Competition & Markets Authority (CMA)
The Cabot
25 Cabot Square
London
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United Kingdom
By email: waterdetermination2020@cma.gov.uk

27 January 2021

Dear whom it may concern,

Cost of Debt and Point Estimate of Cost of Capital Consultations

HRL Morrison & Co (Morrison & Co) is a leading alternative asset manager investing in infrastructure and property through private and listed markets. Morrison & Co has been an active investor in the infrastructure for over 32 years. On behalf of its clients it currently manages over US$12 billion in Australia, China, New Zealand, the UK and Europe and USA and has offices in Australia, New Zealand, Europe and the USA. We are responding to this consultation as manager for the Utilities Trust of Australia's (UTA) stake in South East Water.

Both Morrison & Co and UTA have long-term investment time horizons which is well demonstrated by their tenure with South East Water of almost 16 years. Morrison & Co also focuses on sustainability across the assets we manage, with strong emphasis being put on ESG aspects. This flows from Morrison & Co's belief that value is delivered when outcomes for the community, customers and long-term investors are aligned. We strongly support the regulatory system and the checks and balances that are in place to ensure that all stakeholders are well represented, including the appeals mechanism that the CMA provides and their independent view of regulatory determinations across sectors.

While South East Water elected not to appeal the Final Determination from Ofwat, this was a very challenging decision for our Board. Of significance, the cost and time that we felt would be needed to present our case was substantial for a smaller company. This has been demonstrated to be the case, especially with the extension to the original timing outlined and the substantial changes to the Preliminary Findings which are now being consulted on. We remain supportive of the process the CMA has conducted and provided third-party evidence to support the CMA with more data points when making their decision. As would be anticipated, we have followed the process closely, and we do question why there has been such substantial movement between the Preliminary Findings and the further recommendations that are now being mooted.

This letter supports a submission from South East Water which highlights the challenges that could be posed to other non-appealing companies (particularly smaller Water Only Companies (WOCs)) from the recommendations presented in the Cost of Capital consultations. We note that the CMA decisions are likely to influence future regulatory settlements and seek for CMA to be explicit on the circumstances on which these decisions are based.

Cost of Debt

Morrison & Co notes that substantial change has been proposed in the Cost of Debt calculation, with many factors being reconsidered since the Preliminary Findings. We understand the challenge that is posed to the CMA, with disagreement between experts on the correct approach on this highly technical subject.

Our major concern at this stage is that there appears to be more limited consideration of the challenges posed to smaller companies, which do not have the same level of flexibility in their structures as the larger Water and Sewerage Companies (WASC's) in their management of debt. Furthermore, we note that our debt was efficiently procured at the time with reference to credit rating agency guidance and license conditions. We ask that the CMA considers this and acknowledges that companies in the sector face different challenges and that while the findings being consulted on may reflect the situation for most of the appellant companies they do not necessary reflect the situation across the sector.

We further support the technical arguments that have been repeatedly raised by South East Water throughout PR19 and the CMA process and are again outlined in their response to this consultation. These include: the reversion to a 15-year collapsing average, the failure to consider the transaction cost implications of this approach and the use of a 83:17 ratio of embedded:new debt.

Point estimate of Cost of Capital

Morrison & Co supports the approach that CMA have taken to setting a point for the cost of equity above the mid-point of the range. As noted, the aiming up is designed to address three areas: risk of under-investment in the sector, asymmetry in incentives and financeability. We also note that the CMA has reduced the amount that it considers appropriate to 'aim-up' by, to 25%, of which 10bps are considered to be attributable to offset the risk of under-investment and 10-20 bps to the asymmetry in incentives.

We support the comments from the CMA highlighting that societal benefits do not need to be substantial to justify an increase in the allowed return. We support CMA recommending this approach to endure for future controls. However, we continue to argue (see South East Water submission) that 25bps would be more appropriate than the proposed 10bps to mitigate the risk of setting a cost of capital that is too low.

For the 3 WASC appellant companies, the CMA has proposed a 10-20 bps increase in cost of equity to offset the likely downside risk on RORE as detailed in the consultation. However, we note the further asymmetry between downside risk on water and waste ODIs and urge the CMA to consider this more explicitly. The recent delivery reports for the 19-20 year published by Ofwat highlighted the difference between the 2 sectors, with waste £103m in reward, offset by water £53m in penalty for a net £50m reward. Morrison & Co urges the CMA to take this asymmetry into consideration when recommending an appropriate level to 'aim-up' in the cost of equity for different types of companies within the sector. As detailed in South East Water's paper we believe that an appropriate level of increase to offset likely downside risk for WOCs would be 40bps.

Morrison & Co also supports the financeability position considered by the CMA and agrees that credit metrics should provide a cross-check on allowed return and that where these are weak this needs to be addressed through the cost of equity allowance rather than addressing through fast money adjustments such as PAYG and RCV run-off.

Conclusion

Morrison & Co and UTA (as manager and ultimate owner of South East Water respectively) strongly support the robust appeal process that is provided by the CMA and appreciate the consideration being given to elements of the price control contested by appellants. We have some concern with the amount of movement that is being proposed between the Provisional Findings and these consultations.

On both elements we have some concern that the interests of smaller WOCs are not being as systematically considered, especially given that 3 of the appellants are larger combined WASCs. We have endeavoured to explain why we believe there is a substantial difference in these areas for WOCs. We understand that this appeal is only applicable to the appellant companies but recognise that the CMA's comments are likely to influence future regulatory direction and seek the CMA to consider how it delivers its final advice, and to be explicit about the types of companies for which this is considered appropriate.