Today's Agenda

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PR19 Redeterminations: Companies' Statements of Case

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Following Ofwat's 2019 price review of water companies (PR19), four companies have appealed to the CMA for a redetermination. Each company has submitted its Statement of Case (SoC), which outlines its disagreements with Ofwat's methodology and findings. An important part of Ofwat's Final Determination is the rate of return that each company is allowed to earn on the regulated capital value (RCV) over the five-year period covered by the price review (2020–25) and the financeability of the company over this period based on this allowed rate of return.

While each company has its own specific issues, a few key themes can be drawn out across the four submissions. These themes are pertinent to a number of regulated sectors and jurisdictions, so how they are eventually determined by the CMA will be of interest to many regulated companies and regulators.

Cost of capital

In the Final Determination, Ofwat set the cost of capital at 5.02% in nominal terms (2.96%, CPI-real; 1.96% RPI-real).

All of the four SoCs consider this allowed return to be lower than the actual cost of capital based on market evidence. Key disagreements are around the following:

- the TMR estimate—Ofwat's reliance on the JKM estimator is considered inappropriate by the companies, which consider that weight should be given to other averaging methods and rolling periods;
- the inflation series—the companies support the use of RPI instead of the back-cast CPI inflation series as a measure of historic inflation;
- the risk-free rate—the companies recommend that both nominal and index-linked government gilts should be used as first proxies for the risk-free rate. Moreover, some companies consider that a reliance on September data, which was a particularly volatile period due to the uncertainty relating to general elections and Brexit, inappropriate and also inconsistent with past 'through the cycle' risk-free rate estimates;
- asset beta and debt beta—for asset betas, companies argued for a different rolling period (five years instead of two years). For debt beta, companies considered an estimate of between 0 to 0.1 to be more appropriate than Ofwat's estimate of 0.125;
- the cost of debt—the companies disagree with Ofwat's outperformance wedge and the halo effect on the cost of debt, saying that it does not exist when debt characteristics such as bond tenor are accounted for. For the cost of embedded debt, the companies disagree with Ofwat's exclusion of swaps and other derivatives as well as the proportion of embedded debt in the industry. For the cost of new debt, the companies highlight the inconsistency between the allowed cost of debt based on iBoxx A/BBB indices and the financeability assessment that yields a lower credit rating, with one company arguing for using a BBB iBoxx index to proxy the cost of new debt in PR19.

Bristol proposes a cost of capital range from 2.28% to 2.99% in RPI-real terms accounting for the small company premium. Northumbrian and Anglian propose a range from 2.49% to 2.75% and from 2.5% to 2.9%, respectively, in RPI-real terms.

Financeability

The companies are of the view that Ofwat has failed in its financing duty to make the company 'investable', which has led to a number of recent downgrades by credit rating agencies (CRAs). According to the companies, Ofwat has set the WACC too low and the notionally efficient firm is not investable. This is because Ofwat has:

- underestimated the efficient level of expenditure;
- overstated the performance levels;
- set up a negatively skewed financial incentive regime;
- provided an allowed return on the RCV that is less than the WACC;
- left shareholders to deal with an inadequate interest cover and financeability issues.

The companies also state that Ofwat's assessment is built on incorrect premises, has material gaps, is internally inconsistent, and results in a Baa2 rating or (in the case of Bristol) a Baa3 rating. In particular, they state that:

- Ofwat has not set any clear financeability targets;
- financeability metrics are below the Baa1 threshold,
- Ofwat addresses financeability issues by increasing PAYG ratios, but CRAs look through these adjustments;
- the financeability assessment is inconsistent relative to the cost of debt allowance/WACC, as the cost of debt is based on A/BBB iBoxx indices (i.e. a Baa1 rating) but the notional company is unable to achieve this rating. Therefore, the price control is considered internally inconsistent.

The companies also state that a Baa2 rating for the notional company does not leave any headroom to absorb downside risks, which would have several implications for the business.

Gearing outperformance sharing mechanism

The companies reject Ofwat's gearing outperformance sharing mechanism on a number of grounds, namely:

- it is against finance theory and the Modigliani–Miller theorem and changes the notional gearing from a reference point to a determined level;
- diversity in gearing is needed across companies to account for factors such as different shareholders, governance structures and the nature of debt covenants;
- it is likely to increase bills, as de-levering can have additional costs, removing tax shield benefits and increasing tax allowances.