

Financing Investment

The Cost of Capital

At each price review, the regulator has to determine an appropriate cost of capital for the industry. This is the return to investors for providing finance that is needed to pay for capital investment. (see also **Briefing Note 3 in the links below**). Because the sector, with its network of pipes, treatment works and pumping stations has a large, and growing, asset base, financing costs amount to some 30% of the average household bill. The cost of capital is therefore an important driver of prices. It is important to get it right so that customers do not pay too much, but also so that investors remain willing to invest, thereby ensuring the continuation of a high quality service for one of the fundamentals of life.

The credit crunch has had a very significant impact on the debate on the cost of capital for the next set of price limits, PR09. This briefing note first examines the scale of the investment programme, and then the issues faced by the companies and the regulator in considering the appropriate returns to investors to be allowed in prices.

How big is the investment programme?

Since privatisation in 1990 the water industry in England and Wales has invested on average over £4.2 billion per annum – nearly £4.9bn in 2007-08 - and the total investment spending by 2010 will be around £80bn. The level of spending on new assets is around 50% of the industry's turnover - a far greater proportion than in most other industries.

To put the investment spend of the water companies into context, the current levels are double the pre-privatisation levels of around £2 billion per annum in the 1980s.

The capital investment programme delivers long term benefits. For example, the assets that are built, many with 50 or 100 year lives, serve not just this generation but many future generations of customers. In the same way of course, the current generation of customers is benefiting from the investments put in place historically.

The high level of investment will continue to be sustained by the ongoing need to maintain the asset base, now significantly expanded as a result of the increased investment in environmental improvements since privatisation. There is also still some way to go to improve further the quality of surface waters and, in some parts of the country, it is not water quality but water resources needs that are driving significant parts of the investment programme. Water resources are being impacted by population growth whilst many areas are having to develop alternative sources where current abstractions are now considered, under European law, to be damaging local habitats.

For PR09 companies have been carefully reassessing their plans in the light of the recession, aiming to ensure that necessary investment to maintain services and meet legal obligations is prioritised. For several, revisions have been made to reflect reduced demand as the recession is suggesting lower growth in new housing development. Others have worked with regulators to ensure the most economic solutions are put forward.

How are allowed returns to investors determined?

The cost of capital required by investors to be willing to supply funds to the water sector, is estimated by taking a weighted average of the cost of debt and the cost of equity. A cross check on the companies' 'financeability' is then made – to ensure that companies will be able to maintain financial ratios that will enable them to sustain investment grade credit ratings, and thereby secure them access to finance at the lowest cost end of the spectrum (generally very long term debt).

It is difficult to make the right judgement. For example, in 1999, as the House of Commons Public Accounts Committee then concluded, the regulator probably set it too low. In 1999 water company share prices fell by 40%+ after the price determination, indicating a loss of confidence by equity investors.

By contrast, in 2004, the regulator restored investor confidence with its determination for the present price review period. However, in the next 3 years, capital markets turned out to be exceptionally benign, enabling companies to take advantage of a much cheaper cost of debt, prompting a flurry of acquisitions. But just when some were arguing, with the benefit of hindsight, that the regulator had been 'too soft' at PR04, the credit crunch hit. In the last two years of the price review period, the cost of debt has soared.

It would now seem that over the 5 year period overall, that Ofwat's allowance for PR04 (5.1% fully post-tax) was broadly correct. Ofwat has reflected this turnaround in its recent public statements, moving from an expectation that it would set a 'significantly lower cost of capital' for PR09 than it did for PR04, to a much more cautious public position.

The credit crunch and the consequent economic downturn have indeed made decisions on the cost of capital even more difficult. Setting a single point estimate of the cost of capital for five years will be a tough task, in what is essentially an exceptionally volatile period in the capital markets. Not least, there are widely diverging views on the likely length and depth of the recession, and uncertainty about how successful will be attempts by Governments to underpin confidence in capital markets.

Independent consultants, NERA, were commissioned by Water UK to produce estimates for the WACC for PR09. Their first report was published in July 2008, estimating a range of 4.5 to 4.9 (fully post tax) – below the figure for PR04. This reflects an assumption that companies will sustain some benefit from having locked in a proportion of very low cost debt for the long term. NERA have since updated their estimates, arriving at a slightly higher range of 4.7 to 5.1. This reflects deterioration in the credit markets since the collapse of Lehmans in August. These estimates were

discussed at the recent Water UK City Conference in February 2009, and the NERA report is available on our website, together with Water UK's press release.

What do investors think?

Water UK has undertaken surveys of debt and equity investors supported by Ofwat. The latest was undertaken January 2009 and the results presented in February 2009 at Water UK's city conference.

The survey shows that investors are on the whole positive about the water sector and the way in which the regulatory regime has operated to date – but they have uncertainties about PR09 and the impact of the ongoing turmoil in financial markets.

Regulatory risk is seen as the biggest uncertainty facing the sector – perhaps unsurprising in a price review year. Investors suggest that Ofwat has become more aggressive and difficult to read and that there is a lack of clarity on how Ofwat will respond to the external environment.

Links

To help understanding of the 2009 Periodic Review process Water UK has produced a series of Background Briefs covering the key issues facing the industry, its customers and stakeholders. These Briefs cover:

1. Priorities and Prices
2. Why water services need so much investment
3. Customers and shareholders investing in improvement

All Briefs can be found on Water UK's website at:

<http://www.water.org.uk/home/policy/positions/finance-and-investment>

Water UK 9th Annual City Conference

<http://www.water.org.uk/home/events/events/city-conference-2009?quarter=28>

2009 Investor Survey

<http://www.water.org.uk/home/policy/reports/finance/2009-investor-survey>

Nera Report: Cost of Capital for PR09 (2009)

<http://www.water.org.uk/home/policy/reports/finance/revised-cost-of-capital-nera-report>

Nera Report: Cost of Capital for PR09 (2008)

<http://www.water.org.uk/home/policy/reports/finance/cost-of-capital-for-pr09>

Water UK Press Release: Nera Report 2009

<http://www.water.org.uk/home/news/press-releases/setting-a-cost-of-capital>