

Water Redeterminations 2020

Cost of Capital – Working Papers Executive Summary

January 2021

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1. Introduction

1. On 29 September 2020 the CMA published its provisional price control determinations for four companies: Anglian Water, Bristol Water, Northumbrian Water and Yorkshire Water following a request for a redetermination from those Disputing Companies in response to Ofwat's price control for 2020-2025 (PR19).
2. The CMA's Provisional Findings set out in detail the CMA's provisional conclusions on various elements of the price control that will be redetermined, including the impact of those provisional conclusions on the Disputing Companies' financeability and the indicative potential impact on average customer bills.
3. A key part of PR19 and the CMA's redeterminations is the calculation of an appropriate Weighted Average Cost of Capital (the WACC). The cost of capital is an input into the calculation of the companies' allowed revenue and is used to calculate the profit that the companies need to earn to repay their investors within the price control.
4. As part of its evidence-gathering, the CMA sought submissions from the Main Parties and interested Third Parties, held multiple Hearings and considered extensive representations on its Provisional Findings. Those parties included the Disputing Companies, Ofwat and some Third Parties, for example, the Consumer Council for Water, Citizens Advice and Ofgem. A full list of the submissions received in response to the Provisional Findings is available on the CMA's webpage. The CMA also held further hearings with the Disputing Companies, Ofwat and some Third Parties following the publication of the Provisional Findings.
5. Following consideration of all of the evidence, the CMA is consulting on its updated thinking outlined in two working papers on specific elements of the cost of capital: the Cost of Debt and Choosing a point estimate for the Cost of Capital.
6. In the Provisional Findings we estimated ranges for the constituent elements of the cost of capital. We used a higher than mid-point estimate for the cost of equity and we set the cost of embedded debt at the bottom of the range. Taken together, these two decisions resulted in a point estimate 0.1% above the midpoint for the WACC.
7. The two working papers should be read together and outline the CMA's updated thinking on the issues that they cover in the light of the representations received, further analysis and additional information provided.

8. The working papers reflect the CMA's latest thinking on the issues that they cover but do not cover all the issues that relate to the calculation of the cost of capital or to the bills that customers will be paying. Nor do they represent the allowance to be awarded in our Final Determination.
9. A final decision on allowances will be taken by the CMA following this consultation process, taking full account of all evidence provided, as part of our 'in the round' redetermination and in light of the applicable duties.¹
10. We propose that in our Final Determination we will set separate point estimates for the cost of debt and for the cost of equity.
11. During the consultation period the CMA will be engaging further with the Main Parties on issues relating to the cost of capital.
12. The consultation will close at **4pm on 27 January 2021**. Responses to the consultation should be sent by email to waterdetermination2020@cma.gov.uk.
13. The CMA will be consulting on two further working papers in January 2021 and will be publishing those working papers shortly. The CMA is currently aiming to report on the Final Determinations in Mid-February 2021.

2. Cost of debt

14. The [working paper on the cost of debt](#) has been produced in order to:
 - a) explain the CMA's updated interpretation of the evidence relating to embedded debt; and
 - b) in the light thereof set out the CMA's proposed process for setting an updated cost of debt allowance in the Final Determinations; and
 - c) as a result, provide updated estimates of the components of the cost of debt for this price control.
15. We continue to have a preference for using a benchmark as the primary tool in setting the cost of embedded debt allowance.

¹ The CMA is required under s12(3) Water Industry Act 1991 (WIA91) to determine the reference in accordance with the principles which apply to Ofwat under Part 1 WIA91. These include Ofwat's general duties (primary and secondary), DEFRA's Strategic Priorities and Objectives statement and the principles of best regulatory practice. These are set out in our [Provisional Findings report](#) at paragraphs 2.55 to 2.69.

