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27 January 2021

Citizens Advice response to Ofwat's consultation: PR24 and beyond: Discussion paper on risk and return

Dear Ofwat,

Thank you for the opportunity to respond to this consultation.

Citizens Advice has statutory responsibilities for representing energy and post consumers in Great Britain, and we also advocate and provide advice for consumers on cross-cutting issues. We have focussed our comments on cross-sector, economy-wide issues which are not unique to water but play a key role in this price control. The issues we have focused on are common to a number of essential service sectors where we believe that consumer outcomes could be improved.

We note that a number of these issues, particularly regarding the rate of return allowed to regulated companies, have been subject to appeals to the Competition and Markets Authority (CMA) in recent years. We believe the regulatory approach to components of the allowed rate of return should be coordinated across sectors. This will be more efficient and should provide greater clarity and consistency for all stakeholders. Ofwat has the opportunity at the outset of a new price control review process to examine and progress this, rather than continue with the more standard process.

Nonetheless, whatever the process for PR24, it is important that the outcome fully reflects the developments that arise from the recent CMA appeals in water and energy.

1. **Overall Ofwat proposed risk and return approach**

We welcome Ofwat's ambition to align the interests of water companies and investors with those of customers so that the sector is attractive to investors and that companies can only earn high returns from strong performance. We see this as the correct aim, to use performance incentives linked to high returns, but does not protect high returns across the board.

It is positive that Ofwat recognises that return on capital makes up an important part of allowed revenues and hence customer bills, and therefore that Ofwat wants to ensure that capital is appropriately remunerated but will not leave customers bearing unnecessarily high bills in PR24 and beyond.

We agree with Ofwat that important events since the conclusion of PR19 include the CMA price control appeals for PR19 and RIIO-2. They contain considerable amounts of evidence and arguments, particularly on the cost of capital estimation; and the continuing high premium over Regulatory Capital Value (RCV) from recent equity transactions. For listed water companies this demonstrates a market expectation that returns above the cost of capital look set to continue for a number of companies.

Yet we think that the Ofwat discussion paper doesn't sufficiently reflect either of these developments. In particular, the evidence and arguments in the CMA price control appeals, including Citizens Advice position on the significance of the high equity transaction premium for assessing the cost of capital, need to be fully reflected.

The CMA states:

> *"Citizen's Advice considers that recent high MAR premiums are particularly compelling 'real world' evidence that supports the CMA's view that it is unlikely that such premiums are the result of company-specific factors alone"...*
>
> *"Taking the recent transactions involving Bristol Water and WPD as an example, we noted that only some of KPMG's 'complicating' factors should reasonably apply. Industrial buyers operating in the same regulated sector, as is the case in both of these transactions, it would seem irrational to assume a significantly different 'view of the world' in order to justify a higher premium. In these cases, past outperformance levels of the purchased companies have varied, there are no sizeable unregulated activities to complicate the analysis and we saw no reason why expectations of*

allowances in future controls should justify a materially different view of the value of the assets. Specifically, with regard to expectations of growth, we noted that this should only create positive value if allowed returns are higher than required returns. As a result, KPMG's explanation of premiums (when applied to these examples) appeared to rest on various versions of 'private values' associated with synergies, scarce assets or overpayment (the 'winner's curse'). Of these, synergies appeared to be the most relevant consideration. However, in an asset-heavy utility where the bulk of costs relates to operating activities, we would not expect such savings to be, in isolation, material enough to justify the large premiums that have been paid. It was our opinion that a buyer's expression of private values could reasonably be interpreted as including a view on whether the regulator's allowed return is sufficient. Put an alternative way, we would have to give weight to a significant amount of 'other' justifications to conclude that the purchasers in these transactions had made no assumptions about either expected outperformance or the sufficiency of the allowed return on equity."[1]

We would expect a clear assessment of the value Ofwat sees in using RCV evidence given the growing evidence of premia. Where the considered rate of return appears to not reflect this premia then Ofwat should consider making a downward adjustment.

2. Risk allocation and uncertainty mechanisms

We support Ofwat's aim to "*align the interests of companies and their investors with those of customers, now, and in the long term*"[2], as well as the need to simplify risk allocation mechanisms as much as practical.

We view the risk allocation and other uncertainty mechanisms (including new mechanisms introduced at PR19) chiefly have had the effect of shifting risks from investors to consumers, especially of demand and cost risks (including costs of Net Zero), as the Ofwat discussion paper itself highlights[3]. Accordingly, the water sector risk allocation mechanisms substantially limit the risks facing investors, especially of non-diversifiable risks to equity or beta, the only risks that are necessary or appropriate to compensate investors for (above and beyond the risk-free rate).

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[1] CMA (2021) Final determination: Volume 2A: Joined Grounds: Cost of equity, P5.682
[2] Ofwat (2021) PR24 and beyond: Discussion paper on risk and return p9
[3] Ibid p12

Further, the residual risks facing water company investors – as reflected in Ofwat's Return on Regulatory Equity (RoRE) ranges – invariably only reflect diversifiable risk to which it is neither necessary nor appropriate to compensate investors for. This reflects that the main investors in the UK water companies are all highly diversified global investment institutions, of which UK water companies represent a very small fraction of their total assets, and are themselves typically held by other institutions or retail investors which themselves are also highly diversified against individual company and other idiosyncratic risks. For a more detail see Citizens Advice's response to the CMA RIIO-2 appeal[4]. We want to see Ofwat (and Ofgem in ED2) to look at the feasibility of more appropriate equity return comparators.

