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south east water

# South East Water

CMA submission

1<sup>st</sup> June 2020

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# 1. Introduction

This submission is presented in the context that the CMA are required to redetermine the price controls for the four appealing companies and in doing so there are some key areas the CMA has the opportunity to rethink approaches adopted by Ofwat at PR19 that would be in the best interest of customers, the environment and the future sustainability of the water industry.

In this document we include a number of proposed solutions in key areas – specifically in relation to funding for growth expenditure, cost of debt and the gearing outperformance mechanism.

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## 2. Executive Summary

We recognise there are many positive aspects to the PR19 price review process and the high quality of business plans submitted by companies in response to the challenges set out by Ofwat.

South East Water (SEW) submitted a highly ambitious plan with significant support from our customers for the investment needed and service levels we would deliver. Although we did not request that the Final Determination (FD) for SEW was referred to the CMA, it cannot be assumed that we do not have significant concerns or that there are not superior approaches to those adopted by Ofwat in their determination. The challenge that our Board faced in determining whether to seek a redetermination, is not one of 'acceptance', we at no point have accepted the determination, but of consideration of the significant risk, cost and time of an appeal. The decision to not appeal to the CMA was one of the hardest decisions our Board has had to make in many years. One of our Board's key discussion points focussed on the determinations impact on the future reputation, resilience and financeability of the sector. We believe there are superior alternative approaches that could have been adopted that would have maintained the desired ambition but would also have done so in a way that properly recognises the challenges the industry and individual companies face.

This submission details key concerns with areas of principle and methodology and proposes alternatives in specific areas that we believe the CMA should fully consider when making its own determinations.

### 2.1 Key concerns regarding areas of principle

#### Customers

A business plan has to be developed based on the needs and expectations of customers. We were pleased to see this aspect being a key priority for Ofwat in the PR19 Final Methodology.

Customers were at the heart of our business plan and it was their priorities and views that rightly influenced all aspects of it. For example they shaped the overall priorities, the performance commitments, the stretch of the targets, the design of the incentive rates, the improvements in levels of service that they were willing to pay for.

However, our concern throughout the Draft and Final Determination stages of the process was that Ofwat removed many aspects of our customers' important input to our ODIs. In particular the PR19 process has attempted to create a "virtual upper quartile company" by selecting certain companies to drive each individual performance commitment to a new, untried and untested "package of performance" that, in its entirety, we would argue no company has or can achieve.

Challenging the industry to improve its performance is commendable and necessary, but we maintain that if performance commitments and ODIs are set without any link back to operating conditions or customer preferences, it creates unsustainable risk – not just financial but reputational for individual companies and the industry too. Whilst we have some sympathy with the argument that there would be complexity in setting individual companies performance packages based on local preferences we believe this is not an area where simplicity should be allowed to override legitimacy.

**In its determination the CMA should ensure customer views are taken into consideration when setting Performance Commitments, ODIs and the necessary level of investment to achieve these.**

### Resilience

Resilience was a key focus for many stakeholders and for the industry at PR19 to ensure that there is adequate investment when considering the needs of both current and future customers. This was a key part of our business plan and one where customers supported stable bills over 5-10 years, rather than a bill reduction, to ensure the necessary investment was made to improve resilience. Ensuring there is adequate investment in the short term ensures that future customers do not face substantial bill increases in the longer term.

A significant number of our enhancement schemes to improve resilience were rejected or grossly underfunded by Ofwat at the Final Determination. We note that this approach was replicated across the industry with reductions made to many resilience proposals made by companies. Throughout the process it was unclear how Ofwat assessed the acceptability of resilience schemes and it appears to us that there was no clear policy objective or targeted outcomes on which these decisions were based. All the schemes we presented demonstrated clear resilience benefits yet many were rejected.

**In its determination the CMA should have a clear articulation of the desired resilience outcomes driving its assessment of required resilience investment and fund accordingly.**

### Risk and return

Ofwat's overall PR19 FD risk-reward package is skewed towards downside risks: the lower totex allowance increases the likelihood of overspend, and despite SEW being an above average company in the majority of the key measures we expect to incur significant penalties from performance commitments and associated ODIs in part because they fail to reflect our operating environment, weather conditions and the impact of climate change. This is evidenced by Ofwat's and our own downwardly skewed RORE assessment.

This implies that we cannot expect to earn the cost of capital over PR19, compromising the financeability of our business. The overall package of expenditure allowances and Performance Commitments / Outcome Delivery Incentives for companies should be calibrated to ensure similar upside and downside risks.

While we can anticipate some variations in returns from price control to price control, a sub-2 per cent real return on equity is not acceptable. Taking account of expected penalties for

underperformance on ODIs and the gearing outperformance mechanism, our expected return to equity over PR19 is around zero. A rate of return of return around zero for an above average performing company is not sustainable.

**In its determination the CMA, in the absence of such adjustments, the CMA should set a higher allowed rate of return, to compensate for the expected underperformance and ensure that companies can expect to earn the true cost of capital during PR19.**

## 2.2 Specific areas of concern

We include below a summary of our concerns for three specific areas - funding for growth expenditure, cost of debt and the gearing outperformance mechanism. Sections 3 to 5 expand on these areas in more detail.

### Growth expenditure

The funding of growth expenditure has always represented a challenge over many price reviews. This is highlighted by the fact that the same approach has never really endured for more than one 5 year cycle and indeed was changed by Ofwat a number of times during the PR19 process.

This is a crucial area to get right in that growth inevitably places resilience challenges on existing infrastructure and if not handled appropriately will lead, as it has in our case and also notably in Anglian Water's case, to a continual reduction in resilience.

We describe in Section A the issues we have identified with the current approach used at PR19 and provide some alternative methods for calculating a more appropriate level of growth expenditure.

The actual activity included within growth expenditure is simple, repeatable and the type of work of day to day water company business including for example connecting stop-cocks, meters, mains connections and small networks. However the drivers of the volumes of these activities are complex.

A fundamental problem with the current regulatory process is that it does not capture the real drivers of growth, such as capacity of the existing network and the size of the developments being built. Instead, to help explain growth costs, Ofwat have attempted to use poor alternatives such as the number of connections. This ignores the fact that a connection in one area of the country can consist of a meter, stopcock and a short length of main whereas in an area of continuous growth and less network capacity it can involve significant upstream network improvements including new trunk main networks, booster stations etc to allow that final connection to meet minimum standards. Ofwat have argued that other drivers such as density capture these effects, however this is not correct as an area's density has no correlation to its capacity – there are many other factors involved including the change of use over time in the area, for example from industry to domestic, and the demographics and affluence of the population.

In the absence of this critical capacity data Ofwat have utilised a number of approaches during PR19 to arrive at a determination. For example, Ofwat attempted a simple unit cost model at the IAP stage of the price review and then changed this at the Draft and Final Determination by including growth expenditure into the base cost models. Both of these methods result in companies with ongoing growth being grossly underfunded despite some small out of model adjustments being made to reflect growth in the Final Determination.

#### ***Our request to the CMA for growth expenditure***

Pragmatically, and in the absence of the appropriate cost drivers, we proposed an alternative approach. As articulated earlier the activity needed to invest in growth is simple, regular and is often carried out using the same contractors, management teams and procurement approaches as the activity in base costs. We therefore proposed in our Draft Determination response that Ofwat use the investment proposed by the company and then apply the base efficiency challenge derived from the botex models (excluding growth to avoid any overlap).

