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Competition and Markets Authority
By email to: waterdetermination2020@cma.gov.uk

11 May 2020

Dear Sarah,

Ofwat PR19 Price Determinations

Electricity North West Limited (**ENWL**) appreciates the opportunity to provide comments to the CMA on the issues raised in Ofwat's references and the main party submissions in the above matters and some initial observations on Ofwat's response. ENWL is one of six companies managing an electricity distribution network in the UK regulated by Ofgem, and we are proud to serve communities in the North West of England. Our particular interest in the Ofwat PR19 Price Determinations stems from the clear read-across on key issues to the forthcoming RIIO-2 price controls in the energy sector which, as an electricity distribution network operator, will affect us directly.

ENWL is a member of the Energy Networks Association (**ENA**) and fully supports any submission made by ENA to the CMA on this matter. However, ENWL has some additional comments, on areas not covered by ENA, which it wishes to bring to the CMA's attention. These relate to regulators' financing duties (and how they meet it in practice) and company specific debt costs.

1 Financeability

1.1 We note that all of the appellant companies have raised the issue of financeability in their Statements of Case, which in turn forms a key part of Ofwat's response.

1.2 Three key points we would like to make in this regard are as follows:

(a) Contrary to the suggestion made by one of the appellant companies, there is <u>no material difference between the financing duty in the water sector and that in the electricity sector</u>;

(b) When developing price controls, regulators look to ensure that the price control is set at a level which would allow an efficient notionally geared company in the sector to finance its licensed activities through recovery of its efficiently incurred costs and an allowed cost of capital. However, <u>while establishing that an efficient notionally geared company is financeable under the price control is an important exercise, this alone is not sufficient to discharge the financing duty</u>

(c) To satisfy the financing duty, a regulator must conduct financeability tests and make appropriate adjustments to take into account company-specific characteristics. Size is an important characteristic. A small company can be expected to face higher costs than the sector's notionally geared company, even where both operate efficiently. Regulators must take this into account when taking steps to assess and secure financeability.

1.3 We address each of these points in more detail below.

The financing duty

1.4 Under section 2(2A) of the Water Industry Act 1991, Ofwat has a primary duty to act in the manner which it considers is best calculated to (among other things) "*secure*" that companies "*are able (in particular by securing reasonable returns on their capital) to finance the proper carrying out*" of their functions. This is variously referred to as the "**finance duty**", the "**financeability duty**" and the "**financing duty**". We use the latter in this submission.

1.5 Northumbrian Water Limited suggests that Ofwat's financing duty is "*materially different*" from the financing duty of other sector regulators. Specifically, it states[1]:

> *"The duty to regulate in a manner best calculated to achieve a result is clearly a higher standard to that, for example, in the electricity sector which is only to 'have regard to'."*

1.6 In our view, there is no material difference between the financing duties imposed on the regulators[2]. There are of course differences in the drafting of the relevant statutes. Section 3A(2) of the Electricity Act 1989 provides that, when carrying out its functions, Ofgem "*shall have regard to ... the need to secure that licence holders are able to finance [their] activities*". This is wrapped up in the principal objective to protect the interests of consumers. "Financeability", in the context of the Electricity Act 1989, is therefore neither a subsidiary nor primary obligation, but one of two specified ways in which consumers interests are protected (the other being the securing that all reasonable demands for electricity are met). This is entirely consistent with the fundamental idea behind the financing duty: that it is in the long term interests of consumers to ensure efficient companies are financeable.

1.7 Ofgem does not simply have to have regard to "financeability", but to the "*need to secure*" the financeability of licence holders when making its decisions. Regulators have some discretion as to the means by which they discharge this duty, in that they must do so in the manner in which they consider is best calculated to secure financeability.[3] But the overriding obligation on the regulator is to ensure efficient companies can finance their licensed activities. If an efficient company was unable to do so Ofgem would be in breach of its principal objective in 3A of the Electricity Act 1989.

1.8 We do not think that the CMA, in this determination process, need consider in detail whether Ofwat's financing duty is materially different from the financing duty of any other regulator. However, should it engage in any such exercise, it would be appropriate to seek views from other regulators and regulated businesses.

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1 Northumbrian Water Limited, Statement of Case dated 2 April 2020 (paragraph 983).

