south east water

CMA cost of capital consultation

South East Water response

South East Water
Rocfort Road
Snodland
Kent
ME6 5AH

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Contents

1. Introduction

This submission is presented in response to the CMA Cost of Capital Working Papers published as part of Water Redeterminations 2020, published in January 2021. Please direct any queries in relation to this submission to oliver.martin@southeastwater.co.uk

Our proposed remedies in response to the consultation are outlined below.

Our overriding concern is that on both the aiming up and cost of debt components of the allowed return, the CMA's proposals do not adequately take into account the particular characteristics of water-only-companies (WoCs). We identify a number of areas where WoCs are different and require separate treatment from a wider industry notional approach, as summarised below. We ask that the CMA recognises these WoC specific factors and costs in making its re-determination at PR19 and in setting precedent for the conduct of future price controls.

Cost of equity:

Overall, structural underperformance on totex for the water service and asymmetry in ODI incentives should be addressed through totex and ODIs. However, we welcome the CMA's continued support to aim-up to address downside asymmetric risk in the incentive package, and to address the risk that investment is too low. We also believe that the CMA should additionally allow for 25 bps to mitigate risk of setting a cost of capital that is too low, conservatively assuming 80th percentile ensures socially optimal level of investment.

In relation to WoC specific issues, there are two key points to consider where we require different treatment to the industry:

- the aiming-up component for asymmetry in incentives should be at least 40 bps for WoCs given that the water service incentive regime provides much greater downside risk than wastewater, and therefore WoCs require a greater aiming-up component to compensate for these risks.
- The overall return should be subject to financeability analysis after deducting 40 bps from the allowed return for WoCs for downside risk.

Cost of debt:

Overall, we request that the CMA employs a 20-year trailing average in determining the cost of debt, which better reflects the CMA's own estimate of the average remaining tenor of debt of 13 years.

The CMA should also recognise that WoC are different to the wider industry and provide for a higher allowance. As the CMA shows, WoC debt costs are higher than the industry average which is explained by our relatively small scale and concentrated debt issuance. To account for our higher costs, the CMA should allow for a debt small company premium that reflects our higher issuance costs and higher costs because of historical dated debt, and use an embedded new debt weighting that better reflects a WoC's issuance profile.

2. Selecting a Point Estimate on the Cost of Equity

2.1 Summary

In our June 2020 submission to the CMA, we explained that the overall risk-return package was downwardly skewed, and our expected return on equity was around zero, taking account of the negatively skewed incentive mechanisms and failure to recognise our efficient cost of debt.[1] In our response to the CMA's Provisional Findings, we welcomed the recognition by the CMA that downside risk on the ODI package should be reflected in a higher cost of capital although we noted that 0.1-0.2 per cent under-estimated downside risk.[2] We also questioned whether the CMA had aimed-up given the CMA's CAPM parameters, and we have provided specific comments on RFR and TMR, and beta estimates.[3] We also welcomed CMA's proposed use of financeability assessment as a cross-check on the cost of equity.[4]

Following our review of the working paper on the selection of the point estimate, we continue to support the CMA's decision to select an allowed return on equity above the mid-point estimate for the cost of equity (or to "aim-up") but note that the starting mid-point must be an unbiased estimate of the cost of capital. However, we consider the magnitude of the CMA's proposed adjustment (reduced from 25 bps to 50 bps) fails to reflect the risk of setting a cost of capital that is too low and potential delays to critical investment.

In particular, we ask that the CMA acknowledges the asymmetric risk faced by SEW and water-only-companies (WoCs) given the more challenging water service regulatory framework. In this submission, we provide further evidence on greater downside risks from ODIs for WoCs.

We also continue to support the CMA's confirmation that financeability should act as a cross-check on the allowed rate of return, and weak credit metrics should not be addressed through short-term fixes such as higher pay-as-you-go rates (PAYG) rates. However, we note that the financeability analysis should be conducted after allowing for the structural under-performance of the wider industry and WoCs in particular, as we explain in more detail below.

