From:	Mallon, Ciaran
To:	PR19
Subject:	PR19 - Representation on draft determinations
Date:	30 August 2019 13:51:22

Dear PR19 Team,

I am a fund manager working for Invesco in the UK, managing client portfolios with investments in UK shares. These include investments in Pennon, Severn Trent and United Utilities. Invesco manages about $1,200bn globally, of which about £60bn is managed by Invesco UK (both figures as at 31 June 2019).

I am writing in response to the consultation announced on 19 July 2019 regarding the slow track company draft determinations. You have updated your thinking regarding cost of capital in the publication "PR19 draft determinations: Cost of capital technical appendix". In my view, the proposed cost of equity is low, and suggestions that it may be further reduced in the final determinations is hard to justify.

I will restrict my comments to your consultation to an area where I believe I have an informed and practical insight – the cost of equity.

The consultation documents provide extensive descriptions of your approach to setting cost of equity, but I would note that while compensating equity holders is a cost to any business, to my clients it is the return required for taking risk with their money. And any investment must compete against other alternative investments.

I view the proposed cost of equity allowance as already very low compared to competing investment opportunities and am surprised that there is some suggestion that it may be lower still in the final determination.

The focus of your justification for the cost of equity range is the Capital Asset Pricing Model (CAPM). This may be well established and academically uncontroversial, but it is built on assumptions (such as market efficiency, rational behaviour, constant perception of risk, volatility as a measure of risk) that seem very far from my practical experience.

My particular concern in the use of CAPM is the current "risk free rate". My understanding is that using 10 or 20 year Government bond yields in the CAPM is convention and not prescribed by the creators of this model. Your own cost of capital technical appendix gives this definition: "The risk-free rate is the market yield which investors accept in return for investing their money at no risk to the principal invested" (page 18). I can't see how a negative real yield on gilts, and thereby a guaranteed loss of capital in real terms, is compatible with this definition.

Nominal and real UK government bond yields are around the lowest levels ever recorded. The global bull market in bonds is one of the largest and longest ever experienced. The Bank of England Staff Working Paper No. 686 "Eight centuries of the risk-free rate…" gives some context. It is hard for this investor to view real gilt yields today of around -2% as "risk free". To borrow someone else's line: it is more like "return-free risk" than "risk-free return".

At this level of equity return quoted companies may struggle to appear attractive to investors relative to alternative investments.

Consider the returns on offer elsewhere amongst FTSE 100 companies: one way of looking at potential returns from an investment is the sum of dividend yield and dividend growth (this is derived from the dividend discount model). Currently Morgan Stanley estimate that dividend growth over the next 3 years from the FTSE 100 will average 2%. According to Bloomberg's aggregation of analyst estimates the weighted average prospective dividend yield of the FTSE 100 is 5%. The implied 7% return for the FTSE 100 suggests that the prospect of a 6.56% nominal equity return for equity holders in the draft determinations is below average for blue chip UK companies.

And the water companies do not appear particularly low risk compared to other investment opportunities: they are under ever increasing public scrutiny; the Labour party plans to nationalise the industry (with compensation yet to be declared); and, despite an admirably clear regulatory process, allowed returns appear to be on a constant downward trajectory.

Clearly, the long term legitimacy and success of the industry requires that the companies provide good value to their customers and that companies fulfil their wider roles to society and all stakeholders. But in a model where accountability to shareholders is a feature, the investors who I represent expect an acceptable return for the risks they are taking with their capital.

Sincerely,

Ciaran Mallon