2 We note Ofwat supports this view. See Ofwat response – Introduction, overall stretch on costs and outcomes', at footnote 70 where Ofwat describes the financing duty under the Electricity Act 1989 and states "*Read fully and in context, it is not a diluted version of the duty on Ofwat*".

3 We consider that Ofwat take the point on discretion too far in its response. There are always limits on regulators' discretion – the obligation to secure financeability being just one. The suggestion that a regulator's discretion could be so exhaustive as to virtually preclude any challenge to a price control settlement on the grounds of breach of the financing duty is plainly wrong.

Efficient, notionally geared company

1.9 In practical terms, across sectors, the financing duty means that it is incumbent upon the regulator to ensure that that individual licence holders are able to finance their activities and that companies can secure both debt and equity finance. Regulators tend to start this assessment by reference to a 'notionally efficient company' in the first instance.

1.10 However, it follows from the nature of the financing duty that while this is a useful starting point, it is not enough for a regulator to find that an efficient notionally geared company is financeable under the price control,[4] as it appears is Ofwat's view. A small company can be expected to face higher costs than the sector average by virtue of its size. Regulators need to take this into account in discharging their financing duty.

1.11 We note that this view is consistent with that expressed by the CMA, for example in *Bristol Water plc: A reference under section 12(3)(a) of the WIA91 – Report (2015)*[5], where it stated:

> "*Ofwat's approach will result in some companies, in particular very small companies, being in a position where their notional cost of efficient finance, is higher than Ofwat's assumption. If the notional company is based on a total industry average, the resulting cost of debt could be perceived as too low for these very small companies, which could be perceived as being potentially inconsistent with its finance duty.*"

The financeability of each company

1.12 To satisfy its financing duty, the regulator must therefore assure itself that each company with efficiently incurred costs is financeable. So it should consider the financeability of each company individually, taking into account company-specific information and characteristics. Financeability tests are the means by which a regulator can transparently demonstrate that it has discharged the financeability duty.

1.13 Financeability is secured by allowing recovery of efficiently incurred costs and a reasonable return. This principle, and the need for such financeability assessment to be company-specific was clearly recognised in *Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation: Final Determination (2017)*[6], in which the CMA stated:

> "*Financeability is a term used by regulators to decide if a firm has the ability to pay off its providers of debt and equity finance. In price controls, … it is generally assumed that financeability is achieved when the rate of return (or WACC) has been set at a high enough rate, such that the revenues and therefore cash flows made by the firm are sufficient to pay investors and lenders.*"

1.14 The regulator therefore cannot assume financeability based on simply on the notionally geared company: a price control should ensure financeability of efficient companies. As such, the regulator must make appropriate cross-checks. If regulators expect companies to be able to achieve investment grade credit ratings, they must test to ensure companies proposed settlements meet appropriate ratios. These ratios need to include returns to equity, appropriately

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4 Of course the efficient notional geared company should be financeable without any material adjustments, before attention is turned to individual circumstances. If the efficient notionally geared company is not financeable under the proposed regulatory settlement – without mitigation – the regulator has failed to satisfy the financing duty at the first hurdle.

5 See https://assets.publishing.service.gov.uk/media/56279924ed915d194b000001/Bristol_Water_plc_final_determination.pdf (paragraph 11.75).

6 See https://assets.publishing.service.gov.uk/media/5953bfd8e5274a0a69000079/firmus-final-determination.pdf (paragraphs 7.98 and 7.99). We note Ofwat relies on this case as evidence that it need only establish that the notional company is financeable. We do not support this reading of the case. See 'Ofwat Response – Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case" – Financeability at para 3.84 onwards.

measured, including expected tax and debt performance. Such cross-checks should not be dismissed as merely "a sequence of binary pass or fail tests".[7] They form a necessary part of the regulator's overall assessment to ensure that the price control settlement is financeable. Failure on one or more of the tests would be a strong indicator that there is a financeability concern which needs to be addressed.

1.15 Regulators must also allow sufficient headroom to allow companies to respond to plausible downside financial shocks within regulatory periods and take into account the level of challenge on the companies (e.g. low inflation scenarios or interest rate reversion). It is not in consumers long term interests to see periods of significant underperformance. In that scenario, investors and potential investors would be inclined to "demand" higher long term returns, and, where those are not available, avoid investing.