2.2 We ask that the CMA recognises the far greater downside risks faced by WoCs

The CMA assumes asymmetry in the PR19 incentive package of between 0.1 per cent to 0.2 per cent on RORE, based on a 10 per cent weighting to a 10 per cent downside scenario for all asymmetric incentives.[5] Evidence from AMP6 shows that there is much greater structural asymmetry in the price control for the water service (and therefore WoCs) of around 40 bps. For example, over AMP6, the sector on average underperformed by around 10bps on ODIs, whereas the average WoC

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1 SEW (1 June 2020), CMA submission pp. 5&6

2 SEW (1 October 2020), CMA submission p.10

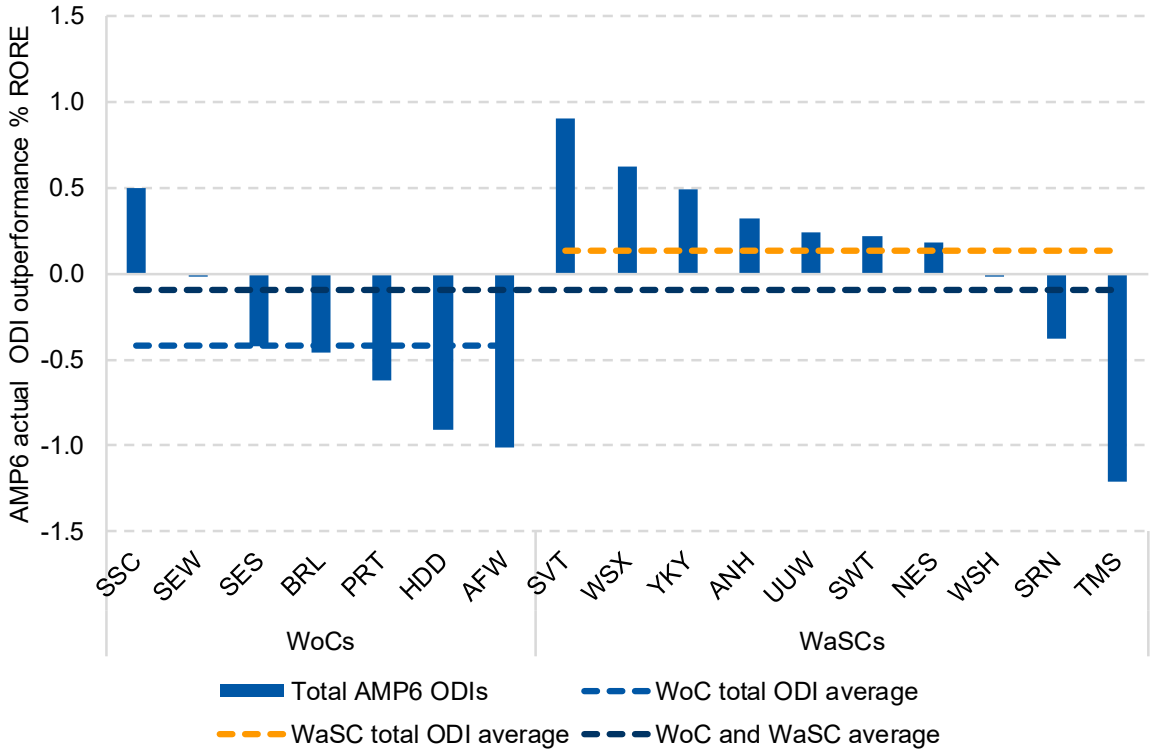
3 SEW (1 October 2020), CMA submission p.9

4 SEW (1 October 2020), CMA submission p.10

5 CMA (January 2021) Setting Point Estimate for the Cost of Capital, para 83, p. 25

underperformed by around 40 bps. Evidence from Moody's suggests that underperformance for WoCs relative to the industry is likely to be further exacerbated over AMP7, given that the Covid crisis principally affects water as opposed to wastewater services and given the tightening of the regulatory regime.[6] Indeed, in its submissions to the CMA, Bristol Water expects to underperform ODIs by around 50 bps over AMP7, marginally worse than our estimate of WoCs underperformance of 40 bps for AMP6.[7]

Figure 1: We ask CMA to recognise the greater risks faced by WoCs (AMP6 WoCs and WaSCs ODI outperformance %RORE)



Source: SEW analysis of Ofwat Monitoring financial resilience report 2019-20 data.

