

Agenda

Advancing economics in business

Decision time: to go or not to go?

In late November 2009, Ofwat, the England and Wales water industry regulator, set out its final determinations for the prices that water companies will be able to charge over the next five years. Since the draft determinations in August, there has been some movement in the package, to the benefit of the companies. Individually, the companies now need to decide whether to accept the package or to seek a referral to the Competition Commission

Final price limits

On November 26th 2009, Ofwat announced the culmination of the periodic review of 2009 water prices (PR09), and its final determinations on the prices that water companies can charge customers over 2010–15.¹ The draft price limits issued by Ofwat were considered in the August 2009 issue of *Agenda*.²

Table 1 illustrates the annual average price limits (K factor) proposed by Ofwat at the draft and final stages of the PR09 process, compared with the movement between draft and final price limits in the 2004 review (PR04). Overall, this shows that, in PR09, the final average annual price limit (K) of +0.5% provides more funding for companies in comparison to the draft proposals (of –0.2%); indeed, this movement in PR09 between the draft and final K (of +0.7 K percentage points) is not dissimilar to the pattern observed in PR04 (of +1.1 K percentage points). Additionally, the table shows that the allowed level of funding in PR09 is still lower than that sought by companies in their final business plans—by around 2.2 K points (similar to the 2.0 K points gap in PR04). So, history has, to some extent, repeated itself. However, the situation varies significantly between the water and sewerage companies (WASCs) and the water-only companies (WOCs), and between individual companies.

Ofwat reached its final decisions for PR09 following representations by the companies on the draft determinations, and further consultation with other stakeholders. The main changes that appear to have driven the increase in allowed funding between the draft and final determinations are outlined below.

- **Capital expenditure (CAPEX)**—an increase in the allowed CAPEX overall for companies, up from £20.8 billion in the draft proposals to £22.1 billion in

Table 1 Industry and Ofwat's proposed annual average price limit (K) factors

	Final business plans	Draft determinations	Final determinations
PR04			
WASCs	+6.3	+3.3	+4.3
WOCs	+5.5	+2.2	+3.1
All	+6.2	+3.1	+4.2
PR09			
WASCs	+2.5	–0.1	+0.5
WOCs	+4.9	–1.1	+0.3
All	+2.7	–0.2	+0.5

Source: Ofwat (2009), 'Future Water and Sewerage Charges 2010–15: Draft Determinations', July; Ofwat (2009), 'Future Water and Sewerage Charges 2010–15: Final Determinations', November; Ofwat (2004), 'Future Water and Sewerage Charges 2005–10: Draft Determinations', August; Ofwat (2004), 'Future Water and Sewerage Charges 2005–10: Final Determinations', December.

the final determinations over the five-year period.

While this is still lower than the £24.2 billion sought by companies, it is higher than that allowed for by Ofwat in price limits during any previous price control period.

- **Asset maintenance assessment (AMA)**—in relation to the above, Ofwat has included more capital maintenance within the CAPEX pot to enable companies to maintain their networks. As part of its AMA (introduced for PR09), Ofwat has taken account of further evidence from companies on the need for additional funding to maintain serviceability.

- **Capital Incentive Scheme (CIS)**—across the CAPEX programme (maintenance, quality, supply–demand and enhanced service), Ofwat has also penalised companies somewhat less in its assessment. This, again, follows improved evidence from companies and changes in the way Ofwat applies ‘one-sided’ versus ‘two-sided’ adjustments.³
- **Operating expenditure (OPEX) efficiency**—although Ofwat has not significantly changed its CAPEX efficiency targets relative to the draft determinations, it has (in a number of cases) reduced the OPEX catch-up efficiency targets applied. This appears to be a combination of Ofwat using the latest available data, reallocations between OPEX and CAPEX, changes in the selection of the benchmark company, and Ofwat taking account of new evidence from companies on ‘special factors’ not captured in Ofwat’s models.

Nonetheless, Ofwat has not moved since the draft proposals on the weighted average cost of capital (WACC), adopting in its final proposals a post-tax WACC of 4.5%. This is also around 60 basis points lower than at PR04, predominantly due to a lower risk-free rate and asset beta.

