Putting the sector back in the balance: Consultation on proposals for PR19 business plans

Consumer Council for Water Response

May 2018

1. Introduction

1.1 The Consumer Council for Water (CCWater) is the statutory consumer organisation representing water and sewerage customers in England and Wales. CCWater has four regional committees in England and a committee for Wales.

1.2 We welcome the opportunity to respond to Ofwat's consultation on 2019 price review (PR19) proposals to require companies to share financing outperformance from high gearing, and provide greater transparency on dividends and executive pay. We also welcome the moves to commit companies to demonstrate evidence of their financial resilience.

2. Executive Summary

2.1 Consumers' trust and confidence in the water sector can be undermined if companies are seen to be making substantial financial gains, especially if they are not delivering tangible improvements to consumers in return.

2.2 Our Water Matters customer survey for 2016[1] shows that value for money is a key driver of customers' level of trust. While the average level of customer trust in the sector is reasonably high at 7.59 (out of a scale of 10), only 73% of customers are satisfied with the value for money of the water service. This is much lower than the level of satisfaction with the service (93%). Water customers' satisfaction with value for money lower than that in the energy sector, which itself is not viewed positively by many customers.

2.3 This shows that there are a number of customers with concerns about the fairness and value for money provided by the sector, as well as a lack of trust. Greater financial transparency and a share of the benefits when companies make gains from debt financing and higher gearing may help address this.

2.4 We would expect to see reasonable investor returns for what is a low risk industry. CCWater has been concerned about the level of financial outperformance resulting from regulatory decisions and initiatives, including companies' ability to finance at a cost lower than the Weighted Average Cost of Capital (WACC) set by Ofwat, the impact of inflation and now, potentially, Outcome Delivery Incentives. While we welcome Ofwat's intentions to introduce 'gain share' mechanisms and requirements to increase financial transparency and resilience through the proposed additional measures for the PR19 methodology, outperformance relating to higher gearing is only one part of the range of outperformance companies achieved in the past.

2.5 Several companies have chosen to increase gearing, in the process issuing special dividends to equity shareholders and taking advantage of lower cost debt financing. This has added risk for customers as higher gearing reduced the 'buffer' available from equity. We have seen how companies have:

- Geared to a level higher than Ofwat's assumption of nominal gearing; and
- Raised debt finance at a significantly lower cost than assumed in the WACC used for price setting.

[1] https://www.ccwater.org.uk/research/water-matters-household-customers-views-on-their-water-and-sewerage-services-2016/

However, higher gearing potentially exposes companies to greater risks from increases in interest rates and other factors.

2.6 CCWater has previously raised with Ofwat our concerns about high gearing. We have also raised concerns that companies have been consistently able to outperform the regulator's cost of capital assumptions, and the lack of transparency in company financial structures and governance. We have in the past called for 'gain share' mechanisms to help ensure customers receive a share of any gains shareholders have received[2].

2.7 While the proposals in this consultation address the risk of significant gains occurring in the future, high investor returns achieved from higher gearing and lower cost debt financing have occurred in the past[3].

2.8 In order to help 'put the sector back in balance', regulatory systems and companies that have increased gearing in this way should also consider resolving these past issues, and the increased level of risk the customers of these companies now face. This would also help improve customer perception of the sector.

2.9 We welcome the two 'strands' of gainshare that are being considered:

- Gains achieved due to a level of gearing above Ofwat's notional level, leading to higher equity returns to shareholders; and
- Gains achieved from the actual cost of debt financing being lower than Ofwat's assumption.

2.10 We agree that these mechanisms should be asymmetrical, in that gains but not losses are shared with customers. Companies should carry the risk of losses associated with their financial structuring decisions.

2.11 We think a consistently applied mandatory gain share mechanism should apply where companies' level of gearing is higher than Ofwat's nominal gearing assumption, which would see 50% of such shareholder gains from increased gearing returned to customers.

2.12 We agree that companies are best placed to propose gain share mechanisms that relate to their actual cost of debt financing, but would like to see Ofwat test companies' proposals for this in their business plans using:

- A measure of actual debt (embedded and new debt) compared to the WACC allowance;
- A minimum 50% share to customers for gains made; and

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[2] Our response to Ofwat's Water 2020 consultation on its approach to the cost of debt (October 2016), raises concerns about the benefits companies have achieved from low cost of debt/high gearing and suggests the introduction of 'gainshare mechanisms.

