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SETTING RETURNS ON REGULATED INFRASTRUCTURE: THE CASE FOR CENTRALISATION

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Introduction

One recommendation from Sir Jon Cunliffe's report is that the CMA should set the WACC methodology for all regulated sectors. Not surprisingly this has important implications beyond the water sector.

The detail of the recommendation is as follows.

- The CMA should set the WACC methodology for all UK regulated sectors.
- It should also set the components of WACC which are not sector-specific.
- In addition, the CMA would also be responsible for:
  - setting standards for the sector-specific components of WACC;
  - specifying regulators' discretion;
  - issuing new guidance (building on the efforts of UKRN); and
  - monitoring and enforcing its application.

We have considered the implications of this recommendation and the options for implementation.

What sort of consistency in setting returns matters the most?

Regulators use an estimate of the weighted average cost of capital (WACC) to determine the allowed return on investment. If the allowed return is higher than, or equal to the investors' WACC one can expect investors to be willing to commit funds to that sector.

Price controls in UK regulated sectors are typically 5 years in length. The asset lives in these sectors are significantly longer (i.e. 40 to 60 years or even longer). Therefore, when investors are making decisions about whether to commit funds, the allowed return is only known for the immediate period (up to five years).

Clearly, the method for estimating the WACC, and setting the allowed return, matters a lot as investors see uncertainty around the method used to set the allowed return in the future as a key regulatory risk. Confidence in the method can reduce the perceived riskiness of the sector and result in a reduction in the cost of finance (i.e. the WACC). Conversely, a lack of confidence in the method can result in a higher WACC and thereby increase costs for the consumer as the allowed return would need to be higher.

If we think about two elements of consistency; consistency over time (i.e. across price controls within the same sector) and consistency between sectors at one point in time. In our view, the most important element is the consistency over time. This is what matters to an investor contemplating a long term investment in a regulated sector. Achieving consistency between the sectors has some value in its own right but is principally important to the extent that it provides for greater confidence in consistency over time.

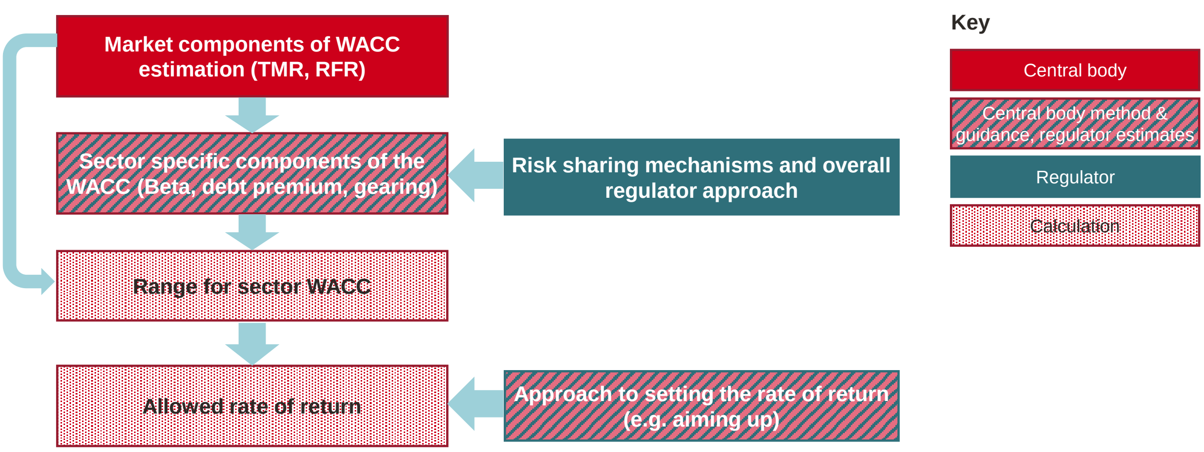
In this context, it is not entirely clear to us that the Cunliffe review has identified the most important root cause for the inconsistency and lack of stability and transparency observed in the setting of the allowed return in the water sector – and the regulated utilities in general in the UK. It has devoted most of its focus and remedy on the consistency between regulators across different sectors. However, without a well-established and transparent way of setting allowed returns across time (especially when market conditions experience seismic changes) investor confidence into the sectors can be undermined, regardless whether or not there is consistency across the sectors.

Below we examine in more detail the recommendations suggested by the Cunliffe review.

The regulatory approach on WACC recommended by Cunliffe review

Figure 1 shows how regulatory decisions on the allowed return might work under the model envisaged by the Cunliffe report. There are elements that would be the sole responsibility of the CMA as the central body; elements where the central body would provide guidance and the regulator would set the values within the guidance; and other elements that would solely be for the regulator.

