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Severn Trent Water Limited

Bruno Basalisco
Ofcom
Riverside House
2A Southwark Bridge Rd
London SE1 9HA

Severn Trent Centre
PO Box 5309
Coventry
CV3 9FH

Tel 02477 715000
Fax
www.severntrent.com
www.stwater.co.uk

Dear Bruno

Discounting for cost-benefit analysis

I am writing to give Severn Trent Water's response to the technical paper on discounting produced by the Joint Regulators' Group.

We agree that assessing the different systematic risk for different cost streams within a CBA, and applying differing discount rates on a stream by stream basis, would introduce excessive complexity. Therefore a pragmatic option needs to be taken. This applies particularly strongly to the water industry, where CBA is applied to a very large number of diverse projects. As suggested, the approach needs to consider the nature of the investment being undertaken. For the water industry, this usually involves projects with private investment leading to benefits for the public and society.

The form of the Spackman approach recommended by Ofwat, which allows financing costs to be taken into account within CBA through a two-step process, has been considered appropriate for the water industry for the PR09 process and has been endorsed by the Competition Commission and by recent UKWIR research on the application of CBA, as identified in this paper.

Since other utility industries are carrying out CBA for a variety of different investment projects, with differing sorts of benefits, then we do not believe it is necessary to adopt a uniform approach across the different utility industries. However, variations in approach should be justified by differences between sectors in the nature of their investment.

The financing cost for water industry projects represents the return which investors require for the level of risk which they are taking, and it is appropriate for these costs to be included in the CBA. However, we do not consider that there is any significant systematic risk in the benefits derived from investment in the water industry. The diverse nature of projects undertaken reduces the likelihood of any systematic risk (though it may be justified to consider specific risk for very large projects). Therefore we consider that the Spackman approach, as adopted in the water industry, with costs, including financing costs, and benefits discounted at the STPR, is generally appropriate.

In addition to the Spackman approach being theoretically justified, there would be practical difficulties in making a change which would mean there would need to be a strong justification for any change in approach. The form of the Spackman approach adopted within the water industry has now been configured within the asset deterioration models and optimisation systems used within the asset management and business planning processes of companies and modifying these would add a significant cost to the periodic review process.

Yours sincerely

A handwritten signature in black ink that reads "A J Ball". The signature is written in a cursive style with a long, sweeping underline.

Dr Tony Ballance
Director of Strategy and Regulation
Severn Trent Water