In the longer term, i.e. for PR24, a wider set of cost drivers needs to be collected and assessed with the potential to use it in a botex model (as part of any base cost assessment) or for use in its own model.

However this is not practical in the timeframe for the CMA determinations so, we reiterate, to ensure that companies with significant growth expenditure are not subjected to a mechanism that in effect decreases their resilience, due to a lack of growth funding, we suggest the CMA considers the approach we have explained above in its determination.

See section 3 for further details.

#### **Gearing outperformance mechanism**

Ofwat has proposed a gearing outperformance mechanism which introduces a penalty where actual gearing exceeds notional gearing, with the penalty based on the difference between the allowed return on equity and cost of debt. We do not believe that the mechanism is in the customers' interest.

Ofwat considers that shareholders enjoy benefits from higher returns at higher gearing, but there is no support for this assertion in theory or in regulatory practice. Mainstream finance theory shows that a company's cost of capital is independent of its capital structure. This is not only a theory but a rule of thumb adopted by financial practitioners and economic regulators. Ofwat has also claimed that higher leverage passes risks onto customers in terms of service deterioration in the event of financial distress. However, there are many mechanisms that both Ofwat and water companies have put in place to mitigate the risks of financial distress, including requirement to maintain an investment grade rating, covenant provisions which ensure dividend lock-up etc. We also incur penalties for deterioration in service provision under performance commitment levels and ODIs.

***Our request to the CMA for the gearing outperformance mechanism***

In its determination the CMA should not impose this unjustified mechanism.

There is no theoretical or empirical support to justify Ofwat's gearing penalty based on the difference between the notional cost of equity and the cost of debt. If the CMA has a concern around financial resilience and the impact on customers, then existing policies on financial distress and the penalties associated with discontinued service should be reviewed.

See section 4 for further details.

**Cost of debt**

Ofwat's overall approach to the cost of debt is a one-size-fits-all which determines a single cost allowance for all companies in the sector. The approach fails to recognise the relatively small size of SEW and other WOCs, with our concentrated debt profiles, which lead to materially different historical debt raising costs and future funding requirements.

For the cost of embedded debt, Ofwat determined a single industry cost allowance based on a trailing 15-year average of the iBoxx index less an outperformance wedge of 25 bps. It also adopted a weighting of embedded: new debt of 80:20 drawing on wider industry evidence compared to our weighting of 96:4. Ofwat's approach failed to recognise the higher efficient financing costs of smaller water-only-companies. We provided evidence to support a small company adjustment for the higher efficient incremental debt costs incurred by small companies of around 30 bps.<sup>1</sup> We also presented evidence to support the use of a 20-year trailing average index value, which is in line with the average tenor at issuance and therefore encompasses a far greater share of historical WOC debt issuance. The weighting on embedded debt should reflect smaller companies infrequent issuance, and the expectation that many smaller companies will have no material debt issuance over the forthcoming regulatory periods. We therefore request the CMA adopts these adjustments to reflect the specific financing characteristics of small companies and their higher efficient costs of debt.

For the cost of new debt, Ofwat's assumed a reduction of 15 bps for alleged outperformance of the iBoxx index. In our PR19 submissions, we demonstrated that no such outperformance wedge exists once differences between tenor and rating are correctly accounted for.<sup>2</sup> In its response to the companies' Statement of Case, Ofwat argues that it does not need to make any adjustments for tenor or rating. We disagree. Ofwat sets the cost of new debt allowance for a notional company and therefore, for consistency, it must assume that companies issue debt at the notional rating (A/BBB, as per its benchmark index) and for a tenor consistent with this benchmark index (at around 20 years).

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<sup>1</sup> NERA (August 2018), Cost of Capital for PR19, section 4.3.

<sup>2</sup> NERA (August 2018), Cost of Capital for PR19, section 4.5.



Overall, Ofwat has determined a cost of debt allowance of 4.18 per cent (nominal) compared to our cost which is closer to 6 per cent, based on Ofwat's own analysis.<sup>3</sup> Our failure to recover debt costs will result in our expected return to equity declining to less than 2 per cent in real terms over PR19 based on a notional structure, permitting no meaningful dividend payments and no de-gearing.<sup>4</sup>

While we can anticipate some variations in returns from price control to price control, a sub-2 per cent real return on equity is not acceptable. Taking account of expected penalties for underperformance on ODIs (including our own assessment of the significant improvements we are forecasting to achieve) and the gearing outperformance mechanism, our expected return to equity over PR19 is around zero. Ofwat's approach to ensuring that we are financeable on a notional basis relies on adjustments to pay-as-you-go (PAYG) and run-off rates from their natural rates, and are not sustainable over successive reviews.<sup>5</sup> The sustainable approach is to correct elements of Ofwat's determination for the allowed rate of return.

#### ***Our request to the CMA for cost of debt***

On the cost of embedded debt, the CMA should move away from Ofwat's one-size-fits-all approach and re-determine a number of elements for smaller companies: to adjust the notional cost of debt for a small company debt premium; to draw on a 20-year trailing average in line with the efficient tenor at issuance; and, apply a greater weighting on embedded debt. The overall framework should reflect the financing characteristics of small companies and their efficient costs of debt.

For the cost of new debt, we request that the CMA removes the negative adjustment for the outperformance wedge of 15 bps and includes a small company premium.

See section 5 for further details.

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<sup>3</sup> Ofwat (December 2019) PR19 final determinations: Allowed return on capital appendix, p. 5 & p. 91.

<sup>4</sup> Calculated as:  $2.92\%$  (Ofwat's real CPIH allowed return) less  $[0.6 \cdot (1 + 5.9\%) / (1 + 2\%) - 1]$  (Ofwat's estimate of our real cost of debt), all divided by 0.4 (Ofwat's notional equity) = 1.6%. Source: Ofwat (2019) PR19 final determinations: Allowed return on capital appendix, pp 5& 91. Link: <https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Allowed-return-on-capital-technical-appendix.pdf>

<sup>5</sup> For changes to our PAYG and run-off, see: Ofwat (2019) PR19 final determinations: Aligning risk and return technical appendix, pp 62-63. Link: <https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Aligning-risk-and-return-technical-appendix.pdf> In our business plan submission to Ofwat, we set out that flaws in the cost of capital methodology should not be addressed through bringing forward revenues. See: SEW Business Plan Annex: NERA (August 2018) SEW Financeability Assessment for PR19, section 2.1

### 3. Section A: Detailed Response – Growth expenditure

#### **New connection growth**

Each year the number of connected properties for a number of water companies will increase for both domestic and commercial properties. This is significantly influenced by external factors outside of the water company's control and will vary considerably across the UK and therefore for each water company area.

In order to plan for this growth companies will use forecast data from a range of sources including developers, local planning authorities, relevant statutory bodies and other infrastructure providers.

Water companies have duties under section 37 and 94 of the Water Industry Act 1991 to develop their networks in order to meet increasing demand due to new connections. Companies are entitled to recover reasonable costs of making the connection, including the cost of laying a service pipe from the main to the boundary of the public highway. This may also result in further investment in the network infrastructure to accommodate the connection(s). The company is entitled to charge for providing the main and any necessary network reinforcement, but must allow for future income that it will receive from the newly-connected property. Additionally water companies are entitled to raise an infrastructure charge (under section 146 of the Water Industry Act 1991) when a property is connected for a domestic water supply for the first time. This covers the cost of improving the distribution network to meet the demand created by the new connection over time. The way a company calculates the infrastructure charge is set out in its licence condition C.