3. Beta estimation (including the period affected by Covid-19)

The chief evidence from the period affected by Covid-19 is that the UK water companies, and other comparable regulated companies, exhibit very low systematic/non-diversifiable risk. This is evident because Covid-19 is one of the few examples of a genuine global systematic/non-systematic risk facing investors. The other chief example in recent history is the 2007-08 global financial crisis. In both periods, UK water company equities showed limited correlation with the overall equities market. Indeed, water company equities reacted much more like government bonds than the average equity markets during these periods, namely, that they exhibited low betas. This reflected the clear expectation among investors that water companies are far safer/less risky assets than equities on average, i.e. much more akin to government bonds.

In contrast, during time periods where no material global shocks are apparent (e.g. periods outside the Covid-19 pandemic and 2007-08 global financial crisis), equity market prices tend to be much more affected by factors that are unrelated to common risk factors. In particular, equity price correlations are substantially driven by buying and selling of shares as part of collective investment funds, which invariably track (or closely track) market indices (such as the FTSE All Share Index). Indeed, substantial

[4] Citizens Advice Application for Permission to Intervene in Energy Licence Modification Appeals 2021

academic research shows that the growth of collective investment funds is the chief driver of equity price correlation, thereby leading to substantial over-estimation of beta as a measure of underlying systematic risk. This was acknowledged by the CMA RIIO-2 decision:

> *"We recognise the submission made by Citizens Advice with regard to index investing and note its views on the negative impact that this may have on shorter term betas."*[5]

We ask that Ofwat (and Ofgem in ED2) consider the options for adjusting their beta assumptions based on the impact of index investing.

Overall, this means that Ofwat should attach far greater weight to the period affected by Covid-19 – as a measure of the true systematic risk facing water company investors – than on other periods.

Total Market Return (TMR)

The discussion paper says that Ofwat "*propose[s] to produce TMR ranges using long-run historical equity returns, while using more recent data to inform the point estimate within the range*"[6].

We strongly disagree with this approach, for the reasons recognised by the CMA RIIO-2 Final Determinations, that TMR means total returns on all assets, not just equities. Indeed, returns on equities may significantly overstate returns on all assets (owing to greater riskiness of equities versus other asset classes). Hence, Ofwat should not just look at equity returns alone. In addition, Ofwat should use the longest possible time series for estimating the TMR, not biased by shorter more recent periods.

This is accepted by CMA as a suitable area for regulators to consider why TMR are overstated and should be addressed in PR24:

> *"Moreover, while such factors might suggest a slightly higher TMR, we agree with Citizens Advice's argument that, theoretically, the TMR should reflect the return on all assets in the economy, and that there is some evidence suggesting that total returns*

[5] CMA (2021) Final determination: Volume 2A: Joined Grounds: Cost of equity, P5.494
[6] Ofwat (2021) PR24 and beyond: Discussion paper on risk and return, p18

across all asset classes are lower than those on equities alone, and potentially materially lower."[7]

Cost of debt

The discussion paper says that it envisages a fixed component for embedded debt and indexed component for new debt[8]. Note that this is directly contrary to the recommendations of the 2018 UKRN cost of capital report, which recommended that all regulated company debt should be indexed[9]. The chief effect of this is a further transfer of risk from investors to customers and further protection of equity holders from diversifiable and non-diversifiable risk factors (i.e. grounds for even lower equity beta).

Gearing Outperformance Sharing Mechanism (GOSM)

As explained in more detail in Redetermining Water[10], Ofwat should adopt similar innovations as adopted in the post-financial crisis banking regulation reforms, that were intended to avert the costs – to consumers – of excessive gearing and making water companies better able to absorb losses and curbing incentives for excessive water company risk-taking. In particular, along with the requirement for ring-fencing UK retail banking activities and limits on maximum bank gearing levels (which are already present for regulated water companies), the Independent Commission on Banking recommended a mandate for long-term unsecured debt that regulators could require to bear losses in resolution (known as "bail-in-able" bonds) and debt that is automatically convertible to equity in the event of predetermined financial thresholds being met (known contingent convertible bonds, or "CoCos"), on the basis that such debt holders would then have a strong interest in guarding against downside risk .

Accordingly, such regulatory requirements have the multiple intended advantages of: (1) creating a strong incentive on debt holders to prevent excessive gearing and/or other forms of excessive company risk-taking, (2) stopping equity investors and management from pursuing excessive gearing and other undue risk-taking, and (3) protecting customers and taxpayers from the risk of disruptive default, i.e. of risk to services to consumers and bail-out costs to taxpayers. We believe that Ofwat should consider the suitability of such mechanisms, in our view if applied to water companies these would

[7] CMA (2021) Final determination: Volume 2A: Joined Grounds: Cost of equity, P5.200
[8] Ofwat (2021) PR24 and beyond: Discussion paper on risk and return, p2
[9] UKRN (2018) Estimating the cost of capital for implementation of price controls by UK Regulators
[10] Citizens Advice (2020) Redetermining Water p54

be a more effective and equitable approach than Ofwat’s gearing outperformance sharing mechanism.

Please do get in contact if you would like to discuss the response further.

Kind regards,

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