Figure 1 Regulatory decisions on allowed return



Source: Frontier Economics

We consider each of the elements in more detail.

- **Market components of the WACC.** These components (the risk-free rate and the total market return) are common across all sectors. Therefore there is a good case for consistency of approach. There are important questions that the central body would need to address.
    - First, both the RFR and the TMR appear to exhibit cyclical trends. The central body would need to decide whether to adopt a long-term average approach, to 'follow the cycle' up and down to reflect the market, or somewhere in the middle. The Cunliffe report appears to recommend annual indexing of the RFR. However, as the UK regulators estimate the TMR directly and the ERP is treated as a balancing figure between the TMR and RFR, the indexation of RFR in the price control has limited impact on the overall CoE estimation. The main inconsistency resides with the way in which the TMR is set from one price control to the next, and this is not explicitly addressed in the Cunliffe recommendation.
    - Second, these components, and particularly the TMR, are estimated with some uncertainty. Does the central body determine a suitable range and allow the regulators some discretion, or does it determine a value based on the evidence available to it?
- **Sector specific components of the WACC.** These components are the Beta, debt premium and gearing level. The Cunliffe report envisages that the central body would set out guidance and possibly tramlines for these components but the decisions would be made by the sector regulator. These components capture the relative riskiness of the sector, including the regulatory methodology for the sector.
- **Regulatory risk mechanisms and overall regulatory methodology.** The sector regulator, in addition to deciding the sector components of the WACC, will also design the risk sharing mechanisms within the price control methodology. These mechanisms, along with the stability and predictability of the overall regime, play an key role in determining the level of risk faced by investors and therefore feed directly into the sector components of the WACC. There is a question therefore whether the guidance and tramlines from the central body ends up influencing the design of the risk mechanisms and, if so, whether the constraints imposed are ultimately in the best interests of customers.
- **Setting the allowed return based on the range for the WACC.** One of the key decisions a regulator makes is where to set a value for the allowed return. There has been extensive debate about the case for 'aiming up' (i.e. setting the return above the midpoint of the WACC range). The Cunliffe report does not refer to this component of the decision. However, assuming that the case for aiming up would be sector specific, one could expect the sector regulators to be responsible for this, presumably subject to guidance from the central body.

This highlights the complexity of the rate of the return decision and the inter-linkages with the overall regulatory methodology. For example, a regulator may wish to change the power of incentives in the wider methodology. On a forward-looking basis this may change the systematic risk the sector they regulate is exposed to. How would a central body take account of this inter-linkage? Would potential 'tramlines' provided to the regulatory be wide enough to accommodate changes such as this?

Therefore, separating this decision between separate authorities does present challenges. Below we discuss the opportunities, risks and implementation issues arising from these decisions.

Assessment and issues for implementation

Table 1 summarises the issues that would need to be addressed in the implementation of this recommendation.

Table 1 Implementation of Cunliffe recommendation on WACC

	Opportunities	**Risks**	**Issues to be addressed**
Market components of the WACC	More consistent TMR and RFR decisions across sectors. Improved investor confidence reduces regulatory risk and required returns.	Will investors be confident in consistent decisions over time. New body could be seen as more exposed to political influence.	**Is long-term average TMR the right approach, in the face of market conditions significantly different from average?** Does the central body sets values or ranges for components? What is the process for reviewing the method for these components?
Sector specific components of the WACC	Combination of guidance from central body and detailed sector regulator knowledge results in good decisions on Beta, debt premium and gearing. Guidance encourages regulators to make sensible decisions on risk mechanisms.	Guidance is too prescriptive or too vague – leading to poor decisions and undermining confidence Insufficient room in these components to ensure the overall allowed return is appropriate for the sector price control	Does the guidance from the central body cover methodology or outcome, or both? Does the regulator have sufficient discretion to properly reflect the sector specific characteristics.
Setting the allowed return	A method is established for setting the allowed return from the WACC range that	This component becomes overly 'tactical' and	Does the central body provided guidance for this component?

	Opportunities	Risks	Issues to be addressed
	is understood and accepted by investors.	decisions are made on short-term considerations.	

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There are a few key themes in this assessment.

- **A good WACC methodology involves a balance of method and discretion.** The experience of the past 30 years has shown that it is not possible write down a complete method that works in all circumstances. The ability to adapt the method, or even to depart from it to some degree, can be valuable. It will be important therefore to allow for the new approach to incorporate an appropriate level of discretion, to enable regulators to deal with events (such as the global financial crisis or Covid pandemic) that are challenging to anticipate.
- **The exercise of discretion can be a positive or negative for investor confidence.** Linked to the above point, when the discretion is transparent, predictable and justified by the circumstances, then it can reinforce investor confidence in the overall system and reduce the perception of regulatory risk. However, sometimes application of discretion could have the opposite effect (see Exhibit below).