In some instances customers of new connections may choose their own contractor to do the work, which is known as 'self-lay'. The monopoly company will take over responsibility for ('adopt') self-laid infrastructure that meets the terms of its adoption agreement with the owner, developer or self-lay organisation that carries out the work

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## Introduction

In our business plan, we forecast the following costs associated with connecting new properties to our network over the course of AMP7.

### Our business plan cost forecast for AMP7 for new connections

	Forecast cost £m
New developments	53.22
New connections	30.52
Enhancement	0.40
<b>Total</b>	<b>84.14</b>

At the Final Determination Ofwat set companies' cost allowances for new connections using its base cost models. Based on modelling analysis and discussion with Ofwat we estimated that only 68% of our proposed £84m investment had been allowed - causing a shortfall of £27m.

In Ofwat's "supplementary information for all companies – grants and contributions" document they acknowledge that the current approach to modelling new connection growth capex will lead to a shortfall due to insufficient cost driver information:

*"We acknowledge that a number of different approaches could have been used to derive an estimate of our developer services cost allowance out of our 'modelled base plus' allowance, and note that the approach we have opted for is likely to result in a conservative estimate of our growth cost allowance as we were unable to identify growth opex in the historical cost data."*

Our Draft Determination response<sup>6</sup> strongly challenged the underfunded expenditure in this area and maintained that our business plan forecast for new connection expenditure was robust, efficient and fair. Behind our certainty on this point is that our forecast of volumes is broadly aligned with Ofwat and the activity we are planning is the same sort of activity we are undertaking in base costs where we were deemed to be efficient. The difference is we need to do more of this activity as our developments are large and our capacity has been eroded by historic growth as explained below.

### Econometric Modelling Shortfalls

In our Draft Determination response our principle challenge was that the Ofwat base econometric models were not suitable to forecast future new connections costs due to key explanatory drivers to new connection expenditure being absent.

<sup>6</sup> <https://corporate.southeastwater.co.uk/media/3474/chapter-3-securing-cost-efficiency-final.pdf>

Ofwat do outline that growth related expenditure can be explained by similar cost drivers to both operational and capital maintenance. We agree that activity can be similar from an operation perspective however the drivers, or triggers, to undertaking this activity are different. New connection activity is driven by economic growth, and meeting this growth can sometimes require significant upstream network (and lumpy) expenditure to ensure the service for the new connections and our existing customer base in that area meets minimum standards. These factors are not reflected in standard operational and capital maintenance drivers.

We note that in Ofwat's response to Anglian's statement of case they acknowledge this issue:

*"...we accepted the company's representation that the integrated models may suffer from missing growth variables and that may lead to the base econometric models only funding the average historical growth rate across the industry."*

In response Ofwat has attempted to correct this by introducing cost adjustments outside of the econometric modelling, however these adjustments are dependent on whether the company operates in a relatively high or low growth area relative to the industry average.

There are numerous other factors that have a significant impact on new connection expenditure which are not reflected in the econometric modelling, or cost adjustment, undertaken by Ofwat.

The next section outlines the explanatory variables that need to be reflected in Ofwat's econometric modelling, or subsequent cost adjustment, in order for there to be adequate growth expenditure funding for companies.

### **New connection costs not adequately allowed for in econometric modelling**

Ofwat's cost modelling effectively produces forecasts based on historical data from all companies. However, we note that our costs have been increasing over time, and this is not due to inefficiency but due to legitimate reasons (explanatory factors) on the ground. We are therefore concerned that Ofwat's approach ignores this trend, and misinterprets changes or differences in costs as a sign of inefficiency, when this is not the case.

We describe reasons for these increasing costs below.

#### **On-site mains**

The cost of our on-site mains work has risen steadily over the last 5 years due to two key reasons:

- Average meterage per site and corresponding ancillaries such as fire hydrants has been increasing; and
- Excavation and reinstatement requirements onsite have been changing.

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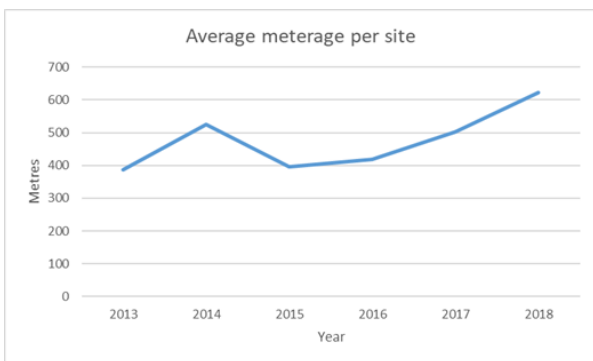
<sup>7</sup> section 1.42, Response to Anglian Water's statement of case, Ofwat, May 2020

The cost of our on-site mains activity is a contracted rate, derived via a fully tendered process and is therefore market derived and inflated by RPI annually. This contract has been in place for the whole of AMP6 therefore showing that the increase in costs over time have not been driven by price-effects or inefficiency, but rather by the type and complexity of work required.

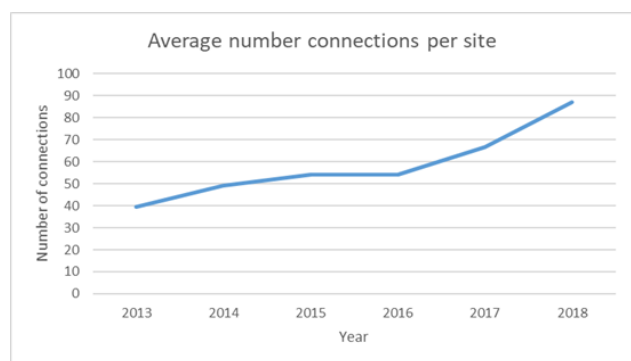
**Average meterage per site has been increasing**

The housing market has changed over recent years with a move away from smaller and infill sites to larger sites that have longer mains per property. This increase in the size of sites and therefore the meterage and ancillaries per site inevitably increases the cost for each new connection. This is shown in the two charts below.

**Figure 1: Meterage has been increasing**



**Figure 2: Sites are now bigger**

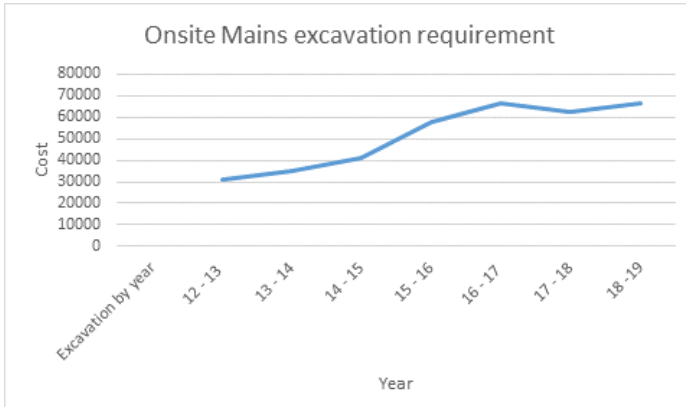


With Ofwat’s models relying on historical data, but without these relevant cost drivers, it will lead to a misinterpretation of lower costs as being more efficient. There are also likely to be considerable differences in the size of developments across the country therefore without this data accurate expenditure forecast for each company would not be possible.

