity improvements while suggesting input prices would be subdued and that the cost of capital would be low. We think Ofwat's DD continues to suffer from this problem and this manifests itself in a cost of capital estimate that continues to place strong reliance on short-term estimates of asset beta and the debt halo and only placing partial weight on the long-term estimates of TMR, therefore firmly anchoring the cost of a capital assessment to a period of low growth and low productivity – while projecting productivity gains well ahead of historic averages. The DD package therefore reduces the resilience of the sector given that the concurrent outturn of these forecasts is very unlikely in practice. The final determination risks exacerbating this, if a mechanistic approach is taken to adjusting the WACC for short-run point estimates leading to a further reduction.

Secondly, the negative outlook, and analysis on financial metrics by Moody's poses a risk for an increased cost of debt, decreasing the likelihood of any future halo effect. We note that an analysis of Ofwat's DDs shows that eight companies under Ofwat's notional structure have Moody's ratios consistent with Baa2 rating or below, and this assessment is before Ofwat's mix of capex and opex is amended to reflect the efficient notional company implied by its cost models which in our case reduces interest covers further.

Thirdly, we note that Ofwat's DD suggests that at an industry level the proportion of new debt that is likely to be raised compared to embedded is less than the 20% assumed. Analysis by FE suggests a ratio of 16%: 84%.

Fourthly, an additional analysis from EI commissioned by us and provided as an appendix to this document evidences that Ofwat's interventions to ODIs mean that returns are likely to be negatively skewed and that the standard CAPM calculation does not account for this. The analysis from EI shows that the negative skew alone should add 5 to 7 basis points to the cost of equity.

This last point is in addition to any additional allowed return required should ODIs and other elements of the determination package mean that the expected outturn incentives for an efficient company are most likely to be negative. There is strong evidence to suggest that this is true, but we make separate representations on these items and consider they are best addressed at source.

Regulatory consistency

In its totality we find that Ofwat's assessment of the cost of capital is not in consumers' interests because it departs from regulatory precedent without sufficiently strong evidence to do so.

The comparatively low returns required by investors in the water sector are reflective of the stable regulatory environment, in particular the stable approach to the cost of capital applied by sector regulators and the CMA, not least as potential investors are having to consider time horizons of up to 30 years. We are concerned that, through the PR19 process, that Ofwat has switched its fundamental approach to assessing the cost of equity, focusing initially on a forward-looking assessment based on DGM, and now in its DD discarding that approach (which is now suggesting a higher value) and placing weight on approaches that it previously discounted. Whichever is the preferable method we do not think that it is of benefit to customers in the long-run that there is such uncertainty in the calculation of this key parameter.

In this context it is important in our view, and in the interests of customers, to return to full consideration of the long-run (ex-post) view as the primary means of assessing total market returns. And we see here that the evidence on ex-post market returns has barely moved since Ofwat last assessed its cost of capital allowance at PR14. The one area where new information may be available relates to alternative datasets for long-term inflation. Given that these inflation datasets all have potential weaknesses we do not consider that there is a sound basis to apply the dataset that results in a material reduction compared to PR14. We consider that the different approaches to indexation create a range of potential estimates for TMR on which a judgement should be formed.

Similarly, Ofwat's approach to estimating the asset beta departs from its approach in recent price controls (and the approach advocated in the recent UKRN report) by using a single point estimate that may be distorted by short-term events. We agree with FE that a range of calculation methodologies should be considered for beta and note that Ofwat's estimate is towards the bottom of that range.

We also note FE's view that there is good reason to choose a value in water that is at the higher end of both of these parameters. These includes the overall balance of risk and reward in the incentive package as a whole, the current economic uncertainty which may see a flight to safety outside of the UK and Ofwat's commitment to switch to CPIH indexation in an NPV neutral manner.

Similarly, when assessing the cost of debt Ofwat has introduced the concept of a debt halo against the iBoxx index when assessing the forward-looking cost of debt. In doing so it needs to be convinced that the debt halo both exists and will be maintained up to 2025. In 2015 the CMA found that no halo existed in the DNO sector and since then further evidence has shown that apparent outperformance of the index can be explained by the weighting of the bond ratings compared to the indices. There is good evidence to suggest that, given the overall balance of the determinations, that if any halo does currently exist that it is unlikely to be maintained through the period in question.

Reasonable cross-checks on the cost of equity

We do not consider that Ofwat's estimate of the WACC takes sufficient account of alternative cross-checks.

FE's analysis of the following cross-checks on the cost of equity highlights two findings. First, that there is no evidence of a reduction in the cost of capital since Ofwat's view in December 2017. Second, that the cost of equity may have been estimated too low. In addition to an analysis of the credit metrics referred to above these include:

- [1] DGM analysis of traded water companies
- [2] Analysis of the implied premium on equity over debt in 100% equity funded company
- [3] Market Asset Ratios

While none of this evidence is without its own drawbacks, some weight should be placed on it as regulators make judgements on uncertain items such as asset betas and total market return. The fact that the determination's mechanistic application of CAPM has diverged from all of these cross-checks is highly relevant to the assessment of a reasonable WACC.

Impact of recent market evidence on the cost of capital calculation

Ofwat states that market evidence since February could lead to a significantly lower WACC. FE's analysis does not suggest the same outcome. The primary reason for this is that the FE analysis of asset beta is based on a wider range of evidence over 2-year, 5-year and 10-year periods and this range of evidence does not show a reduction over the recent months. The fact that Ofwat's analysis, based on a narrower evidence base of short-term data, shows a material reduction of this period serves to highlight the inherent volatility in its approach and the lack of robust cross-checks in its method.

Why the change is in customers' interests

Customers benefit from the low financing costs that the stable regulatory approach to calculating the cost of capital brings.

Reassessing the allowed cost of capital in the light of the factors set out in this representation will benefit customers by reducing non-diversifiable risk and by increasing financial resilience compared to the draft proposals.

Links to relevant evidence already provided or elsewhere in the representation document

Appendix R3.1 to this document is the report from Frontier Economics giving its view on the appropriate cost of capital for PR19

Appendix R3.2 is Frontier Economics explaining the impact of Ofwat's intervention on ODIs on skewness and the consequential impact on the WACC.

Wider context is given in section 1 of our "Summary representations" document.