CCW's response to Consultation:

PR24 and beyond: Discussion paper on risk and return

CCW Response **February 2022**

1. Introduction

1.1 CCW is the statutory consumer organisation representing water and sewerage consumers in England and Wales.

1.2 We welcome the opportunity to respond to Ofwat's consultation. We have responded to the individual questions below. As the consultation paper makes clear, prior price reviews have been over generous to investors at the cost of customers. In establishing the risk return framework we think it is paramount that the customer interest is not forgotten and the scope for over generosity of prior price reviews is not repeated

2. Our response

Q2.1. Do you agree with our principles for reviewing old and new reconciliation mechanisms and do you have suggestions for further reconciliation mechanisms which could be retired for PR24?

Any move to reduce the number of reconciliations would be welcome notwithstanding the feeling that the current suite of mechanisms may offer certain protections that has made the interim determination process less useful to companies. We agree with the approach outlined. We especially support the criteria for this price review which says that Ofwat intends to place significant weight on the principle that risk should be held by the party best placed to manage it.

Q2.2. Do you have any comments on our proposed approach to producing risk ranges, including but not limited to: a. Notional risk ranges for the efficient notional company prepared by Ofwat; and b. Company-specific risk ranges produced by companies.

For the notional company we agree that risk ranges are best used as a sense check for the incentive package as a whole rather than be used to fine tune the allowed level of the return.

We agree that Ofwat should lead on notionalised company risk analysis – with the base case that companies achieve price control benchmarks on service and efficiency. We feel that this will aid comparability of risk ranges between companies.

Q3.1. How should we reflect the period affected by Covid-19 in our approach to estimating beta?

This will depend on the degree to which the Covid period is thought to be indicative of the forecast period. It would seem sense to look at multiple estimation periods to gauge how much beta changes when Covid is taken into account.

In the context of the allowed return on equity, the consultation is open about the generosity of previous price reviews leading to windfall gains for companies' investors. It is critical that the allowed return on equity be a plausible central estimate of the market return requirement. Ofwat proposes to deal with asymmetry and investment incentive issues when considering the constituent parts of the cost of equity. This would then avoid a need to aim-up the overall cost of equity. Transparency of perceived asymmetry and investment incentive issues will be paramount.

Q3.2. Noting the impact of gearing on betas discussed in the report by Professors Mason and Wright, how should we adapt our approach to specifying beta for a company at the notional gearing?

The scenarios for beta considered by Wright and Mason give quite a variance to the return adopted at PR19 with the allowed return ranging from 15 to 62 basis points below the Ofwat assumed return. What isn't clear is the extent to which this would have exacerbated financeability constraints at PR19.

In view of the consultation on financial resilience it would not seem sensible to adopt an approach to beta estimation which could incentivise comparator companies to increase their gearing (notwithstanding that the pure play comparator companies have gearing at the lower end of the industry spectrum).

If Ofwat is considering a reduction in the level of the notional gearing, which would reduce the gap between comparator company gearing and notional company, this would seem to point to an approach to beta which draws away from delevering and relevering between comparator company gearing and notional company gearing.

As Wright and Mason suggest, we would support a variety of approaches being used in this space.

Q3.3. How should we convert RPI-linked yields into their CPIH-linked equivalents when deriving a RFR point estimate?

No comment

Q4.1. Do you agree with our proposed role for benchmark bond indices in crosschecking a cost of debt allowance based on a balance sheet approach?

We agree with this as an approach.

Q4.2. Given the persistent issuance discount of water company bonds against the iBoxxx A/BBB index, how should this be reflected in our new debt allowance-setting?

If there is clear evidence that water company yields are persistently below the chosen index by not making any adjustment means customers effectively pay too much. We would not support this. To take account of the issuance discount we would support the application of an outperformance wedge that Ofwat included at PR19. The alternative would be to consider whether the benchmark index was fit for purpose.

Q4.3 Do you agree with our proposal to restrict company specific adjustments to reflect only factors due to small size, and to remove the benefits test?

We do not believe that any company should receive a small company premium in the absence of value added to offset the impact on bills. This would look perverse to customers and would fail to incentivise small companies to find ways of adding value or mitigating any additional costs caused by their scale. In this context we supported the benefits test Ofwat applied at PR19 and would be disappointed if it was removed at PR24. However, we recognise that that the CMA didn't agree with the benefits/value test for the SCP in its redeterminations.

In the absence of a benefits test, ideally there ought to be clear evidence of customer support for any specific adjustment to the return. We would therefore expect those companies seeking a higher return to engage with their customers on why that additional return is in their interests. Companies should set out what their customers get out of a higher return, apart from a higher bill, and to establish whether, conceptually, customers feel that this is a price worth paying. It is critical that companies' evidence of support is representative of the entire customer base.

Q5.1. Do you agree with the framework we have set out for determining an appropriate notional structure and PR24 and beyond?

We agree with the approach outlined.

Q5.2. Do you agree the proportion of index-linked debt should be increased and what are your views on the composition of index-linked debt for PR24?

We agree that it should be increased to be more reflective of that element of debt from companies' balance sheets. As the consultation sets out the current weighted average debt is over 50 per cent relative to the 33% assumed at PR19.

A consequence of increasing it could mean that financeability constraints are eased as cashflows more readily match interest payments.

On whether to assume all index linked debt is RPI or CPI-linked or some hybrid approach depends on the materiality of the approach to the financial ratios. By assuming all index linked is CPI-linked could improve the AICR – but could potentially mask financeability constraints that would exist if a notional mix of CPI and RPI linked debt was used.

Q6. Do you agree with our proposed framework to evaluate the transition to CPIH indexation, and our proposal to transition fully at the start of PR24?

From the customer perspective the faster the rate of transition the more pressure it puts on bills in the short term. Ofwat's initial analysis suggests that the bill impact over 2025-30 of the full transition would be £3-12 (nominal). We recognise that this would unwind over subsequent years but what is not clear is the pace of that unwind given Ofwat's expectation that there could be a need to reflect implementation costs, akin to Ofgem's RIIO-2 approach.

With regard to financeability benefits, the consultation paper sets out that a glide path to full indexation delays those benefits to cash flow being realised. It is not clear whether the £3-12 quoted is net of any financeability benefits.

There will obviously be competing cost pressures at PR24 and the likelihood of increased pressure on customer affordability in the wider context. In this regard we think Ofwat should explore transition options and test the potential implications for bills with customers before landing on a particular approach.

Q7.1. Do you agree that financeability is likely to be less constrained at PR24 than at PR19?

The move to CPIH indexation, a lower notional gearing level, a higher proportion of index linked debt and lower embedded debt cost would, all other things equal, lead to a likely reduction in the financeability constraint at PR24. Obviously the size of the investment programme and growth in the RCV will be a determinant of overall financeability. Where there is significant growth in the RCV we very much agree that equity has to play its part.

Q7.2. Do you agree that real RCV growth should be funded through a combination of debt and equity such that gearing of the notional company remains consistent with the notional gearing set at the start of the control period?

We agree.

Enquiries

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