**Excavation and reinstatement**

The type of work carried out on site is also changing. Historically all excavation on-site was carried out by the developer (and therefore not part of a water company’s expenditure). But now, we are finding it more common that once we attend site we are required to carry out some excavation and reinstatement. The rise in our excavation work over the last 5 years is shown below.

**Figure 3: The volume of excavation work has been increasing**



Similar to average meterage per site, not allowing for this factor will lead to a shortfall in funding. This factor will also not be consistent across the country and will be another driver of variation between companies.

#### **Other on-site factors impacting on cost**

There are also a number of other factors that impact on on-site mains costs that are also increasing steadily over time:

- The increased precautionary use of barrier pipe on contaminated sites, which is a more costly option;
- Different reinstatement requirements such as crushed concrete; and
- Higher amount of demobilisation and remobilisation on phased developments, where we are requested to lay mains in a phased way rather than laying all the mains in one go, typical of the larger sites now being built; and
- Activity for managing and mitigating any environmental impacts.

Combining all of these factors above, we have seen an upwards impact on the average cost of on-site mains construction driven by changes in activity and not by inefficiency of delivery.

#### **Traffic management costs**

We have seen a significant rise in traffic management costs in our area, with more connections being made in the highway, which requires road closures or other significant types of traffic management. The introduction of the first scheme in the UK of this type the Kent Lane Rental scheme (which impacts us more than other companies) in 2013 has also impacted our costs. It should be noted that the rise in traffic management costs will also impact connections in the highway for new development sites.

The above factors demonstrate that growth costs vary over time and over regions due to development size typical of the South and East and without the appropriate model drivers growth costs are inappropriate for use in econometric models. This issue is not isolated to on-site activity but is also a factor of off-site activity including reinforcement.

#### **Network reinforcement costs are not comparable**

Some new connection activity can require significant (upstream) reinforcement to ensure sufficient resource capacity is adequately supplied to the new properties. This can include new trunk main networks, booster stations etc to allow all connection a good standard of service.

It is not appropriate to carry out high level benchmarking of network reinforcement costs using models that exclude capacity as a driver.

Network reinforcement varies from region to region, and also over time even for the same company, as it is dependent on the level of capacity available in the network.

A company could add many new connections but spend relatively little on network reinforcement if it happens to have spare capacity in that area. Conversely, a company could add a relatively low number of new connections, but still require a high amount of

reinforcement if it does not have spare capacity in that area. Therefore, any differences in these cost between companies should not be used to judge efficiency in providing the underlying service.

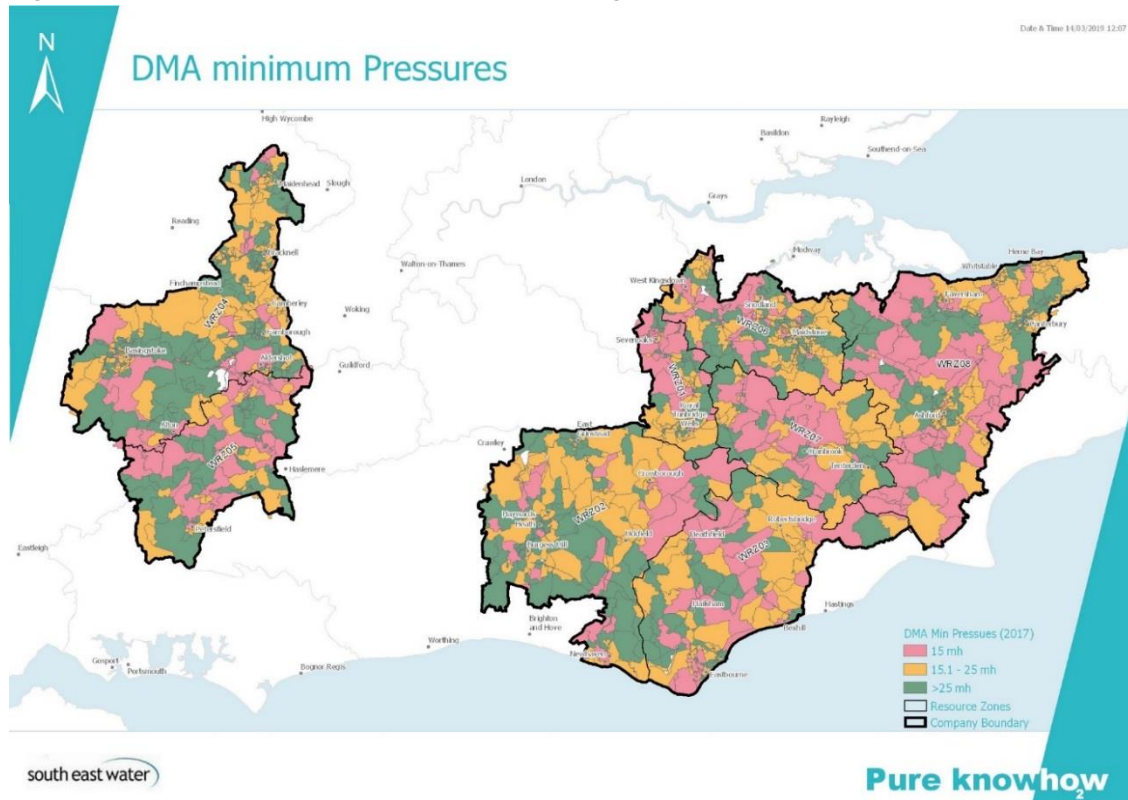
In our Draft Determination response we demonstrated this effect within our own region and we summarise this below in figures 4 and 5. Our evidence clearly shows that areas with growth and limited capacity incur more expenditure compared with areas of similar growth and greater capacity.

A large proportion of our network is already near capacity with many of our District Metered Areas (DMAs) operating at or near pressures of 15 metres head (mh) and parts of the network are fed by small diameter mains with high head losses. This restricts our ability to absorb more development or an increase in demand for water without the need to reinforce our network so the service to our existing customers is not compromised. This reflects our historic approach of trying to achieve maximum utilisation of our asset base avoiding customers paying for potentially unnecessary capacity

Based on the data from our local planning authorities, and areas identified by Government policies as key to growth, we can see that the larger developments are planned in areas where we do not have any additional capacity. Therefore further network reinforcement is required.

The figure below shows our supply area and those DMAs (identified in pink) as being at or near maximum supply capacity, based on the minimum pressures seen at peak demands and velocities in the existing mains.

