Water UK response to CMA consultation on cost of capital

27 January 2021

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Water UK is the representative body and policy organisation for water and wastewater service providers across the UK; individual companies may have different perspectives.

We welcome the opportunity to respond to the CMA's consultation[1] on two aspects of the cost of capital. In doing so, we are conscious that these aspects have significance not only to the four price determinations which have been referred to the CMA, but also to future price determinations for all water and wastewater service providers in England and Wales, to their customers, and to the environment.

In considering the issues raised by the consultation, we start from the overall position that given the well-known long-term challenges facing the sector, it is in the interests of current and future customers for continued investment to be encouraged and for the sector's longer-term attractiveness to investors to be maintained.

This will require the sector to be seen as an investable proposition, with a reasonable prospect of an appropriate balance of risk and returns – particularly in light of the substantial investment that will be needed in subsequent regulatory periods to meet the challenges of climate change and growth.

In this context, turning to the points raised in relation to choosing a point estimate for the cost of capital[2], we support the CMA's maintenance of the well-established regulatory principle that there is an asymmetry of risks to consumers from over- or under-estimating the cost of capital, and that a degree of 'aiming-up' is therefore appropriate and in consumers' interests. We agree that regulation should create a supportive long term investment environment and that the allowed return needs to be set in a way that encourages the right level of new investment.

We welcome the CMA's continued recognition that there is a clear and direct link between the level of risk in a price control and the level of return that is needed. If a price review leads, as is the case for PR19, to asymmetric downside risk, then the level of the WACC and other parameters should reflect this.

[1] https://assets.publishing.service.gov.uk/media/5ff725ade90e07639fd8d468/-_Executive_Summary_-_ONLINE_VERSION_-.pdf

[2] https://assets.publishing.service.gov.uk/media/5ff726168fa8f56407498c29/Point_Estimate_for_the_Cost_of_Capital_Working_Paper_---_-.pdf

We also agree that financeability provides a relevant cross-check on the choice of the cost of equity, and that the overall determination, in the round, needs to include a consideration of whether the WACC assumptions are consistent with the credit rating assumed.

As a matter of principle, if the WACC is set at a reasonable level, both debt and equity investors should earn sufficient returns to cover the costs of financing. As is noted in the consultation, if the alternative solution is a repeating scenario of accelerating revenues from future price controls (through the use of financeability levers), then customers may face the same uplift to bills while companies are more likely to be downgraded by the rating agencies.

Regarding the overall degree of aiming-up that is appropriate, as we noted in our response to the provisional findings[3] (in the context of the degree of aiming-up that CMA proposed in those provisional findings) the investability of the sector should not be taken for granted.

Turning to matters related to the cost of debt, we will not seek to respond to some of the more technical aspects in the document[4], which we anticipate will be well covered by others. However, we are concerned by CMA's proposal to reduce the 'look-back' period from the 20 years proposed in the provisional findings to 15 years.

A 20-year period would be consistent with the tenor at issue of water company bonds, as demonstrated by Figure 2 on page 11 of the document. As the consultation notes, long tenors such as this are appropriate in a long asset-life industry such as regulated water, whereas a 15-year period would, as the CMA acknowledges, exclude 20% of the sector's bond debt.

We also agree that the use of shorter look-backs could provide an inappropriate signal to companies that the regulator is encouraging them to shorten the tenor of their debt in order to reduce costs, potentially trading lower short-term costs for increased financing risk.

What is of particular concern, however, is that the CMA is clearly right to note that "it may be seen as opportunistic to disallow costs associated with the issuance of long-term debt on the basis that 'in hindsight' market rates subsequently fell".

This would risk undermining confidence in the consistency and predictability of the regulatory regime, at a point when significant investment in the sector will be required. We agree with the CMA's view that regulation should create a supportive long-term investment environment and therefore urge the CMA to revert to its provisional findings position of using a 20-year look-back period.

[3] https://www.water.org.uk/publication/water-uk-response-to-cma-provisional-findings/
[4] https://assets.publishing.service.gov.uk/media/5ff72645e90e07639fd8d469/Cost_of_Debt_Working_Paper_---_-.pdf