

Small company premium – key considerations for PR19

Ian Alexander
15 June 2017



Agenda



- 1 Small company premium: context & precedent**
- 2 Key issues for PR19**
- 3 How we can assist you**



1. Small company premium: context & precedent



- **Two potential justifications for the introduction of the SCP:**
 - Higher financing costs
 - Different systematic risks
- **Ways to apply an SCP:**
 - An uplift on the assumed cost of debt; and/or
 - By using a higher asset beta in estimating the cost of equity.
- **Precedent on SCP**
 - PR04 → Ofwat introduced uplifts on both CoD & CoE
 - PR09 → Ofwat applied a SPC on WoCs cost of debt only
 - PR08 → CC used a higher asset beta in estimating the cost of equity for Bristol Water (Bristol Water appeal of Ofwat's PR09 settlement) but rejected the 'small company equity premium' uplift



1. Small company premium: context & precedent



- **PR14 → Ofwat considered SCP as part of its risk-based assessment of companies' proposals**
- **Ofwat set out a 'customer benefits test' to decide whether to accept WoCs' SCP proposals**
 - Resulted in Ofwat rejecting all SCP proposals except for two WoCs
- **CMA came to a different conclusion in its decision on the BW appeal of Ofwat's PR14 settlement**
 - CMA critical of Ofwat's use of the customer benefits test to decide whether to apply an SCP
 - CMA rejected Ofwat's argument on the water sector merger regime
 - CMA followed similar arguments to the ones used in 2010 by the CC on the CoD & asset beta



2. Key issues for PR19



- **Different views between CMA and Ofwat on SCP**
 - **CMA:** Regulators should take a consistent approach to including the SCP in the allowed RoR
 - **Ofwat:** Preference to continue (and enhance) its risk-based approach to setting the regulatory package

Will Ofwat use of a customer benefits test in informing its decisions on the SCP in PR19?

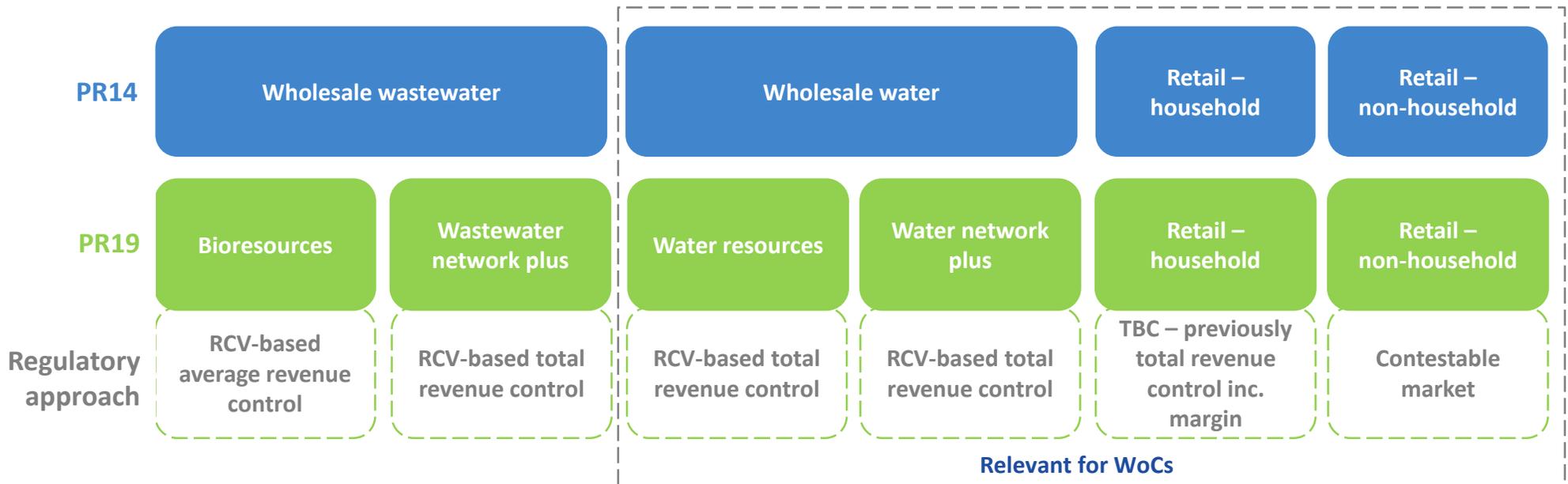


2. Key issues for PR19



- **Some of the changes for PR19 may also have an impact on the SCP, specifically:**
 - **Changes to the cost of debt/cost of equity methodologies;**
 - **Introduction of menus-like approaches; and**
 - **Introduction of separate price controls for ‘water resources’ and for ‘water network plus’**

