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PR24 draft methodology consultation response
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Response to Ofwat's PR24 draft methodology consultation and the allowed return on capital

This letter sets out Corsair Capital's views on the approach to estimation of the allowed return on capital proposed in Ofwat's recent PR24 draft methodology consultation. We are writing in our capacity as investment advisor to funds that own 30.3% of Kelda Holdings Limited, provider of water and sewerage services to domestic and business customers across Yorkshire.

We support the broader points made in separate responses by our investee company, Yorkshire Water, and by our investor association, the GIIA. In this response, we limit our comments to the allowed return on capital, being an area in which we have detailed knowledge, not only of the theoretical foundations of these calculations but also of the practical realities of investor expectations and investor risk/return appetite that we deal with regularly in the infrastructure funding universe.

Summary

Ofwat's approach to the cost of capital allowance should encourage investment to meet critical infrastructure needs of the sector over the PR24 control period and beyond. In evaluating this, Ofwat must recognise the considerable value placed by investors on consistency and confidence. While Ofwat offers continuity from PR19 in many regards, in several notable areas Ofwat's proposals are inconsistent with established precedent, adopt inappropriate innovations, or fail to address known challenges adequately:

- Ofwat proposes to break with CMA precedent on core CAPM parameter values, without supporting evidence.
- Ofwat proposes to abandon 'aiming up' on the cost of equity, at odds with the CMA's position, and without supporting evidence.
- Ofwat proposes a novel approach in estimating the notional cost of equity, which is not properly calibrated.

- Ofwat proposes not to consider explicitly the impact of Covid on the equity beta.

  In all these areas, the approach that Ofwat proposes will reduce the cost of capital allowance and lead to inadequate returns in the sector – at a time when increasing investment is needed to maintain and improve asset health as well as in anticipation of significant challenges of the future. This recognised need for investment was an important part of the reasoning adopted by the CMA in reaching its final decision on the cost of equity – at a materially higher level than that proposed by Ofwat in the PR19 final determinations.

  In all these areas, Ofwat's proposed approach should therefore be revised:

- Precedents for the estimation of specific cost of equity parameter values established by the CMA should be adhered to, barring clear new evidence. Ofwat has not presented the necessary evidence for the departures proposed on the risk-free rate or total market return.
- Ofwat should stick to the approach of 'aiming up' adopted by the CMA. There is no new evidence to support a move away from this. Aiming up should remain. If not deployed generally it should - as a minimum – be used to encourage investment in asset health.
- Ofwat's innovation on de-levering and re-levering may have merit but needs important re-calibration. This will moderate the downward impact of Ofwat's 'more consistent CAPM-WACC' approach on the estimated cost of equity.
- Ofwat has not proposed a sufficiently clear or robust method for addressing the impact of Covid on beta estimates. Consideration should be given to more direct approaches.

Ofwat's proposals break with CMA precedent on core CAPM parameter values

As investors, we were expecting that Ofwat would reflect the approach adopted by the CMA – following the lengthy appeal process – in its PR19 re-determinations. We anticipated that changes would only prevail on core CAPM parameters where new evidence supported an alternative.

There are, instead, clear instances where Ofwat proposes to take a different approach to that of the CMA, without justification. By contrast, Ofwat proposes to broadly follow the CMA's approach for the calculation of the cost of debt allowance – despite this being different to the approach adopted by Ofwat at PR19. This will result in a significantly reduced point estimate for the cost of debt, because expensive embedded debt will fall out of the 'historic average' calculation.

Ofwat's inconsistency – adopting the CMA's approach only where it has a downward effect on the cost of capital – is unbalanced and unjustified.

Two prominent instances of this are set out below. These warrant re-consideration and realignment to the CMA's approach to ensure that the cost of capital allowance is set at an appropriate level.

(1) Total market return

In estimating the total market return (TMR) as part of the PR19 redetermination, the CMA explained that there were a range of estimation techniques that might be used. As noted by Ofwat, the CMA did not find conclusive evidence to favour one estimator over another, eventually settling on arithmetic averages of 10-20 year holding periods. The CMA chose this approach due to its simplicity and transparency. It also noted that using these alternative approaches gave a broader range, but a similar mid-point estimate to the arithmetic mean.

In calculating the mean, the CMA noted advantages and disadvantages with both overlapping and non-overlapping estimators and considered it would be appropriate to take both into account in arriving at a range for the TMR estimate. Ofwat notes the same challenges, but proposes instead to exclude the non-overlapping estimator. This is likely to depress the TMR estimate. Ofwat does not explain why a different approach is proposed, despite an absence of any new evidence.

(2) Risk-free rate

Ofwat proposes to calculate the risk-free rate by reference to index-linked gilts only, rather than using both RPI-linked gilt yields and AAA-rated corporate bond yields, as the CMA did in its PR19 redeterminations.

Ofwat proposes to move away from the approach taken by the CMA partly on the basis of the challenges associated with using a synthetic AAA-rated index. However, it does not address the concerns (raised in the CMA appeals) that a move to pure use of index-linked gilts would potentially understate the risk-free rate.

In a broader context, the recent CAA decision in June 2022 (H7) reiterated factors that may lead to ILG based estimates understating the true risk-free rate. The CAA estimated one of these factors alone – the 'convenience yield' – to be over 30bps.

This seems to contradict Ofwat's suggestion that a convenience yield would be difficult to implement. Both the CMA and CAA accept that there is evidence of a convenience yield, and the CAA has established a methodology to estimate such a yield. If Ofwat chooses to move away from the CMA's approach of a simple combination of both corporate bonds and ILGs, it should consider such alternative approaches – to avoid an artificially depressed estimate of the risk-free rate.