1.16 Finally, we are concerned by the volume of last-minute adjustments and mitigations evident in the PR19 regulatory settlement - and which we note are becoming increasingly common in regulatory settlements more generally. As a point of principle, it would be helpful if regulators focused on meeting the financing duty in relation to each company throughout the determination process, to avoid the uncertainty inherent in a suite of adjustments at its end.

2 Company specific debt cost

2.1 We also wished to comment on a specific point relating to cost of debt. As a starting point, we consider that setting of the cost of debt allowances flows from the financeability duty, and regulators must ensure that each company is financeable, based on its particular circumstances (subject to an efficiency test.). It is not appropriate to rely upon equity returns to cross subsidise underfunded debt returns.

2.2 In its Cross-Cutting Issues paper, Ofwat noted that:[8]

> *"there is some evidence that the smallest water-only companies have tended to have a higher cost of debt than larger companies. We said this was not sufficient to justify an uplift however, as customers should not be expected to fund higher costs that arise due to factors that are under company control (for instance timing or tenor). This is due to the poor efficiency incentives that such a policy would imply."*

2.3 To the extent that smaller companies faced higher debt costs for reasons other than timing or tenor, Ofwat's view is that small companies "*cannot expect to pass higher size-related financing costs on to their customers."*[9]

2.4 We support the principle of adjustments made by Ofwat at PR14 and PR19 (company specific adjustments or small company premiums) which show that an additional allowance for the size of company is appropriate. However, it appears that these have been applied in a restrictive way.

2.5 In our view, it is important that regulators do not penalise companies for past management decisions where these were efficient when taken and which cannot be ameliorated by refinancing. If regulators, succumbing to hindsight bias, do not make allowances for such efficiently incurred debt, then the financeability of the company is not secured. Ensuring financeability in this way

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7 See Reference of the PR19 final determinations: Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case, paragraph 3.83.

8 See https://www.ofwat.gov.uk/wp-content/uploads/2020/03/Reference-of-the-PR19-final-determinations-Cross-cutting-issues.pdf at paragraph 5.67.

9 See https://www.ofwat.gov.uk/wp-content/uploads/2020/03/Reference-of-the-PR19-final-determinations-Cross-cutting-issues.pdf at paragraph 5.68

does not threaten to "greatly dilute incentives to issue debt efficiently"[10]: only efficiently incurred debt costs would be recoverable.

2.6 In a similar vein, is the treatment of derivatives. In our view, it is unreasonable to review underlying financing structures without also taking into account the cost or benefit of derivatives, where these have been entered into primarily for risk management purposes. By way of example, it would be illogical to exclude derivatives where these are used to hedge against inflation risk where index-linked debt was not available. In such circumstances, they should (alongside the underlying nominal debt) be treated consistently with index-linked debt. Similarly, we agree with the position taken by Anglian that "*It is inconsistent for Ofwat to exclude swaps from the analysis whilst including inflation-linked bonds.*"[11]

2.7 Ofwat does not agree that the costs of financial risk management should be borne by customers. Effective financial risk management limits the sensitivity of a company's financial performance to systematic, macro-economic risks relating to (for example) currency, inflation and interest-rates. This is supportive not only of a company's credit metrics and overall financeability, but also of the equity betas typically observed in the utility sector, which then translate into a reduced cost of capital for consumers. Providing the risk management costs are efficiently incurred it is appropriate for these costs to be recovered through the price control. We note that Ofwat points to a number of examples where there may be difficulties in including swaps (e.g., assessing whether a given swap was efficiently incurred, and in comparing their cost to ordinary debt instruments) but this does not justify a blanket exclusion.

We have provided these initial views by 11 May deadline in order to assist the CMA, but may of course wish to make further comments and submissions during the process (particularly as we further digest Ofwat's Response, published on 5 May 2020). We are also happy to confirm that nothing contained within this submission is confidential, and we are content for it to be published in full on the CMA's website.

If you have any questions, please do not hesitate to contact me or Paul Bircham [redacted]). Should you wish to hear from us in person (or by videoconference given the current restrictions), we will seek to make ourselves available where possible.

Yours sincerely

[redacted]

David Brocksom

Chief Financial Officer

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10 Reference of the PR19 final determinations: Risk and return – response to common issues in companies' statements of case, paragraph 3.94.

11 https://assets.publishing.service.gov.uk/media/5e8dc457e90e07077abf9a4c/Anglian_Water_PR19_CMA_Redetermination_Statement_of_Case_Corrected.pdf at paragraph 142 (iii).