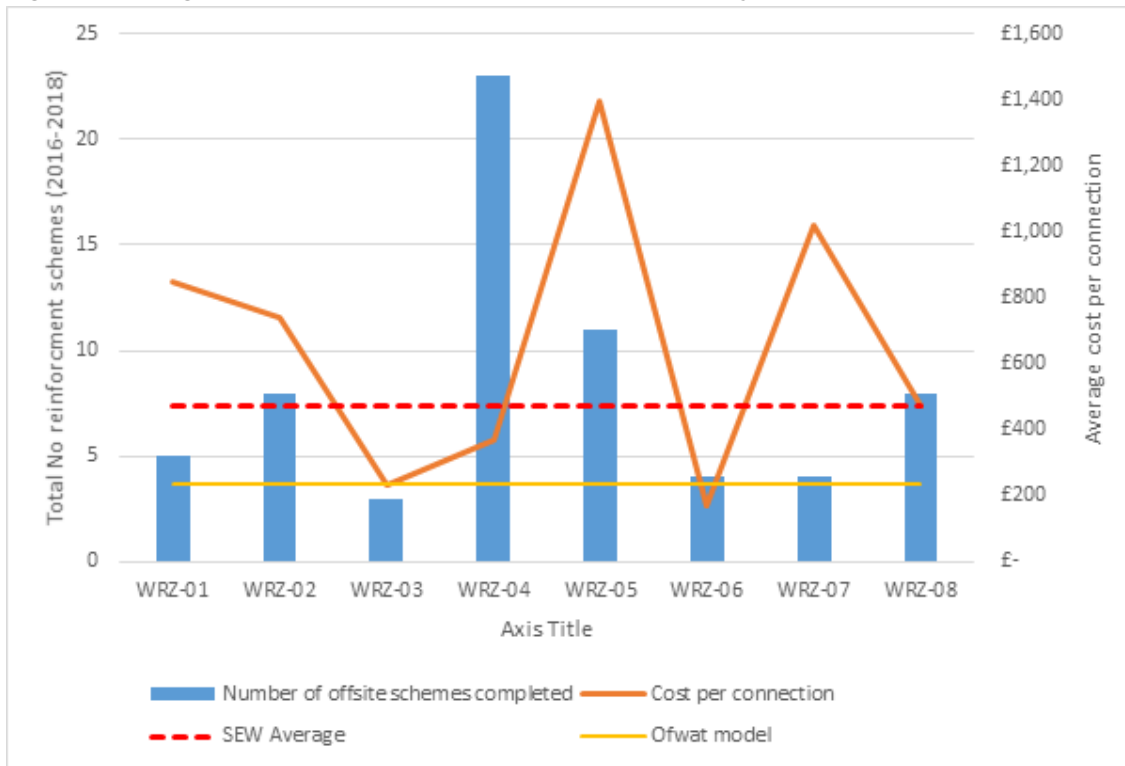
Figure 4: DMA pressures for the South East Water region



The below chart shows the number of schemes completed or planned and the average cost per connection – for each of our water resource zones (WRZs) – over the current five-year period.



**Figure 5: Average cost of offsite reinforcement per connection by WRZ (2014 – 2018)**



This shows that some WRZs require more reinforcement work than others due to the existing network capacity. It also shows the average cost per connection varies depending on where and how much offsite work is required. As explained above all activity is procured using the same schedule of rates with the same contractor and management team so the only variable is the scope, not the price of the work.

Under Ofwat’s current approach a company which forecasts a high (but efficient) level of cost for network reinforcement would be penalised as all new connection costs would be deemed inefficient. This is a flawed approach as it penalises companies with networks close to capacity (through effective network management) and will lead to a reduction in overall network resilience.

**Forecasting Growth**

The price review process required all companies to produce a forecast for growth in their region. Companies will do this through using data from a range of sources including developers, local planning authorities, relevant statutory bodies and other infrastructure providers.

We note that Ofwat has instead chosen to use a single source of the ONS forecast.

Given that companies have obligations under the Water Industry Act to appropriately plan for growth we consider that company forecasts, using a range of data sets, will be a more robust reflection of future growth, rather than reliance on ONS forecasts produced in 2016. We acknowledge that the ONS data could be used as a check against company submissions but should not be used to replace company forecasts.

**Data inconsistencies**

As explained above Ofwat's approach is built on using historic data. However, throughout the price review process it became clear to companies and Ofwat that the quality of historic data collected for historical growth expenditure was weak and inconsistent. This issue was not resolved and will inevitably lead to inaccurate allowances for growth expenditure.

It is essential that the correct range of cost drivers, robustly and consistently collected, are used in future price reviews. This issue is also recognised in Anglian Water's Statement of Case (Chapter E2, Section 5.2.1).

***Our request to the CMA for growth expenditure***

As explained above, a modelling approach that includes new connection expenditure in the current botex-plus modelling, without the correct cost drivers, is not appropriate given the significant levels of variation of new connection requirement across the companies.

Pragmatically, and in the absence of the appropriate cost drivers, we proposed an alternative approach. As articulated earlier the activity needed to invest in growth is simple, regular and is often carried out using the same contractors, management teams and procurement approaches as the activity in base costs. We therefore proposed in our Draft Determination response that Ofwat use the investment proposed by the company and then apply the base efficiency challenge derived from the botex models (excluding growth to avoid any overlap).

In the longer term, i.e. for PR24, a wider set of cost drivers needs to be collected and assessed with the potential to use it in a botex model (as part of any base cost assessment) or for use in its own model.

However this is not practical in the timeframe for the CMA determinations so, we reiterate, to ensure that companies with significant growth expenditure are not subjected to a mechanism that in effect decreases their resilience, due to a lack of growth funding, we suggest the CMA considers the approach we have explained above in its determination.

## 4. Section B: Detailed Response – Gearing Outperformance

### SEW's PR19 submission

In our submissions to Ofwat during the PR19 review process, we explained why we consider that Ofwat's PR19 gearing outperformance mechanism does not operate in the customers' interest.<sup>8</sup> We summarise our concerns with Ofwat's PR19 gearing outperformance mechanism as follows:<sup>9</sup>

- We disagree with Ofwat's premise that companies with gearing above the notional level enjoy a financial benefit that needs to be shared with customers. Customer bills for all companies are determined using the same allowed rate of return based on Ofwat's notional gearing assumption, irrespective of companies' actual financing choices. There is therefore no "cost of capital benefit" that companies with higher gearing accrue at the detriment of customers.
- We also disagree with the premise that companies' shareholders enjoy financial benefits equal to the difference between the cost of equity and the cost of debt for the actual proportion of gearing which is above notional, as assumed in Ofwat's gearing penalty calculation. As mainstream finance theory explains, higher equity returns associated with higher gearing represent a compensation for risk and not outperformance.<sup>10</sup> Empirical evidence also shows that water companies with higher gearing experienced greater variation in realised equity returns historically, in line with finance theory that higher leverage leads to higher equity risk.<sup>11</sup> There is therefore no basis for Ofwat to claw-back equity returns for highly leveraged companies, which reflect shareholders' compensation for greater risks and not outperformance.
- Water companies, in line with other GB and European network utilities, have increased gearing over recent years for a number of reasons: as a means to impose discipline on management; to seek higher equity risk; and, to take advantage of favourable debt markets, with the latter fully passed-through to customers by Ofwat's low cost of debt allowance. None of these factors imply that equity investors outperform at high levels of gearing which would justify sharing of alleged benefits with customers.
- Ofwat's gearing outperformance penalty calculation implicitly assumes that water companies' cost of capital falls with increasing leverage. This is inconsistent with finance theory, which explains that companies' cost of capital is broadly insensitive to increases in gearing, as the higher share of relatively cheaper debt in the capital structure is offset

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<sup>8</sup> SEW (17 May 2018) Putting the sector back in balance, SEW response; SEW (30 August 2019) Draft Determination response – Aligning risk and return, Chapter 2. Link: <https://corporate.southeastwater.co.uk/media/3476/chapter-5-aligning-risk-and-return-final.pdf>

<sup>9</sup> SEW (17 May 2018) Putting the sector back in balance, SEW response

<sup>10</sup> The so-called Miller formula, which shows that equity beta increases linearly with gearing, has been consistently used by UK regulators for setting allowed rates of return, including by Ofwat itself at PR19 and the CMA at previous reviews. See SEW (17 May 2018) Putting the sector back in balance, SEW response, p.5-6