The higher risks of WOCs have, however, been recognised to some extent through a premium on the cost of debt as well as lower gearing, leading to a post-tax WACC of 4.8–4.9% for the WOCs (in comparison to the allowance of 5.4–6.0% for the WOCs in PR04). However, Ofwat’s allowance for the WACC in the PR09 final determinations is considerably lower than that assumed in the companies’ final business plans, particularly for the WOCs.

Table 2 provides a summary of how Ofwat’s PR09 judgment on the WACC compares with that of PR04, and provides a further comparison with Ofgem’s December 2009 final proposals in the electricity distribution price control review (DPCR). The table also presents the assumptions used by the Competition Commission (CC) in the October 2008 Stansted Airport report. This illustrates that Ofwat has assumed a higher equity risk premium than the upper range put forward by the CC (albeit a year earlier, at the start of the financial crisis).

On financeability issues, Ofwat has assumed, in its final proposals, that Thames Water, Bristol Water and South East Water could raise equity over the next five years, equivalent to 20%, 10% and 7.5% of outstanding notional equity respectively, in order to finance their investment programmes. Ofwat has assumed an additional allowance in cash flows for transaction costs of 5% of any new equity raised, but with the same cost of equity—included within the WACC—for these companies. In the draft proposals, only Thames was assumed to have a notional equity injection.

Decision time?

The companies now have until January 26th 2010 to accept Ofwat’s final determinations or to ask for a referral of the package to the CC.

At the time of going to press, eight companies have announced that they have accepted Ofwat’s final determinations: Northumbrian, Yorkshire, South East, Anglian Water, South West Water, Severn Trent, Bournemouth & West Hampshire, and Dŵr Cymru (Welsh Water).⁴ In price limit (K point) terms, the differences between the amount these companies put

Table 2 Allowed cost of capital (%)

	Ofwat PR09	Ofwat PR04	Ofgem DPCR5	CC BAA Stansted
Risk-free rate	2.0	2.8	2.0*	2.0
Equity risk premium	5.4	4.9	3.0–5.0*	3.0–5.0
Asset beta	0.40	0.45	0.24–0.34*	0.55–0.67
Cost of equity (post-tax)	7.1	7.7	6.7	5.0–8.2
Cost of debt (pre-tax)	3.6 (3.7–4.0)	4.3	3.6	3.4–3.7
Gearing	57.5 (52.5)	55	65	50
WACC (post-tax)	4.5 (4.8–4.9)	5.1 (5.4–6.0)	4.0	3.7–5.4

Note: The numbers in parentheses represent the respective allowances for the WOCs. *Indicative values presented by Ofgem for the components of the cost of equity.

Sources: Oxera, based on Ofwat (2009), ‘Future Water and Sewerage Charges 2010–15: Final Determinations’, November; Ofwat (2004), ‘Future Water and Sewerage Charges. 2005–10: Final Determinations’, December; Ofgem (2009), ‘Electricity Distribution Price Control Review Final Proposals: Decision Document’, December; Competition Commission (2008), ‘Stansted Airport Ltd. Q5 Price Control Review’, October.

forward in their business plans, and Ofwat's allowance, were -1.6, -1.2, -3.9, -2.2, -1.5, -1.7, -3.4 and -1.5 K points, respectively.

However, one company—Bristol Water—has asked for its price limits to be referred to the CC. Bristol Water asked for an annual average K of 5.7, but was allowed only 1.8 in its final determination.⁵ It is important to note that, while companies must inform Ofwat of their intention to appeal, they are under no obligation to tell the regulator that they accept Ofwat's decision. Hence, it is possible that some remaining companies are continuing to mull this over.

This is not an easy decision. Companies will need to take an objective view on the merits of their case, rather than making a leap into the unknown based on wishful thinking. Having been immersed in their business plans (and in negotiations with Ofwat) over the past months, companies will invariably be very close to their respective cases. In these situations, companies will need to look in turn at each of the price limit building blocks, and then consider whether the case 'stacks up' as a coherent whole.

As with the recent wintry conditions in the UK, a change of shoes may be required—specifically, companies should put themselves in the CC's shoes, rather than their own. So, in practice, what questions might a company ask in order to reach an informed decision? Here are some examples.