Example: where divided responsibilities could increase risk

A situation where the central body has set the market components below the level that the sector regulator considers appropriate for this price control. This could be due to decisions around long-term versus short-term evidence, or because the central body has selected too narrow a range.

In response the sector regulator could use its discretion over the sector components (e.g. using a Beta value at the top/bottom of a reasonable range). However, if this is not sufficient then the regulator is faced with one of two out-turns. Either the regulator could set the rate of return below/above the level it considers appropriate, or it could 'stretch' the sector parameters (e.g. Beta) beyond what is justified by the evidence (because that is the only lever that it has to achieve the rate of return). Either out-turn could undermine investor confidence and therefore be counter productive against the objective of the reform.

This situation is not necessarily a likely outcome but it is certainly a possible one, and minimising this risk would require careful consideration in the implementation.

- Under the approach recommended by the Cunliffe review, the decisions around method versus discretion become more complex, with the central body making these judgements for the market components and regulators making the judgement for the sector components (but subject to some constraints). Developing good practice in this area will be fundamental to the successful implementation of this approach.
- **Central body role in sector components needs careful thought.** There are a myriad of options for how the central body could provide guidance on the sector specific components. This particularly relates to the Beta. There is benefit of consistency in method for Beta estimation but, at the same time, there are many dimensions to the method for Beta estimation. These include: how to select appropriate comparators; the time period for the estimation; the data frequency and regression method; and so on. For some of these there may be a robust basis for establishing best practice, but for others the appropriate method will be context dependent and will vary over time. An alternative approach would be for the central body to identify 'tramlines' for the Beta (specifically the asset Beta) for sector, based on its assessment of relative risk. This though would require the central body to have an understanding of the risk and regulatory characteristics of the sector, creating an overlap with the role of the sector regulator.
- **The CMA as the central body.** Finally, the Cunliffe report has identified the CMA as the appropriate central body for this WACC setting role. In our view there are potential drawbacks with this aspect of the proposal.
    - First, the review considers the CMA as a more 'independent' regulator as it has been deferred to for the purpose of appeals and redeterminations, but it is not clear to us that if the CMA were to put in the same 'front line' position as the sector regulators it would be immune to the pressures that arguably have caused these inconsistencies across the regulatory decisions to date. We therefore do not see a priori clear reasons why the CMA can be expected to do a better job than the sector regulators if put in the same position. If the only added benefit is so that decisions across sectors are consistent, it could still be that they are consistently wrong, and/or inconsistent across time, which would not be a guaranteed improvement from the status quo.
    - Second, in our view undertaking this role would require a detailed understanding of the landscape of infrastructure investment and infrastructure investors. This does not fit naturally with the CMA's core responsibilities and activities. Arguably the National Infrastructure Commission or NISTA would be better suited to this role.

- Third, it is suggested that a benefit of the CMA taking this role is that it would make appeals of the rate of the return unnecessary. However, the option to appeal the decision to the CMA is part of the process that gives confidence to investors about the robustness of the process. Downgrading the option for a substantive appeal process could be a concern to investors.

Overall conclusion and next steps

We have assessed the recommendation made by the Cunliffe review on the regulatory WACC setting approach. We see opportunities but also some material risks from the recommended approach for both the water sector and regulated utility sectors in general.

We think that one of the most important and urgent issues to be resolved is how regulators should balance the long-term average levels of returns and the prevailing macro environment which puts pressure on the appropriateness of such long-term averages in price control periods; where the market demands a level significantly different from such averages.

We do not see having a central body making these decisions necessarily a solution to this problem, enough though it may promote some consistency across sectors. A more thorough debate on the appropriate methodology and policy instrument to achieve this balance would be a more direct remedy for this problem and is urgently needed in the current environment where investment need is paramount and the macro conditions are less accommodative than the previous decade. To this end, Frontier has developed a policy discussion paper on the way the TMR should be set GB regulated utilities which strikes the right balance between stability and market reflectiveness in a transparent and predictable way. This paper has been submitted to Ofgem as a part of the RIIO-3 consultation process.

Further, even though there may be merit in concentrating the decision powers of market parameters into a central body, we see some concerns with the CMA being the institution taking up this responsibility. The CMA is currently the appeal body, and its direct involvement of decision making could negatively affect the effectiveness of the appeal process, which has been a corner stone of the UK regulatory landscape that has helped cement regulatory accountability and maintain investor confidence. A different body, who is more familiar with the infrastructure investment environment, who is currently not involved in the regulatory process, may be more suitable if such central body role is to be established.

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