[6] Moody's (January 2021), 2021 outlook returns to stable as companies settle into a tough regulatory period, p. 11, Exhibit 11. *"The overall penalty for the industry would be around £32 million for a 5% PCC increase across all companies and £58 million for 10% during 2020-21, but would only be paid in 2022-23. Compared with our aggregate five-year estimated penalty range at final determination, as outlined above, the* ***potential single-year impact of this one ODI is significant. As shown above, in our example the risk of materially weaker interest coverage sits disproportionally with the smaller WoCs, rather than the larger WaSCs****."*

[7] Bristol Water (October 2020) PR10 Redetermination Bristol Water: Response to CMA Provisional Findings para 228, p. 50

Table 1 shows ODI performance for water and wastewater services separately. This shows that WoCs and WaSCs have both underperformed on water-related ODIs whereas WaSCs have outperformed on wastewater-related ODIs. That is, the underperformance of WoCs is related to the more challenging regulatory framework for the water service, as opposed to a WoC specific issue.

Table 1: AMP6 water and wastewater-related ODI outperformance (£m)

	ODI Performance (AMP6, £M)
Water service	
WoCs	-17
WaSCs	-117
Industry	-134
Wastewater service	
WaSCs	171
Water and wastewater	
WaSC	54

Source: SEW analysis of Ofwat, "FD outcome PC and ODI database"

As well as incentives, there is also structural underperformance on totex for the water service. For example, over AMP6, Ofwat's data shows that companies' overspent water service allowances by around 8 per cent, whereas WaSCs outperformed on wastewater services by around 5 per cent.[8] The water service underperformance corresponds to around 60 bps on RORE.[9]

2.3 Aiming-up to mitigate risk of under-investment should be at least 25 bps

As the CMA sets out, aiming-up is required to reflect the risk of setting the cost of capital too low, and the consequential risk to capital investment with a corresponding societal cost (e.g. in terms of failure to tackle climate change). To mitigate this risk, the CMA indicates an aiming up of 10 bps, a marginal increase in the cost of capital.[10]

We disagree with the CMA's arbitrary designation of 10 bps. Instead, the value should be informed through modelling of the societal costs of understating the true cost of capital combined with the likely distribution of the CAPM parameters, which provides an objective basis for determining this element. For example, as the CMA itself observes, selecting a value 25 bps above the midpoint, implies a 20 per cent risk that the allowed return is set below the true cost of capital and consequential risk to socially desirable investment. Other evidence submitted to the CMA suggests that the societal optimal level of aiming up should be higher than the 80th percentile. Conservatively assuming 80th percentile ensures socially optimal level of investment, 25 bps above an unbiased estimate of the cost of equity to mitigate the risk of setting a cost of capital that is too low. In addition, the CMA should allow for 10-20 bps to compensate for asymmetric risk for the wider industry, i.e. it should aim-up by at least 35-45 bps using the CMA's conservative figures.

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8 SEW analysis of Ofwat AMP6 performance data. Source: https://www.ofwat.gov.uk/publication/service-and-delivery-report-2019-20-data/

9 Calculated assuming 50 per cent sharing factor and 6% totex to RAV ratio. Calculation: 8% underperformance *6% totex to RAV*50% sharing, divided by (1-notional gearing).

10 CMA (2021) Setting Point Estimate for the Cost of Capital, para 51, p. 17

However, for WoCs the uplift for the structural underperformance of the water service should be at least 40 bps to account for incentives, conservatively setting aside water service totex underperformance of 60 bps. Therefore, the overall level of aiming up for WoCs should be at least 65 bps (25 bps + 40 bps) relative to a reasonable mid-point estimate of the cost of capital.

2.4 We support CMA's proposed use of financeability as a cross-check on the allowed return

We support CMA's statement that there needs to be a consideration of whether the allowed return is consistent with the outturn credit rating assumed, as an important consistency check on the overall package.[11] The alternative solution of bringing forward revenues, e.g. through a reduction to PAYG rates below their natural level (as per Ofwat's approach at PR19 for SEW and other companies), does not address the fundamental inconsistency in the financial package, and is unsustainable over successive price controls. These are points that we have made to Ofwat over successive consultations.[12] However, we note that the CMA should undertake its financeability analysis after deducting from the allowed return the expected losses from asymmetric incentives of at least 10 to 20 bps for the wider industry, and at least 40 bps for WoCs. The CMA should also use a cost of debt estimate that is consistent with the actual industry cost of debt, correcting for factors that we identify in the section below.