<sup>11</sup> For example, drawing on Ofwat's own data, we show that the standard deviation in dividend yield increases for water companies as gearing increases. See SEW (17 May 2018) Putting the sector back in balance, p. 7, Figure 2.2.

by an increase in the cost of equity. The CMA and other GB regulators have reached the same conclusions at recent price reviews.<sup>12</sup>

- Indeed the only benefit associated with higher gearing relates to reducing companies' tax liabilities due to a higher debt tax shield. However, this benefit is fully passed through to customers via lower bills in PR19. Perversely, Ofwat's gearing outperformance mechanism will incentivise companies to de-gear to the notional level to avoid penalties, increasing companies' tax liabilities, which will be passed through to customer bills as a result. Our analysis shows that the industry's average customer bill would increase by around £2.30 annually over PR19 if all companies adopted a gearing of 60 per cent. For our own customers, the increase in the combined bill would be around £3.70 per annum. Ofwat's proposals are demonstrably not in the customers' interest, as they result in higher customer bills without any corresponding benefit.
- Ofwat has other measures in place which are sufficient to safeguard companies' resilience and protect customers against the risk of financial distress (e.g. license requirements for investment-grade rating). Perversely, Ofwat's gearing outperformance mechanism would undermine financial resilience, by reducing the allowed return for highly geared companies below the efficient financing cost level.

### The CMA PR19 Appeal submissions

All four appellants raise similar concerns in their respective Statements of Case to those we have voiced in our PR19 submissions to Ofwat, as summarised above.<sup>13</sup> In its response to the companies' Statements of Case, Ofwat argues that:

- Its gearing outperformance mechanism is not inconsistent with finance theory, because the Modigliani Miller theorem which claims that capital structure is irrelevant, does not hold in practice. Specifically, Ofwat argues that higher gearing results in a transfer of risk from investors to consumers in the form of higher default risk, which increases the risk to customers from potential service interruptions and/or from potentially foregone investments in service quality improvements, reducing companies' cost of capital as a result.<sup>14</sup>
- Ofwat accepts that there are mechanisms which protect customers from a risk transfer, such as debt covenants associated with highly geared structures, regulatory ring fencing or special administration, but argues that such mechanisms are imperfect and some costs of financial distress associated with highly leveraged structures may still fall onto consumers.<sup>15</sup>
- Overall, Ofwat concludes that *“where regulated monopolies increase gearing to levels materially above the notional level, they may transfer some risk to equity investors, but also to customers or taxpayers at their potential expense. This underlines the importance*

<sup>12</sup> For example, in the 2010 Bristol Water appeal, the CMA analysed the impact on WACC of gearing changes in a range between 50 and 80 per cent and concluded that the WACC is not sensitive to the level of gearing. Source: CMA (February 2010), BRISTOL WATER plc Notice of Reference: Determination of Adjustment Factor for the period 2010- 2015, Appendix N para 30 and 32.

<sup>13</sup> Yorkshire Water, 2 April 2020, PR19 Redetermination, Yorkshire Water Services: Statement of Case; Northumbrian Water, 2 April 2020, NWL Statement of Case, PR19 CMA Redetermination; Anglian Water, 2 April 2020, PR19 Redetermination, Statement of Case; and Bristol Water, 2 April 2020, PR19 Redetermination, Bristol Water: Statement of Case (Non-Confidential).

<sup>14</sup> Ofwat, May 2020, Reference of the PR19 final determinations: Risk and return – response to common issues in companies' statements of case, paras 5.16-5.18.

<sup>15</sup> Ofwat, May 2020, Reference of the PR19 final determinations: Risk and return – response to common issues in companies' statements of case, paras 5.19-5.21.

*of companies taking account of customer interests in financing decisions and to be prepared to share the benefits of these arrangements with customers”.*<sup>16</sup>

While we understand and support Ofwat’s objective of ensuring companies remain financially resilient, we continue to believe that Ofwat’s PR19 gearing outperformance mechanism does not operate in the consumers’ interest.

We acknowledge that real world factors (e.g. taxes, financial distress costs, agency costs, asymmetric information) imply that investors will not necessarily be indifferent to capital structure choices. As explained in our PR19 submissions, there are a range of reasons why individual water companies chose to increase gearing in the recent years, e.g. as a means of disciplining management, to reflect shareholder risk/return preference or to take advantage of favourable debt market conditions. Water-only-companies have also increased leverage because of their small scale relative to the minimum efficient size of debt. However, none of these factors imply companies outperform the allowed return.

Although the conditions underpinning Miller-Modigliani irrelevancy proposition may not hold in practice, both financial practitioners and UK regulators<sup>17</sup> have assumed as a rule of thumb that cost of capital remains broadly unchanged with gearing changes and have set allowed rates of return based on notional financial structures, leaving actual capital structure decisions as a choice for companies. Ofwat’s mechanism represents a material departure from established UK regulatory precedent.

Ofwat has failed to provide any evidence of the shortcomings of the existing regulatory approach based on the notional capital structure, or any rationale for the calibration of its penalty mechanism. Ofwat has also failed to provide any evidence or explanation as to the source of the alleged outperformance enjoyed by highly leveraged companies and crucially that such alleged outperformance can be quantified as (COE-COD)\*gearing in excess of 65 per cent.

Ofwat argues that highly leveraged companies transfer risks of financial distress to consumers, specifically risks associated with potential service interruptions or foregone service quality improvements.<sup>18</sup> We do not agree that this is a valid reason for imposing a penalty on our allowed return. There are existing regulatory arrangements to protect customers from the potential risks associated with service interruption:

- The PR19 regulatory framework is an incentive-based regulatory framework, with a number of mechanisms in place which reward/penalise companies for improving/failing service quality. To the extent that companies’ financing choices would compromise service quality, we will incur penalties for such failings through the incentive framework

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<sup>16</sup> Ofwat, May 2020, Reference of the PR19 final determinations: Risk and return – response to common issues in companies’ statements of case, para 5.22.

<sup>17</sup> For example, in the 2010 Bristol Water appeal, the CMA analysed the impact on WACC of gearing changes in a range between 50 and 80 per cent and concluded that the WACC is not sensitive to the level of gearing. Source: CMA (February 2010), BRISTOL WATER plc Notice of Reference: Determination of Adjustment Factor for the period 2010- 2015, Appendix N para 30 and 32.

<sup>18</sup> Ofwat (2020) Reference of the PR19 final determinations: Risk and return – response to common issues in companies’ statements of case, pp 145-146

(e.g. ODI, C-MeX, D-MeX penalties). This provides companies with incentives to take into account customers' interests in relation to service quality in their decision making (including in selecting their capital structures). Indeed, these penalties and rewards are calibrated to reflect the value that customers place on quality of service aspects.<sup>19</sup>

- The regulatory framework also includes mechanisms which are designed to protect customers from the risk of financial distress (e.g. licence conditions which require companies to have adequate financial resources and facilities to enable them to carry out their regulated activities, to maintain an investment grade credit rating). These regulatory mechanisms are also supported by financial covenants reflected in companies debt instruments (e.g. dividend lock-up provisions). These covenants are designed to protect bondholders from default risks and hence also provide protection to customers from service interruptions associated with potential default events.

***Our request to the CMA for the gearing outperformance mechanism***

In its determination the CMA should not impose this unjustified mechanism.

