SOUTH WEST WATER

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Dear Mr Basalisco

Discounting for CBAs involving private investment, but public benefit

Response from South West Water

We are pleased to provide comments on the Joint Regulators Group consultation on the approach to discounting for Cost Benefit Analysis (CBA). South West Water is the appointed water and sewerage undertaking serving 1.6 million people in Devon, Cornwall and parts of Somerset and Dorset. As such we operate in a highly regulated sector, with economic regulation provided by Ofwat.

We undertake extensive Cost Benefit Analysis as a tool to support investment planning decisions across the full range of our activities. Our responsibilities to customers and stakeholders require us to take a long term view of the costs and benefits of the decisions we face. There are wide public benefits and consequences of involved. For instance, water customers are currently contributing through bills to our "Upstream Thinking" catchment management projects, which are rewetting upland moor areas to improve long term water quality. This project provides an alternative to expensive "end of pipe" treatment solutions where the impacts are relatively certain over the short term. However, catchment management may be a more sustainable long term option and also have vital wider benefits to the environment such as habitat protection and carbon capture.

Cost Benefit Analysis played an important part in ensuring our choice of approach to tackling the challenges we face was in customer and stakeholder interests. Because of the long term consequences of the decision, it was important that the discounting approach used in the analysis reflected both the financing approach built into the economic regulation regime on the cost side and the wider public benefits. In developing our approach, we concluded that in order for CBA to look at the overall impact to society, costs should reflect the timing of recovery from customers through bills by including financing costs using the "vanilla" pre tax debt, post tax equity Weighted Average Cost of Capital (WACC). Both costs and benefits could then be discounted on a consistent basis using the Social Time Preference Rate (STPR).

Through UKWIR and our work with the WFD collaborative research programme, we fed our ideas on this area into OXERA, whose report to Defra is referred to in the consultation. This approach has another key advantage for us; we can calculate an impact on average customer bills by taking the Equivalent Annualised Value (EAV) of the costs and dividing it by the number customers. This makes customer and stakeholder engagement on CBA analysis straightforward, as the distinction between bill impacts and wider public benefits are easy to understand.

We can therefore fully support the conclusion in the consultation that all costs (including financing costs calculated using a WACC) should be discounted using the STPR.

When necessary we supplement our CBA through sensitivity testing. This can reflect uncertainty in benefit values, cost risk and delivery risk when comparing different approaches. We have used Monte Carlo simulation as a decision support and presentational tool for this sensitivity testing. We find this type of analysis allows risk and uncertainty to be exposed for alternative approaches in a clear way than through adjusting the approach to discounting.

Please do not hesitate to contact me if you require any further information.

Yours faithfully

Iain McGuffog
Economic Regulation Manager