2.5 Proposed remedy

Overall, we welcome the CMA's continued support to aim-up to address downside asymmetric risk in the incentive package, and to address the risk that investment is too low. We also believe that CMA should additionally allow for 25 bps to mitigate risk of setting a cost of capital that is too low, conservatively assuming 80th percentile ensures the socially optimal level of investment. Further, we ask that the CMA recognises the following points where the industry wide approach needs to adapted to reflect WoC specific factors:

- **the aiming-up component for asymmetry in incentives should be at least 40 bps for WoCs given that the water service incentive regime provides much greater downside risk than wastewater, and therefore WoCs require a greater aiming-up component to compensate for these risks.**
- **the overall return should be subject to financeability analysis after deducting 40 bps from the allowed return for WoCs for downside risk**.

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11 CMA (January 2021) Setting Point Estimate for the Cost of Capital, para 97, p. 30

12 See for example, NERA (August 2010) SEW Financeability Assessment for PR19, A report for SEW

3. Cost of debt

3.1 Summary

In our June 2020 submission to the CMA, we noted that Ofwat's allowed cost of embedded debt – based on a 15 year trailing average – failed to account for smaller companies' efficiently incurred debt costs, which were higher because of our concentrated debt issuance.[13] Similarly, Ofwat's 80:20 weighting for embedded and new debt failed to reflect our limited new debt issuance over AMP7. We also noted that the small company premium on debt should not be subject to a consumer benefits test. We also considered that there was no evidence to support the adjustment to the cost of debt allowance for the outperformance wedge.[14]

In our October 2020 response to the Provisional Findings, we welcomed the proposed use of a 20-year trailing average consistent with the tenor of debt across the sector, and the economic useful life of assets.[15] We also welcomed the use of embedded: new debt of 83:17, although noted that in our case we expect a weighting of 97:3.[16] We also welcomed the allowance of small company premium (SCP) on debt, but which we thought was insufficient relative to our own estimate of 30 bps. We also welcomed the removal of the outperformance wedge.[17]

Following our review of the January working paper, we are disappointed that the CMA no longer considers a 20 year trailing average is appropriate, but instead proposes a 15 year collapsing average and that the embedded:new debt ratio has been proposed to change to 80:20 moving further from our demonstrable ratio for PR19.[18]

As the CMA shows, WoC debt costs are higher than the industry average which is explained by our relatively small scale and concentrated debt issuance. To account for our higher costs, the CMA should allow for a debt small company premium that reflects our higher issuance costs and higher costs because of historical dated debt, and use an embedded:new debt weighting that better reflects a WoC's issuance profile.

3.2 We ask that CMA recognises that WoCs need to be treated differently to WaSCs given size and issuance profile

WoCs face higher costs than the industry average as a consequence of our relatively small scale. To achieve the minimum efficient debt issuance, WoCs access debt markets less frequently and our historically dated debt issuance has led to higher costs in a falling interest rate environment. By contrast, in a rising interest rate environment, our collective costs would have been lower as a result of our historical debt profile.

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13 CMA (January 2021) Water Redeterminations 2020, Cost of debt – Working Paper, p. 8.