Similarly, our response to Ofwat's Water 2020 'meeting the challenges' consultation (September 2015), called for more to be done to redress the balance of risk and reward between customers and company investors, as evidence of financial outperformance (particularly from 2009 onwards) shows that customers have overpaid for a higher assumed cost of capital, when companies have been able to finance at a lower cost of debt.

[3] See National Audit Office 2016 report on economic regulation in the water sector, which details the level of financial gains achieved by companies from lower cost debt financing and higher gearing during the 2010-15 period.

- A commitment to engage with customers on the appropriate method of sharing the benefit (reduced prices, additional investment above and beyond that allowed for in price determinations, or financing further affordability assistance schemes, for example).

2.13 At present, 13 out of 18 regulated water companies have geared to a level higher than Ofwat's notional gearing for 2015-20 (62.5%)[4]. While gearing levels are not static in that companies may decide to reduce or increase gearing in the future, the current level indicates that the majority of companies have made gains from these financial structuring decisions, from which customers may not have received any benefit. It may be seen that the introduction of this mechanism drives companies to reduce gearing in the future, possibly increasing their financial resilience as a result.

2.14 We also welcome moves to deliver greater transparency in companies' dividend policies and executive pay so that this is directly related to how well a company delivers its commitments to customers, though we would like to see this reporting of correlation to customer commitments in relation to shareholder returns more widely. We also support greater financial resilience tests in the initial assessment of business plans to demonstrate to customers that companies are resilient to 'cost shocks'.

2.15 We expect companies to be transparent with CCWater and their Customer Challenge Groups in their development of business plan 'gain share' proposals to allow scrutiny and challenge ahead of the business plans submission to Ofwat in September 2018. We will ensure that companies with higher gearing do not reduce their customer-driven commitments in business plans in the light of Ofwat's 'gain share' proposals, and expect Ofwat to check for this when plans are assessed from September 2018.

2.16 We also suggest that Ofwat could use the measure of customer trust in our annual Water Matters customer surveys to measure any possible increase in trust that these new mechanisms may help drive.

1. Responses to consultation questions

Q1: Do you agree that companies should be required to propose mechanisms for sharing financing outperformance in their business plans, and that we should assess such mechanisms in the IAP?

Yes. In the past companies have consistently outperformed Ofwat's assumption of the cost of new and embedded debt in the WACC at customers' expense. Higher gearing has also seen equity shareholders receive benefits without any share given to customers. We welcome Ofwat's recognition that these scenarios can erode consumer trust and confidence in the sector.

Q2: Where adequate mechanisms are not offered in business plans, do you agree we should intervene to impose a sharing mechanism, to ensure customers will receive an appropriate level of benefit from companies with highly geared structures?

[4] See Economic Consulting Associates' analysis of companies 2016-17 financial performance (commissioned by CCWater).

Yes. Ofwat should intervene if a company's proposed mechanism is inadequate with regard to sharing outperformance from new or embedded debt financing, where companies are able to finance at a lower cost than Ofwat assumes.

However, we recognise that a uniform, mandatory benefit sharing mechanism for debt financing gains may be difficult to apply, given the diversity of company financial structures and the types of embedded debt carried by companies.

We therefore suggest that a company's proposed sharing mechanism relating to the cost of debt should be assessed against the following principles:

- **Transparency –** Companies' business plans should transparently show their embedded debt and new debt financing structures, highlighting the difference between the actual cost and the cost assumption in Ofwat's WACC (including the index linked cost of new debt from 2020).

- **Commitment to share -** Based on the above, companies commit to share at least 50% of outperformance against the Ofwat assumptions with customers.

- **Openness -** Any changes to the company's financial structure or debt financing arrangements are reported to Ofwat, with subsequent adjustments to the sharing mechanism if necessary to reflect this.

- **Customer Engagement -** Decisions on where to deliver an outperformance share with customers (and when) should be subject to customer engagement, with input from stakeholders including CCWater and the Customer Challenge Group. This will commit companies to explore options such as:

    - Additional investment above and beyond that allowed for in price determinations, to reflect areas of service that are customer priorities;

    - Increased funding for affordability assistance schemes; or

    - Reducing future bills.

