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

26 October 2020

Dear Sarah,

Ofwat PR19 Price Determinations: CMA provisional findings stage

Electricity North West Limited (**ENWL**) made a submission to the CMA in respect of these redeterminations on 11 May 2020 and is now responding to the **Provisional Findings (PF)**. In broad terms we consider that the PFs represent a step in the right direction – both for the water companies whose price controls are being redetermined, but also in terms of setting the context for equivalent regulatory processes in other sectors. In this response we focus our comments on those issues that are pertinent to the CMA's final determination for the water companies, but which particularly have significance for other regulated sectors such as the energy sector in which we operate as an electricity distribution network operator.

The importance of ensuring and maintaining investment into UK infrastructure

(1) ENWL agrees that the CMA has rightly recognised the critical need to attract investment into water infrastructure, including to mitigate against the impact of climate change. We particularly welcome the CMA's express acknowledgment that the risks to consumers of underinvestment, which might arise if the cost of capital is set too low, are materially more damaging for consumers than any welfare that might be lost from bills being slightly too high. We agree that it is important to take steps to ensure investment in UK infrastructure remains attractive compared to international markets, through allowing an appropriate level of expected equity returns.

(2) We welcome the CMA's recognition that this broader real-world view of investment incentives is intrinsically linked to providing adequate returns to investors: "*The main role of the cost of capital is to ensure that investors in a regulated business are given a sufficient incentive to invest (but not given a return in excess of that level*" (PFs, para. 9.180).

(3) We also agree that the CMA has acknowledged the importance of the views of rating agencies as vital inputs for informing the CMA's determination of the water price controls. These are, by definition, company specific assessments made by independent expert bodies whose profession is to assess the actual credit risk of companies and who are, crucially, trusted by debt providers. These agencies gauge risk to debt investors based on the actual debt allowance performance. By looking at the financeability through the rating agencies' prisms, using their methodologies,

the CMA recognises the need to consider financeability on a company specific and actual, not abstract or notional basis.

(4) We suggest the CMA goes further and explicitly states that the CMA considers that it is in consumers' long term interests that equity investors are appropriately rewarded for their investment after all debt costs are taken into account (in turn including the all-in economic costs and benefits of any derivatives). Investment decisions and investor attractiveness are not gauged against notional companies, rather against the actual circumstances of actual companies. Debt costs should only not be funded where they are shown to be inefficient. Equity should not be asked to subsidise efficiently incurred debt costs.

(5) The approach the CMA has provisionally adopted for the water sector to ensure adequate returns is equally appropriate, if not even more pressing, for the energy sector. Net zero carbon ambition is now government policy that needs to be delivered through significant investment and innovation. It is vital that shareholder returns are set at a level that incentivises the investment required, in the timeframe needed.

(6) The CMA, in addressing issues raised through the PR19 redetermination, is constructively informing the equivalent regulatory processes in other sectors and influencing other regulators, including Ofgem. We request that the CMA deliver strong and clear messages in its final determination about the type of regulatory approach that will ensure the long-term interests of consumers are protected by attracting and retaining investment. Doing so will mean there is a greater chance that this important message is understood by infrastructure investors and heeded by other regulators, including Ofgem, thereby potentially limiting the need for a substantial number of consecutive appeals in other sectors raising the same or similar issues.

The approach to setting the cost of capital and assessing financeability

(7) We consider that there remain important unresolved issues with respect to the interpretation of the financing duty and the approach to the assessment of financeability not explicitly set out in the provisional findings.

(8) In particular, we consider that for, the regulator to satisfactory discharge its obligations under the financing duty, it is not sufficient to simply secure that a notional company, or the industry overall, can finance its functions. It must have full regard to the actual financial position of individual companies. The financeability assessment must, therefore, take due account of actual circumstances and ensure that both equity and debt are properly funded for the company's actual, efficiently incurred, costs.

(9) Equity investors in companies whose actual costs of debt are higher than the notional assumed level will not have the same prospect of earning the allowed equity return as investors in companies that 'beat' the assumed cost of debt. Under the current regulatory framework this is the case regardless of whether the actual debt was efficiently incurred. If underfunding of actual efficient debt costs results in equity investors subsidising debt allowances over the course of multiple regulatory periods, to significant levels, this will be a breach of the financing duty to equity to ensure adequate returns. If it results in a repricing of equity risk, it would be to the long-term detriment of consumers through increased charges. It would also provide a major disincentive relative to investment returns in other regions or internationally and will lead to a misallocation of investment. It was precisely to mitigate this risk that the financing duty was included within the privatisation legislation.

(10) Conversely, equity investors in companies that are overfunded for their debt allowances are being handed a "*return in excess of that level*". Adopting a one-size fits all approach allows those lucky and/or large companies that raise debt at lower cost than allowances, set by reference to an index, to continue this outperformance from one price control to the next. Given that those companies that benefit are not required to share the benefits with consumers, this results in significant structural outperformance for equity in some companies. This distorts and reduces the incentive for those companies to outperform on expenditures or on other incentives, to the detriment of customers. We note that, in the water sector, certain listed companies are outperforming their cost of debt sufficiently to distort the MARS cross checks.