14 SEW (1 June 2020) pp. 23-24

15 SEW (17 October 2020) p. 8

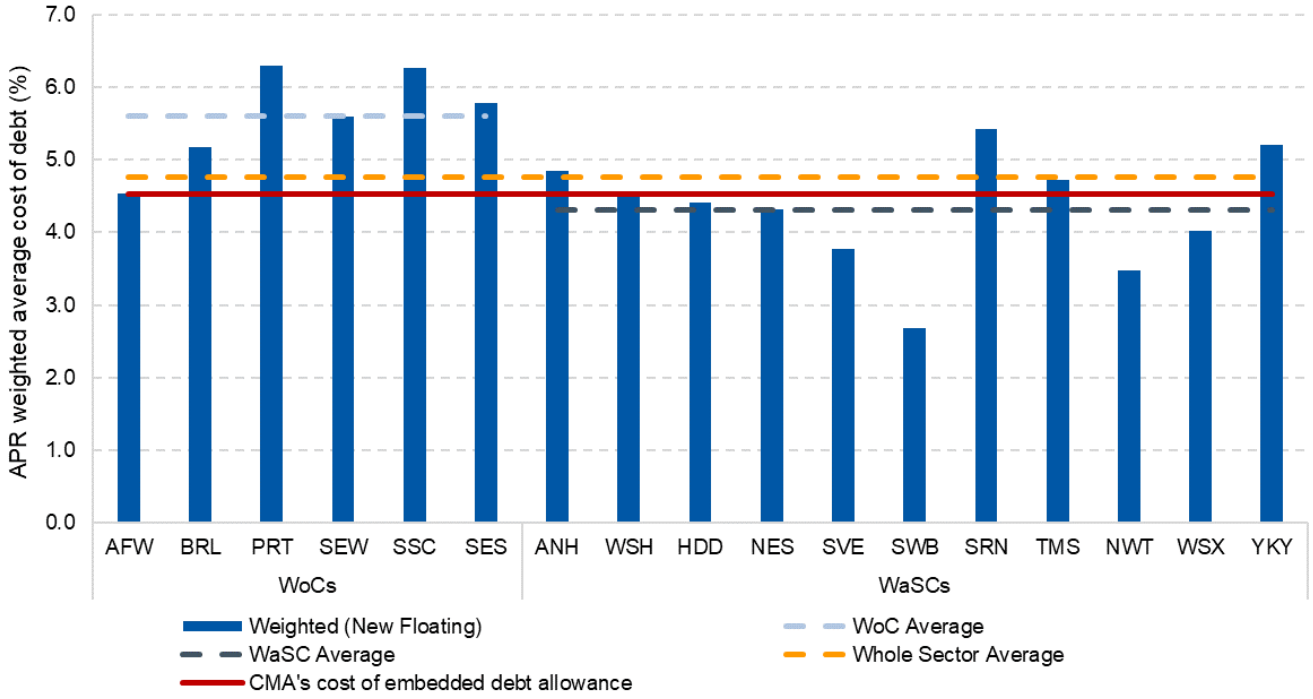
16 SEW (17 October 2020) p. 9

17 SEW (17 October 2020) p. 8

18 CMA (January 2020) Water Redeterminations 2020, Cost of debt – Working Paper, para. 80

The structural difference in WoCs relative cost of debt is evident from CMA's own analysis. The CMA reports a WoC median cost of embedded debt of 5.68 per cent compared to an equivalent WaSC cost of 4.41 per cent, i.e. around 120 bps higher.[19] As a consequence, the CMA's proposed allowed embedded cost of debt fails to provide adequate funding for any WoCs.

Figure 2: The CMA's allowed embedded cost of debt underfunds all WoCs



Source: NERA analysis of CMA (January 2021) Water Redeterminations 2020, Cost of debt – Working Paper, Table 1

The CMA's proposed embedded: new cost weighting of 80:20 also fails to reflect the expected level of new debt for an infrequent issuer. We expect our new debt issuance to be around 3 per cent over AMP7. Bristol Water has provided evidence that more generally WoCs will issue between 5 and 10 per cent new debt over AMP7, supporting an average weighting of 95:5.[20] The CMA's proposed 80:20 weighting leads to further under-funding of WoCs' efficient costs.

3.3 CMA's 15-year collapsing average is not justified even for the industry average, let alone WoCs

The CMA appears to support a 15-year collapsing average for the cost of embedded debt based on a high-level assumptions around the tenor of debt, and supported by a series of cross-checks. The CMA employs two different approaches: deducting a "matching adjustment" to the conceptually correct 20-year trailing average to calculate the actual industry cost of debt.