  Customers may prefer to see <u>all</u> customers receive a benefit from a price reduction, or support certain groups of customers from receiving the benefit (e.g. from increasing social tariff funding or investment to reduce the risk of sewer flooding). Should companies opt to fast-track investment as a result of this, Ofwat should ensure that any future returns associated with the resulting growth in the Regulated Capital Value does not effectively reimburse the company of the share it has given to customers.

If a company proposal does not comply with the above principles, we would like to see Ofwat intervene to ensure the company's debt outperformance sharing mechanism meets these requirements.

Q3. Do you have views on our proposals for the design of the outperformance sharing mechanism for highly geared structures? Do you agree that the calculation should be on a nominal basis and take account of the actual, rather than notional, cost of debt?

We agree that a second outperformance sharing mechanism is needed to address shareholder gains associated with higher gearing. For this, a consistent mechanism to benchmark outperformance would be easier to apply based on a comparison between the notional and actual levels of gearing.

We recognise that actual gearing changes over time due to various factors including the investment programme and inflation, so Ofwat's suggestion to apply dead bands above the notional level of gearing should accommodate this.

Company equity shareholders have often received large special dividends when companies substituted equity for cheaper debt. We would like to see at least 50% of this outperformance shared with customers, and would like to see Ofwat's methodology leading to companies committed to engaging with customers to identify their preferred option for delivering this share (extra investment, reduced prices etc.).

Q4: Do you agree that companies should explain their approach to dividend policy in their business plans and that our IAP assessment should assess both transparency and how the policy takes account of factors which include obligations and promises to customers, delivery of service to customers, financial resilience and employee interests?

Yes. Consumers' perception of the legitimacy of the sector may be improved if it is demonstrated that shareholders receive dividends commensurate with how well the company has served its customers.

We agree that the challenge to companies should be to explain in their business plans how their dividend policy works. However, this should also clearly show how dividends <u>and</u> total shareholder returns reflect a delivery of commitments to customers and the relatively low risk water companies' face.

Ofwat should intervene if:

- The company fails to adequately show this in its business plan; and
- Does not provide evidence in its annual reporting that it's issuing returns in line with this commitment, and/or is not transparent to its customers in doing so.

Ofwat's WACC for 2020-25 includes an assumption of the cost of equity (4.5%), which provides a baseline for the nominal level of dividend yield. If companies are to propose dividend yields that are higher than the nominal, they need to justify this by showing what improvements customers are receiving in return.

Q5: Do you agree that companies should explain their approach to any performance related element of executive pay in their business plans and that our IAP assessment should assess both transparency and that policies for awards of any performance related elements of executive pay demonstrate a substantial link to exceptional delivery for customers?

Yes. Companies should make commitments in their business plans to be transparent about executive pay, but also to demonstrate that the performance related element is linked to delivery of customer commitments and cost efficiency.

As per our response to Q4, Ofwat should intervene if the company fails to produce such a commitment in its business plan, or fails to adhere to this commitment. This would demonstrate to consumers that higher rates of executive pay are only awarded if tangible improvements for customers have been achieved.

Q6: Do you agree with our proposed revisions to extend the confidence and assurance test area to include trust and with the revised wording of question 3 of this test area?

Yes. Given the proposals in this consultation, the PR19 methodology test now needs to show how Ofwat will assess companies 'gain share' and financial transparency proposals. Therefore we agree with the revised wording of Question 3, which shows that Ofwat will assess company proposals for these mechanisms and intervene if necessary.

Q7: Do you have any comments on the additional clarification of our approach to financial resilience in the IAP?

We agree that tests to measure the financial resilience of companies is important as this can demonstrate to customers' that companies are able to withstand economic shocks without harming service provision.

Therefore, we agree that business plans should include evidence to show how the company has included a range of potential economic risk scenarios and the potential impact if each one arises.

Companies can then demonstrate how they will mitigate or absorb such shocks to give customers assurance. Without such resilience, a poorly protected company could require Ofwat to 'rescue' it financially from any of these scenarios, at customers' expense.

We would expect Ofwat to intervene if a company has either failed to present the scenarios, or their proposed mitigations are inadequate.

Enquiries

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