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'Aiming up' on the allowed return on equity

In its proposals for calculating the allowed return on equity, Ofwat suggests use of the mid-point of its estimate. Ofwat argues that there would be a high evidential bar for moving away from this, limited to evidence from market cross-checks.

This approach is at odds with the position taken by the CMA in the PR19 redeterminations. The CMA decision was made in explicit recognition of the fact that the risks of under-investment because of a WACC allowance set too low were considered greater than the risks of additional returns resulting from a WACC allowance set too high. Ofwat does not explain why it believes that the assessment of risks as set out by the CMA no longer applies.

The PR19 appeals decision is the only appropriate CMA reference for Ofwat. In contrast, in the CMA decision on energy appeals, its finding was only that Ofgem's decision was within a 'margin of appreciation' – not that the Ofgem view aligned directly with that of the CMA. In addition, the balance of upside opportunities and downside risks is substantially different between the water sector and the energy sector. Accordingly, the CMA decision in energy should be disregarded.

That said, we accept that 'aiming up' may be a blunt way to create incentives to invest. In many areas – where the existing system can be shown to have delivered the right level of investment – Ofwat can continuously 'tune' the incentive system to meet specific needs without offering the possibility of higher returns.

In the face of continued and increasingly prominent evidence of underinvestment in critical areas of infrastructure, however, there remains a legitimate role for 'aiming up'. This should be considered by Ofwat, where the creation of effective incentives has presented challenges that remain unresolved.

For example, investment in asset health in the water and wastewater sector has not allowed for replacement cycles which reflect engineering realities. As a consequence, for example, the funding of water mains replacement would need to be 5 times higher to match the European comparable and the funding of wastewater mains replacement would need to be 3 times higher to match the European average. The funding levels for the maintenance and replacement of long-lived assets have not, historically, been sufficient. They were probably insufficient prior to privatisation and have probably remained so ever since at least in part due to the regulatory system which, at each price review, has tended to seek efficiency improvements from a historical expenditure which was itself insufficient. The regulatory system should foster an increase in this investment, not repeat the mistakes of the past.

Owing to the challenges of measurement of asset health, and statistical uncertainty, it has not featured significantly in Ofwat's cost efficiency models. The efficiency models have primarily

relied on statistically robust and proven relationships between operating context, outcomes, and expenditure. There has been no check by Ofwat that the expenditures allowed for infrastructure renewals are consistent with the engineering design lives of the assets being renewed or replaced. This is a fundamental flaw that would need to be addressed before considering the removal of the "aiming up" adjustment to the allowed return on equity.

De-levering and re-levering the beta

Ofwat proposes a novel approach to de-levering and re-levering the equity beta in moving from an actual to notional assumed gearing. The approach is intended to ensure consistency with the Modigliani-Miller theorem – whereby the WACC estimate should not be sensitive to the assumed level of gearing.

The CMA panel, in the PR19 redeterminations, concluded that the sensitivity of the WACC to changes in gearing was small. It undertook a set of 'de-levering and re-levering' calculations which used – in the CMA's view – a plausible estimate of debt beta. The CMA's approach was adopted in full recognition of the 'problem' identified by Ofwat, and which Ofwat's novel approach is intended to resolve.

Ofwat proposes instead to adopt an approach described as a 'more consistent CAPM-WACC'. It obtains its set of estimates by re-calibrating the debt beta assumption so that the 'true' WACC[1] effectively holds constant in the face of a difference between actual gearing and the notional gearing assumption.

However, the Modigliani-Miller position – that the cost of capital should be unaffected by gearing is generally taken to apply to the fully post-tax WACC,[2] and it is this which should be held constant in Ofwat's model. It would not apply at the 'vanilla' level[3] illustrated.

This is a complex aspect of Ofwat's proposals, but one that requires further consideration. Moderation to reflect the issue highlighted would have an upward effect on the potential proposed cost of capital allowance.

Beta estimation – the impact of Covid

In estimating equity beta, Ofwat appears to propose – in line with the CMA – not to explicitly adjust for the impact of the Covid pandemic. Instead, Ofwat suggests consideration of the beta evidence broadly and over a longer backward period.

[1] Ofwat's WACC calculations do adjust faithfully for the difference between the promised yield and expected yield on debt, which adds necessary complexity but is not dealt with here.
[2] The post-tax WACC considers all personal and corporate taxes for the marginal investor. It also reflects that the taxation system is largely denominated in, with calculations made against, nominal returns – it is not sufficient to apply headline tax rates (personal or corporate) against the 'real terms' values shown by Ofwat
[3] The 'Vanilla' WACC combines a post-corporate tax cost of equity with a pre-corporate tax cost of debt.

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First, we note that the CMA's position was established at a point when limited Covid data was available and when observed water company betas remained largely driven by pre-Covid equity market data.

Second, we note that the impact may be non-trivial. Because of Covid, it is likely that there is a downward distortion of today's observed equity betas in the water sector. Heightened volatility was observed due to Covid in many market sectors – while regulated utilities were largely sheltered. Because of this, utility betas calculated using a short backward-looking dataset may exhibit lower 'raw' values.

Therefore, while we agree that it would not be appropriate to exclude Covid data, we also suggest that the simplistic inclusion of the data in the beta calculations used by Ofwat may drive a superficially low WACC estimate for PR24.

Ofwat should consider further analysis to identify the effects of Covid on beta and evaluate directly how these should be reflected in the PR24 WACC allowance.

We would, of course, welcome the opportunity to meet with Ofwat to discuss and elaborate on any of the above points. If you would find this helpful, the most appropriate point of contact in Corsair Capital for such a discussion would be our UK Operating Partner, [redacted] whose email address is [redacted]

Sincerely,

[redacted]

Partner and Head of Corsair Infrastructure