The cross check based on deducting 40bps matching adjustment from 20 year trailing average is wrong because the 40 bps itself is incorrect

[19] CMA (January 2020) Water Redeterminations 2020, Cost of debt – Working Paper, Table 2, p. 51

[20] Bristol Water (2020) Statement of Case, paras. 228-236

In calculating the matching adjustment of up to 40 bps, CMA assumes that EIB debt reduces overall costs by 12.5 bps, and floating rate debt contributes 15-31 bps. However, no WoCs have EIB debt. For the industry more widely, the CMA's assumed 100 bps lower financing costs for EIB debt is overstated and the proportion of outstanding EIB debt is overstated, given that the tenor is typically shorter than 20 years. The CMA itself acknowledges that these are highly simplified assumptions. In determining the 40 bps matching adjustment, the CMA has also adopted the top-end of its estimated range of 15-31 bps for the benefits of floating rate debt. Therefore, this approach does not provide a viable cross-check on the 15-year collapsing average.

The cross check based on "actual-notional" is wrong because it wrongly ignores a tranche of index-linked debt (ILD)

In its assessment of the industry actual cost of debt, the CMA adopts two different approaches which provide a range of 4.45 to 4.82 per cent based on "actual notional cost of debt" and "actual adjusted cost of debt". It considers that these estimates support its proposed allowance of 4.52 per cent based on the 15 year collapsing average.

In calculating actual-notional cost of debt of 4.45 per cent, the CMA takes the average cost of fixed rate and ILD reported in companies' APRs and then assigns them a 2/3 and 1/3 weight, in line with the notional assumption on the share of ILD, to calculate an average embedded "notional actual" cost of debt. This re-weighting reduces the industry average cost of debt because the average cost of ILD is higher than the average cost of nominal debt and ILD has a greater share in companies' actual structures than the 1/3 notional assumption. However, ILD is on average higher cost because it is *older* relative to the outstanding nominal debt, and not because ILD was necessarily more expensive relative to nominal debt issued at the same point in time. The CMA's notional-actual calculation therefore effectively removes some of the old outstanding debt and replaces it with newer lower cost debt. However, this removal of old and more expensive debt is completely unjustified, given the CMA accepts the benefit of long-term financing for the sector as a whole. If the CMA continues to use its notional-actual calculation, it should correct its approach to account for the difference between the cost of ILD and equivalent nominal debt issued at the same point in time – and not simply remove an historical tranche of ILD.

The cross check based on "actual adjusted" shows that 15 year collapsing average is insufficient, but includes low cost floating rate and ignores higher cost derivatives

In calculating the "actual adjusted" cost of debt of 4.82 per cent, the CMA includes lower cost floating rate debt. However, at the time of issuance, floating rate debt is priced equivalent to fixed rate debt adjusted for risk and will out- or under-perform fixed rate debt according to outturn market movements. The issuance of floating rate debt is a company decision around interest rate risk exposure, and we consider these risks should be borne by companies (which would be to our benefit in a falling interest rate environment). In contrast to its approach to floating rate debt, the CMA excludes all derivative costs, which also involve company decisions around interest rate exposure (and inflation etc) but in this instance the CMA determines that these costs should be borne by companies. Therefore, the CMA appears to cherry-pick the factors that it accounts for in the "actual-adjusted" cost of debt.

Indeed, if the CMA removes floating rate debt from its actual-adjusted calculation, then the average industry cost of debt is around 5 per cent, which is also equivalent to the value for the 20 year trailing average of A/BBB iBoxx index, as reported by the CMA.[21]

CMA's cross-checks suggest that 15 year collapsing average is insufficient for the industry, and worse for WoCs

In summary, the CMA's cross-checks demonstrate that the CMA's 15-year collapsing average of 4.52% is inadequate in funding industry embedded debt costs. We have shown that the "actual-notional" cost of debt estimate of 4.45% understates industry costs because the CMA excludes a tranche of historic ILD debt. The higher-bound estimate of 4.82% also understates costs as it unreasonably includes floating rate debt yet excludes derivative costs. Correcting for these factors, would support a trailing average of around 20 years.