16. We consider that using a collapsing average approach is a more accurate measure of costs related to the benchmark over the price control.
17. We also now provisionally propose a 15-year collapsing average approach, suggesting a cost of embedded debt allowance estimate of 4.52%. This represents a change from the 20-year approach suggested in the Provisional Findings.
18. We discuss the use of actual costs as a cross-check to our selected benchmark and note the multitude of potential 'actual' costs figures that have been submitted as evidence. We discuss our preference for a range when dealing with actual costs, and provisionally propose to use 4.45% to 4.82% as a suitable cross-check range. On that basis, we conclude that the actual cross-check range does not suggest any 'matching adjustment' to our selected benchmark is required.
19. We consider that the underlying principles of our approach remain broadly consistent with the approach at Provisional Findings and consider our updated approach and estimate of 4.52% (nominal) to be a more accurate estimate of the embedded debt costs of the notional-capitalised company.
20. We have reassessed our approach to estimating new debt, noting that April - September 2020 provides a more appropriate measurement period that avoids any overlap with the measurement of embedded debt. We continue to note a lack of compelling evidence to support either an outperformance wedge or a forward rate adjustment. We have updated our nominal estimate of the cost of new debt to 2.19% from the 2.38% used in the Provisional Findings.
21. We have also reassessed our approach to estimating the appropriate ratio of embedded and new debt, taking into account submissions received and the impact of our updated approach to calculating embedded debt. We provisionally propose to use an updated range for the proportion of new debt between 18% and 22%, and use a point estimate of 20% versus the 17% used in the Provisional Findings.
22. Bringing these new estimates together implies a total cost of debt allowance of 2.12% in CPIH-real terms. An allowance of 2.12% represents a 33bps reduction versus the 2.45% used in our Provisional Findings. The impact on WACC (at 60% gearing) would be a reduction of approximately 0.20%.

3. Choosing a point estimate for the Cost of Capital

23. The [working paper on choosing a point estimate for the cost of capital](#) ('aiming') has been produced to outline the additional analysis undertaken of the effects to take into consideration in choosing a point estimate and takes into account the responses to the Provisional Findings and evidence from the hearings.
24. Our updated view on choosing a point estimate for the cost of capital is that we should take the following approach:
 - a) we will use the approach described in the cost of debt paper to determine a point estimate for the cost of debt;
 - b) we will determine a range for the cost of equity following the approach in the provisional findings, updated to reflect, our consideration of responses to the provisional findings;
 - c) we will set a point estimate for the cost of equity at around 0.25% above the mid-point of that range, subject to our financeability analysis
25. This approach contrasts with the approach taken at Provisional Findings where we:
 - a) picked the bottom of the range as the estimate of the cost of embedded debt;
 - b) picked the middle of the range as the estimate of the cost and weight of new debt;
 - c) picked a figure between the midpoint and the top of the range as the estimate of the cost of equity.
26. In the Provisional Findings we expressed concern about the risks to long-term investment and capital availability should the cost of capital be set too low.
27. We have again considered in principle arguments relating to the selection of a point estimate, evidence from market prices and broker forecasts and evidence of capital availability.
28. Our view remains that there are a number of benefits from choosing a point estimate for the cost of equity above the middle of the range. Our view is that

this will result in an appropriate balance of risk in the round across the determination, including:

- a) addressing the level of risk associated with setting the cost of equity too low in the context of a sharp reduction since AMP6;
 - b) addressing asymmetry in the broader financial settlement; and
 - c) addressing the risks to financeability from setting the cost of capital at lower levels within the range.
29. We continue to consider that the risk of an exit of capital in AMP7 is relatively low, given current market conditions, and that this reduces the size of the risks from setting the cost of capital too low. We consider that the risk of setting the cost of equity too low is not as high as we had implied in our Provisional Findings, since there is a greater probability that the right estimate is towards the middle of the range.
30. Taking these considerations together, our updated judgement is to use a cost of equity of around 0.25% above the middle of our range. The final figure for the cost of equity will take account of our updated analysis of the risk-free rate, beta and the total market return as well as consideration of the responses to this consultation.
31. We will consider the responses to this consultation (alongside other evidence already received as part of this process including in the responses to the Provisional Findings) before deciding on the final figure for the cost of capital, this will be considered in the context of any wider changes to our 'in-the-round' assessment which will take account of all our duties, including our final analysis of financeability.

4. Impact on bills

32. All other things being equal, the combined impact of the proposed updated estimates within this consultation would decrease the WACC by approximately 0.3%.
33. When fed through into overall costs, this proposed decrease in the WACC would on average represent a further reduction in customer bills of around 1.5% over and above the average 9.3% reduction proposed for the four Disputing Companies in the Provisional Findings. This represents approximately a 11% fall in average customer bills over the period of the price control relative to those applying in the 2015 to 2020 period.

34. By way of comparison, Ofwat's determinations for the four Disputing Companies would have led to around 12.5% reduction in bills.