There is no theoretical or empirical support to justify Ofwat's gearing penalty based on the difference between the notional cost of equity and the cost of debt. If the CMA has a concern around financial resilience and the impact on customers, then existing policies on financial distress and the penalties associated with discontinued service should be reviewed.

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<sup>19</sup>

Ofwat, December 2019, PR19 final determinations – Delivering outcomes for customers policy appendix, p. 93.

## 5. Section C: Detailed Response – Cost of Debt

Ofwat's overall approach to the cost of debt is a one-size-fits-all which determines a single cost allowance for all companies in the sector. The approach fails to recognise the relatively small size of SEW and other WOCs, with our concentrated debt profiles which lead to materially different historical debt profiles and costs and future funding requirements.

### SEW's PR19 submissions

In our submissions to Ofwat during the PR19 review process, we set out a number of concerns with Ofwat's approach to determining the cost of debt for PR19. Our concerns with Ofwat's PR19 approach to setting the allowed cost of debt are the following:<sup>20</sup>

- Ofwat's calculation of embedded debt costs should take into account smaller companies' historical efficiently incurred debt costs. Our smaller size means that we have concentrated debt profiles, and we are unable to closely track Ofwat's benchmark debt indices. Ofwat's own analysis shows that our embedded cost of debt over PR19 is around 6 per cent (nominal) compared to its notional allowance of 4.47 per cent (nominal). Indeed, Ofwat own analysis shows that, with only one exception, WOCs will not recover embedded debt cost over the regulatory period.<sup>21</sup> The recognition of efficiently incurred debt costs can be achieved by allowing for a small company premium to reflect the incremental efficient financing costs of WOCs, or by recognising the efficiently incurred debt costs of SEW and WOCs' debt directly.
- Ofwat's calculation of a small company adjustment or premium for the cost of debt should not be subject to a consumer benefits test, and instead Ofwat should allow for efficiently incurred costs.<sup>22</sup>
- Similarly to the calculation of embedded debt costs, the weights for embedded and new debt costs should reflect the concentrated debt issuance of SEW and other WOCs' debt. We explained that our expected ratio of embedded: new debt over PR19 is 94:6, compared to Ofwat's determination of 80:20.<sup>23</sup>
- For the new cost of debt, we disagree with Ofwat's assumed outperformance wedge of 15bps for new debt relative to the A/BBB iBoxx index benchmark. This apparent outperformance is driven by Ofwat's failure to adjust for differences between the tenor and rating of companies' bonds and the A/BBB iBoxx benchmark index. Once differences between tenor and rating are accounted for, there is no evidence that water

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<sup>20</sup> SEW (30 August 2019) Draft Determination response – Aligning risk and return, Chapter 2, pp. 12-14. Link: <https://corporate.southeastwater.co.uk/media/3476/chapter-5-aligning-risk-and-return-final.pdf>

<sup>21</sup> Ofwat (December 2019) PR19 final determinations: Allowed return on capital appendix, p. 91. Link: <https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Allowed-return-on-capital-technical-appendix.pdf>

<sup>22</sup> SEW Business Plan Submission, Cost of capital annex: NERA (August 2018) Cost of capital for PR19, A report for SEW, p 34-36

<sup>23</sup> SEW (30 August 2019) Draft Determination response – Aligning risk and return, Chapter 2, p. 13

companies outperform the benchmark indices and hence there is no basis for including a 15bps outperformance wedge in the cost of new debt allowance.

Overall, Ofwat determined a cost of debt allowance of 4.18 per cent (nominal) compared to our expected cost closer to 6 per cent, based on Ofwat's own analysis.<sup>24</sup> The under-recovery is further compounded by a switch to CPI indexation, which will expose us to basis risk given our index-linked debt issuance. Our failure to recover debt costs will result in our expected return to equity declining to less than 2 per cent in real terms over PR19 on a notional basis, permitting no meaningful dividend payments and no de-gearing.<sup>25</sup>

### The CMA PR19 Appeal submissions

The appellants raised similar concerns with Ofwat's approach to setting the allowed cost of debt in their respective Statements of Case.<sup>26</sup> In its response to the companies' Statements of Case, Ofwat argues that:

- Companies have control over their financing choices – including on timing and tenor – and they should bear the consequences of these choices over successive periods. Recognising actual debt costs in setting allowed rates of return would dilute incentives for companies to raise debt efficiently.<sup>27</sup>
- Setting the share of embedded:new debt based on a notional approach, which assumes companies' embedded debt will be refinanced at a constant rate over time is appropriate. While it is true that individual companies' shares will fluctuate around the notional assumption, Ofwat expects these fluctuations to balance out and using company specific weights could incentivise inefficient debt financing choices.<sup>28</sup>
- There is no need to adjust for differences in rating and tenor between the company bonds and the benchmark iBoxx index in calculating the outperformance wedge of 25bps for historical debt and 15bps for new debt. Ofwat also presents evidence from three new debt issuances post PR19 Final Determinations which support its assumption that water companies outperform the iBoxx index.<sup>29</sup>
- On the customer benefits test, Ofwat states that in a competitive market small companies would not be able to recover higher financing costs unless these were offset by a cost or quality of service advantage.<sup>30</sup>

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<sup>24</sup> Ofwat (December 2019) PR19 final determinations: Allowed return on capital appendix, p. 5 & p. 91.

<sup>25</sup> Calculated as: 2.92% (Ofwat's real CPIH allowed return) less  $[0.6 \times (1 + 5.9\%) / (1 + 2\%) - 1]$  (Ofwat's estimate of our real cost of debt), all divided by 0.4 (Ofwat's notional equity) = 1.6%. Source: Ofwat (2019) PR19 final determinations: Allowed return on capital appendix, pp 5& 91. Link: <https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Allowed-return-on-capital-technical-appendix.pdf>

<sup>26</sup> In particular, Bristol water raised the same concerns with Ofwat's approach to calculating embedded debt costs and weights, given it is in a similar position to us as a small company. Sources: Yorkshire Water, 2 April 2020, PR19 Redetermination, Yorkshire Water Services: Statement of Case; Northumbrian Water, 2 April 2020, NWL Statement of Case, PR19 CMA Redetermination; Anglian Water, 2 April 2020, PR19 Redetermination, Statement of Case; and Bristol Water, 2 April 2020, PR19 Redetermination, Bristol Water: Statement of Case (Non-Confidential).

<sup>27</sup> Ofwat, May 2020, Reference of the PR19 final determinations: Risk and return – response to common issues in companies' statements of case, para 3.94.

<sup>28</sup> Ofwat, May 2020, Reference of the PR19 final determinations: Risk and return – response to common issues in companies' statements of case, paras 3.106-3.108.

<sup>29</sup> Ofwat, May 2020, Reference of the PR19 final determinations: Risk and return – response to common issues in companies' statements of case, paras 3.111-3.113.

<sup>30</sup> Ofwat, May 2020, Reference of the PR19 final determinations: Risk and return – response to Bristol Water's statement of case, para. 6.43.



While we understand Ofwat's concerns with ensuring that the approach to setting the allowed cost of debt should incentivise companies to raise debt efficiently and minimise debt costs, we do not believe that Ofwat's one size fits all notional approach to setting the allowed cost of debt is appropriate for SEW or for smaller companies more generally.