Moreover, as set out above, the CMA's evidence for WoC costs supports an embedded cost of debt allowance far higher than the 15-year collapsing average, demonstrating that the 15-year collapsing average is inadequate for WoCs

3.4 The CMA failed to consider the transaction cost implications of its 15 year collapsing average approach

The CMA allowance based on 15-year collapsing average makes new assumptions about notional company debt, namely around shorter tenor debt and bank debt. These assumptions have implications for the additional cost of debt, as shorter tenors and bank debt impose higher transaction costs and cost of carry (both of which increase with a decrease in tenor). As a consequence, the CMA's proposed 15-year collapsing tenor means that the 10 bps additional cost of debt allowance is inadequate. Any reconsideration of the notional company debt financing must involve a reconsideration of the additional cost of borrowing. For example, relative to Ofgem's recent RIIO-2 additional cost of borrowing of 25 bps, CMA's allowance is inadequate in relation to the cost-of-carry.

Table 2: CMA's Additional Cost of Borrowing Is Inadequate for the Newly Defined Notional Company

	Ofgem FD (bps)	CMA PF
Transaction cost	6	
Liquidity/ RCF	4	
Cost of carry	10	
CPIH issuance/ basis risk	5	
Total	25	10

Source: Ofgem (December 2020) Decision - RIIO-2 Final Determinations – Finance Annex, pp 14-15

3.5 Conclusions: CMA should revert back to 20-year trailing average with an uplift to reflect WoC specific factors

The evidence supports use of 20-year trailing average for the industry

For the industry as a whole, we have explained that CMA's cross checks demonstrates the 15-year collapsing average is insufficient to fund actual debt costs. Rather, correcting for errors, the cross-

[21] CMA (September 2020) Provisional Findings, para 9.405, p. 605. Link: https://assets.publishing.service.gov.uk/media/5f7c467ee90e070dde709cee/Water_provisional_determinations_report_all_-_September_2020_---_web_-online-2.pdf

checks support the use of a 20-year trailing average for the industry. This is also in line with the industry average tenor at issuance. Based on Ofwat and CMA's own analysis, the weighted average remaining years to maturity is 13.1 years for the sector and therefore supports an average tenor at issuance of 20 years, and a 20-year trailing average.[22] Indeed, an average remaining tenor of 13 years suggests an average tenor at issuance of closer to 26 years, assuming uniform debt issuance over time. By contrast, a 15-year trailing average implies the average remaining tenor to maturity of debt of around 7.5 years far below the CMA's estimate of 13 years.

There are other good conceptual reasons for using a 20 year trailing average. The average industry RCV run-off rates allow for the recovery of investment over an approximate 20 year period and therefore a 20-year trailing average provides a match between assets and debt liabilities.[23] A 20-year trailing average also encourages long-term financing which reduces refinancing risk that would be associated with the CMA's shorter 15-year tenor.

We ask CMA to recognise that WoCs are different which requires a separate approach

However, even with a 20-year trailing average most WoCs would remain underfunded for their embedded cost of debt, as the CMA's own analysis shows. The CMA should distinguish between WoCs and WaSCs in its notional assessment, with regard to embedded costs and the embedded: new debt ratio. In our earlier submissions to Ofwat and the CMA, we have provided evidence of a small company premium on debt of 30 bps, higher than CMA's 10bps premium to iBoxx for a notional small company as set out in Provisional Findings. We also provided evidence for an embedded:new debt ratio of 97:3.

3.6 Proposed remedy

In summary, we request that the CMA employs a 20-year trailing average in determining the cost of debt, which better reflects the CMA's own estimate of the average remaining tenor of debt of 13 years.

We also ask that the CMA recognises that WoCs are different to the wider industry which requires a separate approach. Our costs are higher than the industry average because of relatively small scale and concentrated debt issuance. To account for our higher costs, the CMA should allow for a debt small company premium that reflects our higher issuance costs and higher costs because of historical dated debt, and use an embedded:new debt weighting that better reflects a WoC's issuance profile.

22 CMA (January 2020) Water Redeterminations 2020, Cost of debt – Working Paper, Table 1, p. 49

23 RCV run-off rates lie in the approximate range of 3.5 per cent to 7 per cent. Source: Ofwat (2019) PR19 final determinations: Aligning risk and return technical appendix, p. 65, Figure 5.6. Link: https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Aligning-risk-and-return-technical-appendix.pdf

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Contact Us

South East Water
Rocfort Road
Snodland
Kent
ME6 5AH

southeastwater.co.uk

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