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BRIEFING NOTE

Ofwat's Risk and Reward Guidance – Gambling on Innovation

On 27 January Ofwat published its much anticipated 'risk and reward guidance', laying out its views on cost of capital (WACC), retail margins and the package of rewards and penalties English & Welsh water companies face for under or out-performing their price controls. With Ofwat's announcement of which companies have pre-qualified for 'enhanced' status just days away, companies and investors will be weighing up the merits of Ofwat's guidance. However, the headline WACC of 3.85% (real, vanilla) announced by Ofwat implies a rate of return that the sector's investors will presumably not be happy with (given the difference between business plans and Ofwat's guidance), suggesting the industry will be considering a combination of:

- Is there a case for a higher WACC?
- Are there other ways to enhance returns over and above the allowed WACC? and/or
- Is now the right time to start preparing to appeal to the Competition and Markets Authority (CMA)?

Is there a case for a higher WACC?

On the face of it, a WACC lower than any company in the industry proposed – and significantly below what most included in business plans – must surely be open to challenge. But on what grounds? And what are the chances of success?

Ofwat argues that the Competition Commission's (CC's) Provisional Findings for Northern Ireland Electricity (and related cost of capital decisions and consultations from CAA and Ofgem) only served to reinforce their own internal views, so the battle would appear to be to convince Ofwat that its analysis isn't appropriate (rather than to tackle the CC's proposals, a topic which hundreds of pages have already been devoted to). However, Ofwat's analysis appears to be in line with other recent regulatory pronouncements and some analysts have suggested the guidance is "reasonable", though all of Moody's, Fitch and S&P have noted the guidance would put negative pressure on credit ratings (with Fitch going further and placing the industry on negative outlook).

Box 1: Pushing back on the WACC

Given that Ofwat's proposed cost of debt is higher than some companies' proposals, the focus is likely to be on the cost of equity. Here, beta and risk-free rate are the parameters which appear most open to challenge, but some other questions also arise:

- Ofwat's proposal adjusts the cost of equity down for the ONS's revisions to the way RPI inflation is measured, but is the overall framework still internally consistent as a result?
- Has the postponement of cashflows (that results from offsetting a reduction in the WACC through a higher expected rate of RCV indexation) been properly factored into the WACC?
- Is the probability of expected returns, taking into account the scope for under- and out- performance, normally distributed? If not, has that been factored into the WACC?
- Is it reasonable that the non-household retail margin appears to be based on a WACC very similar to what the CAA has just proposed for Gatwick Airport and, separately, for NERL (the UK's air navigation service provider)?

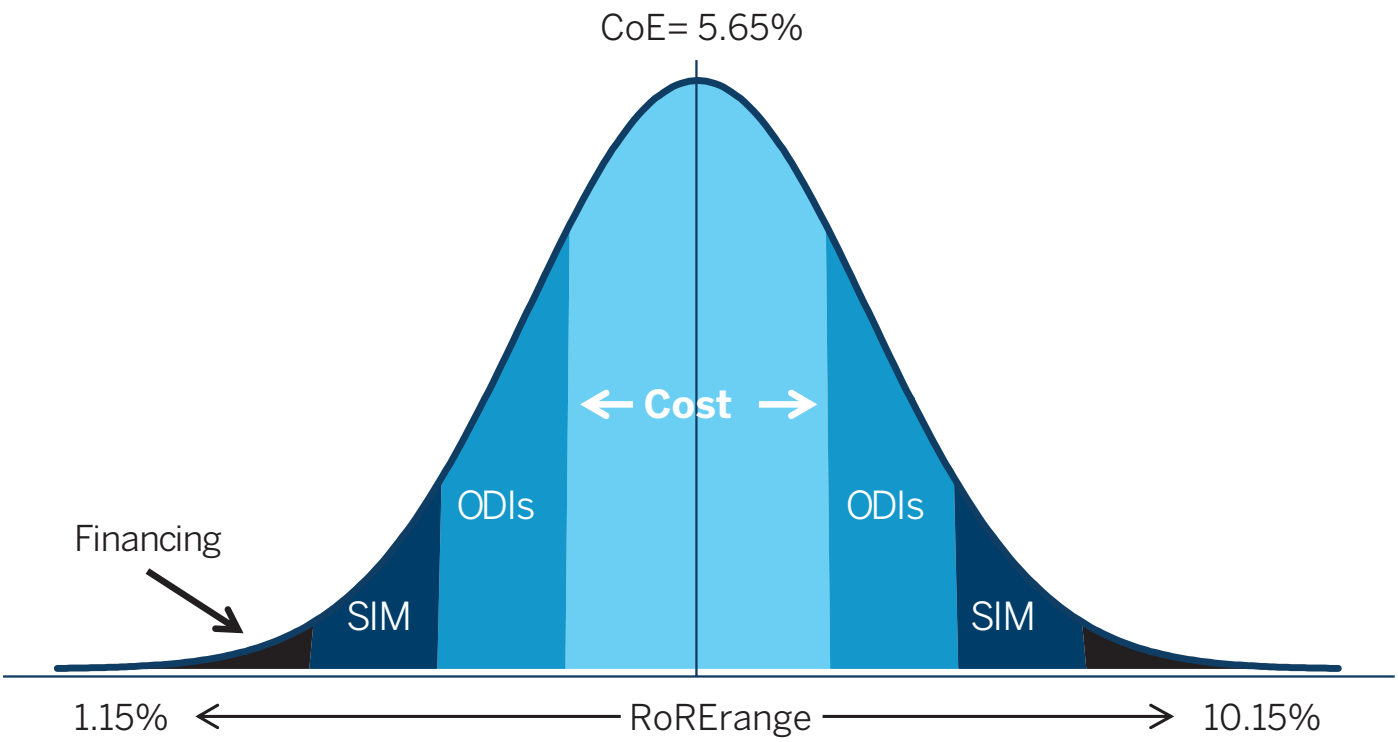
Ofwat's request for more justification for small companies' additional costs of finance obviously also needs to be responded to (not least on the ground that it is difficult to see how Ofwat's guidance is consistent with its financeability duty or with the CC's decision in Bristol Water's appeal in 2010).