As explained above, there are fundamental differences between how SEW and other WOCs finance themselves compared to WASCs due to the differences in their relative size. These differences have important implications for the cost of embedded debt as well as the weight of embedded:new debt in their capital structure over time. To be able to access efficient forms of debt financing (e.g. bond markets), SEW and other WOCs have relatively concentrated debt profiles. Given the continued decline in interest rates over recent years, embedded debt costs for SEW and most other WOCs are higher compared to historical averages of benchmark debt indices relied on by Ofwat at PR19.<sup>31</sup> As a consequence of our relatively infrequent issuance and the tenor of debt, the share of new debt costs for SEW and all other WOCs for PR19 is also far lower than the 20 per cent assumed by Ofwat for PR19 – as set out above, our share of new debt issuance will be around 4 per cent over PR19.<sup>32</sup>

Ofwat's notional or industry average approach to setting embedded debt costs as well as the weight of embedded and new debt results in material under-recovery of embedded debt costs over PR19 and beyond for SEW, given the concentrated nature of our debt issuance. The CMA should reflect differences between how WOCs and WASCs can efficiently access debt markets in its approach. This could be achieved by recognising the higher debt costs of WOCs relative to WASCs in the form of a small company premium. For PR19, we provided evidence to support a small company adjustment for the efficient incremental debt costs incurred by small companies of 30 bps.<sup>33</sup> Ofwat claims – in analysis conducted after the final determination – that the majority of 35 bps uplift it allowed for two small companies is explained by longer tenor of small companies' bonds.<sup>34</sup> Our analysis measures the spread to benchmark gilt of WoCs' debt relative to WaSCs, and therefore explicitly controls for any differences in tenor. Overall, we show that the evidence for a small company premium is more compelling now than at PR14.<sup>35</sup>

Ofwat does not provide any further rationale to subject the recovery of our efficient costs to a customer benefits test relative to earlier appeals. The CMA considered the test as part of the

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<sup>31</sup> As shown in Ofwat, December 2019, PR19 final determinations, Allowed return on capital technical appendix, p. 91, Figure 6.6.

<sup>32</sup> As shown in Ofwat, December 2019, PR19 final determinations, Allowed return on capital technical appendix, p. 77, Figure 6.1.

<sup>33</sup> This was based on evidence on Artesian debt and bank debt finance considered at PR14 by Ofwat, and consistent with CMA's allowance of around 40 bps at both the 2010 and 2015 Bristol Water appeals. See: NERA (August 2018), Cost of Capital for PR19, section 4.3.

<sup>34</sup> Ofwat, May 2020, Reference of the PR19 final determinations: Risk and return – response to Bristol Water's statement of case, para. 6.50.

<sup>35</sup> Our analysis draws on a wider set of companies' bonds than PwC, Ofwat's advisers, at PR14. We also find evidence of a small company premium from our analysis of traded yields, which PwC did not identify at PR14. See: SEW Business Plan Submission Annex, NERA (August 2018) Cost of Capital at PR19, A report for SEW, Table 4.7. p. 34.

Bristol Water 2015 appeal, and concluded that it was not relevant, and could result in setting a cost of capital below WoCs' efficient financing cost.<sup>36</sup>

We also presented evidence to support the use of a 20-year trailing average index value, which is in line with the average tenor at issuance and therefore encompasses a far greater share of WOC and wider industry historical debt issuance.<sup>37</sup>

We also consider that that Ofwat has erred in its calculation of the alleged outperformance wedge for determining the cost of new debt. In our PR19 submissions, we demonstrated that no such outperformance wedge exists once differences between tenor and rating are correctly accounted for.<sup>38</sup> In its response to the companies' Statement of Case, Ofwat argues that it does not need to make any adjustments for tenor or rating and indeed that recent issuances support the continued existence of an outperformance wedge. We disagree. Ofwat sets the cost of new debt allowance for a notional company and therefore, for consistency, it must assume that companies issue debt at the notional rating (A/BBB, as per its benchmark index) and for a tenor consistent with this benchmark index (at around 20 years). The additional evidence from the three issuances presented by Ofwat is selective<sup>39</sup> and is contrary to the findings of more objective and comprehensive studies which show that companies issue debt in line with the iBoxx benchmark indices used to set debt allowances.<sup>40</sup>

Ofwat has claimed that its approach recognises that small companies can remedy financing diseconomies themselves.<sup>41</sup> We, along with other WOCS, have achieved an efficient scale by issuing bonds of a minimum efficient size to achieve a yield in line with the benchmark iBoxx A/BBB index, at the time of the issuance.<sup>42</sup> The consequence of achieving the efficient scale is that we have a concentrated debt profile, and in a falling interest rate environment our embedded debt costs are inevitably higher than Ofwat's notional assumption that is only relevant to much larger WaSCs. Contrary to Ofwat's statement, rather than recognising the way in which we have remedied potential diseconomies, Ofwat's approach penalises us.

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<sup>36</sup> CMA (2015) Bristol Water plc, para 58

<sup>37</sup> For evidence on the efficient tenor at issuance for water and other regulated utilities, see NERA (September 2019) Cost of Debt at RIIO-2, A Report for Gas Distribution Networks, p. 9.

<sup>38</sup> NERA (August 2018), Cost of Capital for PR19, section 4.5.

<sup>39</sup> For example, two of the three bond issuances Ofwat presents have a substantially shorter tenor of 6 and 13 years compared to the iBoxx benchmark of around 20 years, with tenor differences being the key driver of the alleged outperformance.

<sup>40</sup> See for example, NERA (July 2018) A Response to Ofwat's Halo Effect for PR19, A Report for Anglian Water. Link: <https://www.anglianwater.co.uk/siteassets/household/about-us/pr19-15c-a-response-to-ofwats-halo-effect-for-pr19.pdf>; NERA (September 2019) The Halo Effect and Additional Costs of Borrowing at RIIO-2, Appendix, a report for the Energy Networks Association. The latter study summarises other studies undertaken prior to PR19 on the regulatory halo, and finds that there is no support for systematic outperformance of benchmark indices.

<sup>41</sup> Ofwat (March 2020) Reference of the PR19 final determinations: Explanation of our final determination for Bristol Water, para 1.25, p.7. Link: Reference of the PR19 final determinations: Explanation of our final determination for Bristol Water

<sup>42</sup> SEW 2010 bond (ILD, BBB, 31.5 years tenor, issuance 11/02/2010) achieved a yield-at-issuance of 2.53 per cent relative to real iBoxx BBB index yield of 2.58 per cent (calculated as nominal rate less 10 year break-even inflation). SEW 2004 bond (nominal, AAA, 24.5 years tenor, issuance 27/07/2004) achieved a yield at issuance of 5.58 per cent relative to iBoxx A index yield of 6 per cent

Under its one-size-fits-all approach, we are incentivised to adopt shorter-term debt financing – with its higher costs and greater refinancing risk – to more closely match the frequency of issuance of Ofwat’s notional company.

***Our request to the CMA for the cost of debt***

On the cost of embedded debt, the CMA should move away from Ofwat’s one-size-fits-all approach and re-determine a number of elements for smaller companies: to adjust the notional cost of debt for a small company debt premium which should not be subject to a customer benefits test; to draw on a 20-year trailing average in line with the efficient tenor at issuance; and, apply a greater weighting on embedded debt. The overall framework should reflect the financing characteristics of small companies and their efficient costs of debt.

For the cost of new debt, we request that the CMA removes the negative adjustment for the outperformance wedge of 15 bps and includes a small company premium.

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