- If the company thinks that Ofwat's efficiency targets are too harsh, what evidence can be shown to strengthen their case, and what is the CC likely to make of this?
- Even though the business thinks that the capital maintenance allowance provided by Ofwat is too low, can it prove that serviceability to customers would deteriorate with this level of funding in place? What would the CC think?
- Given recent CC precedence in the Stansted Airport case, and the time lapse since, what evidence does the company have to show that the cost of capital set by Ofwat is too low?
- If the company thinks that the CIS or AMA processes adopted by Ofwat are not robust, have these approaches necessarily arrived at the wrong answer? What alternative approach would the business suggest?

Importantly, and as identified in a previous *Agenda* article, going to the CC is not a one-way ticket: numbers can go up, but they can go down as well.⁶

While the CC might, as a starting point, take account of the main points of contention between a company and Ofwat, its function is not merely to act as an 'arbitrator' on specific issues. Rather, its role is to reach an overall view on the price limit package, and this essentially involves examining all issues—not just points of difference. Companies might 'win' on certain issues but, relative to the Ofwat settlement, lose on others.

The CC would also enjoy the advantage of having a six-month period in which to examine companies in depth (either just a few, or perhaps even one), rather than needing to review (as Ofwat does) information on over 20 companies. So, very few stones would remain unturned: the CC could uncover issues not examined by Ofwat and, given the time that has elapsed since the final determinations, could have the benefit of more recent information. On certain issues, the CC might also put forward its own ideas on appropriate methodologies (eg, by developing its own approach to modelling OPEX efficiency), or an alternative approach to the CIS. Again, companies might win or lose, depending on how these issues pan out.

Finally, CC inquiries not only cost money in a tangible sense, they can also be a distraction to the day-to-day running of a water business. Rather than getting on with financing and implementing the CAPEX programme, the business would instead need to devote enough resources to attending CC hearings, providing evidence to the CC, and answering detailed questions. The CC would also examine in detail how a business 'ticks' on a day-to-day basis, including its management and business planning processes. These are all important strategic issues to be borne in mind.

Depending on how the land lies when all of the above issues are taken into account, it may be that certain companies decide to seek a CC referral, while others decide to accept Ofwat's final determinations.

Concluding thoughts

By the time that the next issue of *Agenda* is published in February, it will be plain to see exactly how many companies have decided to pursue the route of referring their price limits to the CC, and those which have accepted Ofwat's proposals. Looking beyond this, the processes and methodologies adopted in PR09 are still worth scrutinising, in terms of what could be improved going forward. Indeed, Ofwat has recently announced that it will review how it approaches regulation of the water sector going forward.⁷

Moreover, the Cave and Walker reviews in 2009 of the water sector, and recent work by Ofwat and the Environment Agency, illustrate that water regulation is

not the only game in town.⁸ Companies will need to think hard about how to position themselves for retail competition and accounting separation, which look set to be introduced in the sector over the coming years. In

the medium and longer term, upstream market mechanisms could also be introduced—forcing water companies and other stakeholders to think about what might be the most appropriate models.

¹ Ofwat (2009), 'Future Water and Sewerage Charges 2010–15: Final Determinations', November.

² Oxera (2009), 'Water Draft Determinations: A Stake in the Ground', *Agenda*, August.

³ One-sided adjustments apply only to Ofwat's assessment of the CIS baseline, and increase the CIS ratio, penalising the company. Two-sided adjustments, by contrast, are applied to both the company's view of required CAPEX and Ofwat's baseline, with no net effect on the CIS ratio. See Oxera (2009), *op. cit.*, for an explanation of the CIS.

⁴ Ofwat website, as updated January 20th 2010, and as at the time of publication of this article.

⁵ Bristol Water website, as updated January 21st 2010.

⁶ Oxera (2009), *op. cit.*

⁷ Ofwat (2009), *op. cit.*, p. 6; and Ofwat (2009), 'Response to the Consultation on the Cave Review of Competition and Innovation in Water Markets', p. 10, December.

⁸ See, for example, Ofwat (2009), 'Response to the Consultation on the Cave Review of Competition and Innovation in Water Markets', December.

If you have any questions regarding the issues raised in this article, please contact the editor, Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

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