South West Water

Peninsula House, Rydon Lane, Exeter, EX2 7HR
www.southwestwater.co.uk

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By e-mail: waterdetermination2020@cma.gov.uk

Dear Sir/Madam

South West Water's response to the CMA *Cost of Capital – Work Papers* in relation to the Water Redetermination 2020.

We appreciate the thorough and diligent way the CMA is continuing to review Ofwat's determinations and we welcome the opportunity to comment on this given the importance for future determinations.

We note that the CMA has requested comments on specific aspects on the cost of capital, rather than the overall approach and final cost of capital proposed. As noted in our response to the provisional findings, we strongly believe that the sector has significant future investment requirements to ensure resilience in the face of climate change and population growth, and therefore it is essential that any price determination balances the risk and returns for companies.

Given the technical nature of the working papers we have commissioned a third-party report from Frontier Economics to provide an independent assessment of the two working papers on the cost of capital. This assessment has helped to inform our response.

The comments we make in this response are consistent with the detailed representations made in our Draft Determinations response in August 2019.

Cost of Equity

We agree with the CMA that it is the fundamental to promote efficient investment in the sector.

As we highlighted in our previous submissions, we strongly believe that the sector has significant future investment requirements to ensure resilience in the face of the climate crisis, the need for environmental improvement and to meet population growth. It is therefore vital that the sector remains attractive to investors and can raise finance at efficient rates.

It is against this context that we provide comments on the working paper relating to the point estimate of the cost of equity. In particular, it provides a more comprehensive framework for assessing the issue than we have seen previously in regulatory decisions. In our view it provides a foundation for a better and more robust assessment of this issue in future decisions.

We agree that the following factors, highlighted in the working paper, are relevant for setting the point estimate of the cost of equity.

- The risk that setting the WACC too low will adversely impact investment, including future investment plans, and the ability to attract external finance. This is particularly important for the water sector looking forward, given the need to meet the challenge of factors such as climate change.
- The balance of risk in the other parts of the price control package (e.g. ODI penalties and cost sharing incentives).
- Other cross-checks on the cost of equity, including notional financeability metrics as a cross-check on the cost of equity.
- The impact customer bills and affordability from setting a WACC above the expected 'best estimate' level.

By setting out all of these different factors the working paper provides a useful framework for assessing where to set the point estimate. An added positive would be applying this clear and robust framework for assessing the point estimate and doing so consistently over time. This would encourage investors to have even greater confidence in the regulatory methodology and lower perceptions of regulatory risk, supporting the ability of UK infrastructure to raise finance on efficient terms going forward.

We agree with the CMA that applying this framework requires the exercise of judgement and a qualitative assessment of these different factors. While it would be attractive if the overall assessment could be undertaken using a modelled quantitative method, in reality, our view is that this is not possible, and that judgement will always be required in this assessment. This does not mean that quantitative analysis cannot inform parts of the assessment, for example, the degree of uncertainty and asymmetry in the cost of equity range. In addition, the exercise of judgement should always be supported by evidence and clear reasoning.

Cost of Debt

South West Water has always been supportive of assessing the cost of capital based on a notional capital structure. This enables companies to decide their own financing strategy and corporate structure. For this reason, as we noted in our previous submissions, we have also supported Ofwat's proposals for companies to share financing outperformance from higher gearing.

The importance of using a notional capital structure is that companies should be incentivised to make efficient financing decisions. As a result, they should bear the responsibility for their decisions and where companies choose to do something different, we do not believe it should be to the detriment of customers. It is inherent in this view that the regulator has a responsibility to provide as much clarity and certainty to companies on the details of the notional structure. By doing that companies will be able judge if their decisions are departing from the notional structure.

On this basis we support the CMA's broad approach to assessing the cost of debt as set out in the working paper. In particular the use of a notional capital structure and the use of independent benchmarks as the primary tool to assess the cost of debt financing.

Furthermore, we agree that the iBoxx indices for A-rated and BBB+ rated corporate bonds are appropriate independent benchmark to use to assess the costs of financing. It is a well-established index and both companies and regulators are familiar with it and comfortable with it as a benchmark. In our view this should be the primary tool to assess the cost of debt.

In our view this is a reasonable cross-check provided that it is applied, as the CMA has done, at an industry average approach and not applied on a company specific basis that would undermine the incentive properties of a notional structure.

We agree with the CMA's conclusion that there is no evidence for a downwards matching adjustment (or 'halo effect') on the cost of debt. This is consistent with the findings of the independent analysis we commissioned at PR19. In relation to the time frame assumed for setting the cost of debt we believe whatever the metric there is a need to ensure an approach and basis that can be consistently applied across multiple price reviews to enable companies to plan financing for the long-term.

The assessment by Frontier of the CMA working paper considered the specific components of the cost of debt and cost of equity calculation and a copy of Frontier's report can be made available on request.

In summary, we believe the CMA should consider the overall balance of risk and return, enabling long-term efficient investment into the sector which in turn will ensure companies can deliver a resilient service into the future.

Yours faithfully

[redacted]

Louise Rowe
Finance Director
D: [redacted]
E: [redacted]