Figure 1: Segmentation of the water and sewerage value chains



2. Key issues for PR19



- **Ofwat is likely to regulate different parts of the value chain differently**
 - PR19 → preparation for the introduction of competition for water resources
- **Separation of activities into different revenue caps and the variation in risk profiles make it harder for Ofwat to use the actual debt costs of WaSCs and WoCs to inform its cost of debt estimate**
- **The use of share prices of listed WaSCs to estimate beta values becomes a less comparable metric**
- **Change in the approach to assessing the SCP?**



2. Key issues for PR19



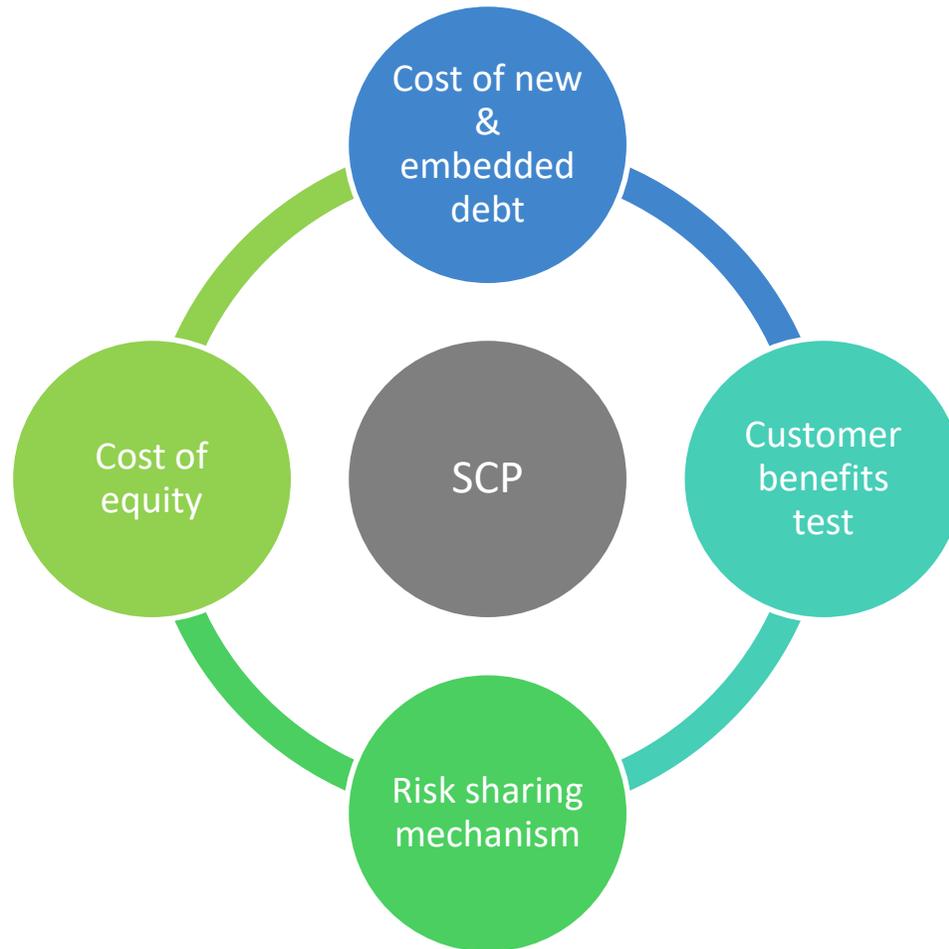
- At what level will the SCP be set at?
- How will it interact with Ofwat's general approach to PR19?



3. How we can assist you



To provide the most up-to-date value of the SCP, we can...





CAMBRIDGE ECONOMIC POLICY ASSOCIATES

**Queens House, 55-56 Lincoln's Inn Fields
London WC2A 3LJ**

Tel: 020 7269 0210

Fax: 020 7405 4699

info@cepa.co.uk

www.cepa.co.uk