Leaving the merits of the debate to one side, Ofwat will be loathe to shift its position lest it create the impression that PR14 is just like all the previous price controls despite the fanfare about changes to its approach. On the other hand, companies might feel compelled to push back to preserve the credibility of their business plan proposals. Of course, companies might also take the attitude that it is pointless trying to respond to Ofwat on the assumption that whatever evidence can be produced will fall on deaf ears. So it might be that a WACC of 3.85% appears in Final Determinations later this year, but even if there is ultimately some adjustment it is unlikely to be very large.

Consequently, the industry is going to need to outperform the price control package in order to achieve a satisfactory rate of return.

Can returns be enhanced in other ways?

Outperformance can be achieved in a range of ways, such as cost (totex) efficiencies, exceeding performance targets (rewarded through outcome delivery incentives (ODIs) or the service incentive mechanism (SIM)) or through achieving a lower cost of finance than assumed.[1] Ofwat's consultation places Return on Regulatory Equity (RoRE) analysis at the heart of its approach to calibrating incentives, suggesting that an appropriate range of returns is +/- 3.5 – 4.5% around the cost of equity. Ofwat has not advanced any justification for why this is an appropriate range, notwithstanding that at an extreme this could imply a RoRE of 1.15%, well below the cost of debt (which Ofgem has typically used as the low end of its RoRE ranges).[2]



Now while those are fairly standard sources of outperformance and it doesn't seem unreasonable for Ofwat to want companies to focus on operational matters rather than financial ones (which Ofwat intends will provide only a small amount of potential up or downside), there are risks to Ofwat's approach. In particular, Ofwat's approach is heavily reliant on successful innovation to deliver out-performance (and a RoRE investors would be more likely to be satisfied with), yet innovation is an inherently risky activity with uncertain outcomes.

[1] It is also possible to enhance returns through performance in the competitive non-household retail market, but this item is not considered further here as it is unlikely to be material given the size of the market and Ofwat did not include this item in its headline discussion of the sources of RoRE out/under performance.

[2] It is also noteworthy that because the SIM has different implications for RoRE for different companies, achieving Ofwat's preferred RoRE range will require different strength incentives for costs, ODIs and finance for different companies.

Box 2: Is it credible to expect rewards from ODIs to be increased?

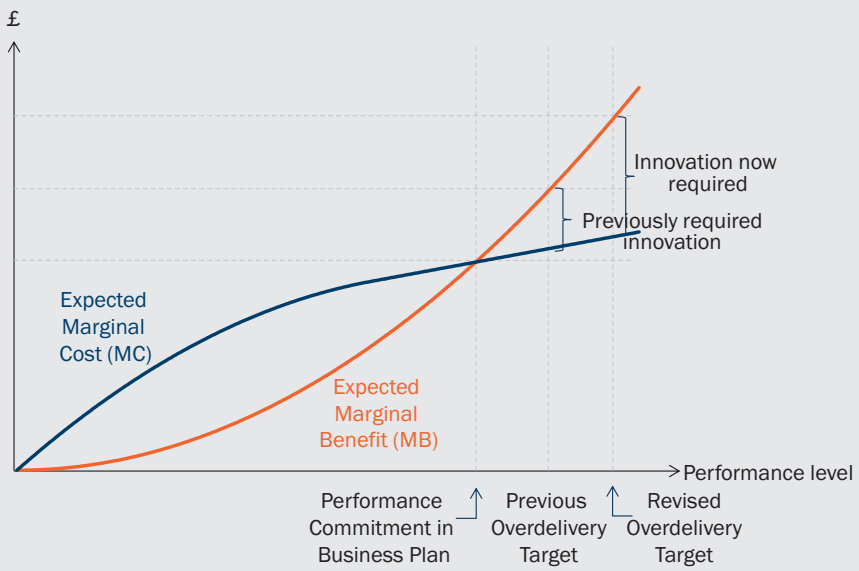
Ofwat has suggested that companies need to revisit their ODIs, but what are the options for increasing the scope of financial rewards from over-delivering against performance targets? Rewards associated with ODIs are a function of several parameters:

- the performance commitment level: the base level of service the company proposes to provide;
- the overdelivery target level: the level of service (above the base level) at which the company receives a reward;
- the cost performance incentive (CPI) rate: the share of the additional costs of providing a higher level of service funded by customers

Accordingly, if companies want to increase the strength of rewards accruing through ODIs, one of these levers will need to be adjusted.[3] A range of options may be availalable:

OPTION	ASSESSMENT
Reduce the performance commitment level	Customers would be unlikely to buy-in to a lower level of service and Ofwat makes it clear companies are not able to revise their totex proposals (which they would want to do if the cost of delivery decreased).
Increase the rewards for meeting the 'overdelivery' target	Allocating more of the benefits of overdelivery to companies (without increasing the size of benefits) comes at the expense of customers, so there may be limited scope to increase companies' share without customers ending up net losers.
Increase the (or add a second 'stretch') 'overdelivery' target	By setting the target even higher, the marginal benefit (WTP) of customers will increase, meaning there is more benefit to be shared around (though it is less likely to be achieved).[4]
Adjust the cost performance incentive rate to allocate a greater share of benefits to companies	The CPI has a significant effect on the rest of the price control and it would be risky to adjust this parameter without visibility of Ofwat's totex cost menu.

If the third option is the only truly feasible one (as the above suggests), then while the marginal benefit (and the available reward) grows as the target is ratcheted up, the expected marginal cost grows more quickly meaning that the scale of successful innovation required (so that outturn marginal cost is less than expected marginal cost) becomes more and more significant. If we assume that the original overdelivery targets were challenging (why else would they not have been included in the base level of performance?) and already required some innovation, then how likely is it that companies will be able to achieve revised overdelivery targets?



[3] This analysis assumes that: (i) committed performance levels were at the economic level (where marginal cost equals marginal benefit) in business plans; (ii) companies cannot readily convert non-financial incentives included in business plans to financial ones; and (iii) trading-off an increase in the share of benefits accruing to companies during AMP6 against a lower share of benefits in AMP7 (and beyond) is not a sustainable solution as it is only a short-term fix that will make achieving a satisfactory RoRE range at later price controls more difficult.

[4] While the customer research conducted by many companies indicated that customers' willingness to pay for overdelivery was limited in many cases, by definition there must be some increase in overdelivery that customers would be willing to pay even more for, allowing the magnitude of rewards available to companies for overdelivery to be increased.

If the extent of innovation required to trigger the rewards under the ODI package is too great, then the probability distribution of RoRE could be skewed to the downside. There may also be other downside risks e.g. a tough totex efficiency challenge could also require successful innovation to meet, further risking the possibility that the range of likely outcomes is skewed to the downside. Given the already very low returns at the bottom end of the RoRE range, it is vital that the risk/reward balance is evenly poised. Only time will tell, but it is not obvious that Ofwat has got the balance right.

Is it time to prepare to appeal?

If the expected rate of return (factoring in anticipated under/out performance) is less than the 'true' WACC that investors actually demand (which itself might be higher than it previously was because of the uncertainty of depending on successful innovation to deliver required returns) then investors and companies might be tempted to appeal Ofwat's determinations to the CMA.

However, the decision to appeal Ofwat's determination depends not only on whether a company is happy with what Ofwat proposes, but also on whether the chances of success appear high. At this early stage, with most components of the price control yet to be unveiled, it is difficult to make definitive decisions one way or the other and it might seem easy to conclude that it is too early to be worried about a potential appeal. However, if a company was to accept enhanced status in March, would it then be able to appeal in December? Would rejecting enhanced status amount to deciding to appeal? Either way, with the limited time available within the context of a pressurized price control delivery programme and the short time permitted to make a decision to appeal once Final Determinations are published, starting laying the groundwork for a potential appeal might be a sensible precaution.

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