(11) We request that the CMA more fully consider the impact of debt costs on overall investment incentives, including on a company specific basis, and on the long-term interests of customers. This should include the impact of different equity returns, net of debt performance, on the regions, their economies and regional net zero progress. We ask the CMA to make it clear that this should form part of the price setting assessment.[1]

Setting the cost of debt

(12) In the following section we consider the aspects of the CMA's PFs that recognise and support our proposed approach, as well as considering those areas where we consider further clarification and refinement of the provisional findings approach is required. Whilst we have focused our discussion on the application of these tests in the water sector, we note that these principles are equally applicable to the energy sector.

Debt that is efficiently incurred should be compensated

(13) We support a debt allowance methodology that meets the efficiently raised embedded debt costs (including derivatives) of actual companies, across a price control period, while also incentivising companies to raise new finance as efficiently as possible (within an overall sensible framework of tenor and risk) during the next and each future price control period. New financing issuances made in the price control transition to become embedded debt in the next price control, ensuring that customers benefit from this incentivisation. We also consider the in-period costs and benefits should be shared with customers to ensure customers also benefit from such incentivisation. At present consumers do not benefit from this incentivisation.

(14) The CMA's provisional approach is to "*estimate a reasonable level of debt costs for a company with the notional financing structure, with shareholders retaining benefits and incurring costs of the difference between the assumed reasonable level of debt costs and the companies' actual debt costs*".[2]

(15) Whilst we agree that starting with the notional company is practical and efficient when setting allowances, the financing duty (being owed to debt and equity in each company) will not be properly discharged if actual company positions are not considered in making sure a price control decision complies with a regulators financeability duty. We do not support a debt allowance mechanism that leaves some companies permanently benefitting from overfunding (without customers ever benefitting) and other companies hoping that future issuances might be timed fortuitously.

The assessment of debt should take into account all types of debt instruments and debt costs

(16) It also follows that the notional company assessment should be based on a close representation of the companies within the sector, incorporating aspects such as actual credit ratings, debt tenor, the actual proportion of index-linked financing and derivatives, as well as the non-index costs such as cost of carry. These debt costs can be significant, particularly for smaller companies. Setting the notional company assessment on theoretical positions is of no benefit to any stakeholders.

(17) We continue to stress that derivatives are an important part of the actual debt costs and should therefore be taken into account by regulators in setting cost of debt allowances. Whilst the CMA's PFs acknowledge this debate they appear to endorse Ofwat's focus on 'pure' debt. We recognise that the approach taken by the CMA in the PFs means that any question as to what should be included within an assessment of actual debt costs is a secondary consideration. We consider, however, that this remains an important point of principle which should be addressed directly in the CMA's decision.

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[1] The scale of the differentials is clear from our letter to the CMA dated 22 June 2020, a copy of which is attached to this submission..

[2] PFs, para. 9.321.

The perceived complexity of the assessment should not be a bar to reaching the right decision

(18) The CMA has highlighted the perceived difficulties in conducting a forensic assessment of individual debt instruments to assess whether they were issued efficiently as justification for not attempting to do so and queried whether it would be an effective use of regulatory resources.[3] Given the significant implications of underfunding on customers and investment, concern about the potential difficulties in analysing the existing debt portfolios of the companies must not in itself act as a barrier to reaching an informed view.

(19) Such concerns are, in any event, overstated. A number of companies have already commissioned external reviews of the reasonableness of their debt portfolio, both for present or past price control periods. Much of this work has already been carried out and could be reviewed or extended as necessary. Even if the CMA were to conclude that this were not feasible within the timeframe of a CMA process, that should not preclude regulators from incorporating this into price control methodologies given that the cycle from setting of methodology to reaching final determinations typically takes 2-3 years or longer.

Debt underperformance does not equate to inefficiency

(20) The PFs hint at an assumption that if companies are spending inappropriately long periods of time on the wrong side of the debt allowance line they are not "*efficiently run*".[4] Similarly, choosing not to fund actual embedded debt costs in full is to assume, without evidence, that a company has been inefficient and has over-paid compared to what would have been achieved by an "efficient" company issuing at the same time and same tenor in the same liquid markets.

(21) In practice debt issuance pricing is only very marginally influenced by the efficiency of the issuance process. Instead it is far more influenced by market rates on the day of issuance itself, with the issuer credit rating being the most important variable after the benchmark. Issuance costs vary according to the issuance size. The cost of carry will vary according to the frequency of issuance. Absent timing, tenor and credit rating, the level of efficiency to be gained by even the most efficient issuer issuing on the same day as the least efficient is not significant and certainly nowhere close to the levels of debt allowance under or over performance being shown in returns.

(22) At the point of issuance, the best outturn in respect of tenor is unknown. Regulators have historically encouraged long dated issuance as this reduced refinancing risk and provided more stability to interest costs. However, this failed to predict the significant fall off in interest rates that has happened subsequently.

(23) It should also be noted that the underfunding of debt causes a feedback loop through the ratings agencies. Taking a view over a price control (usually 5 years), if the ratings agencies see material debt allowance underperformance built in by a regulator they will downgrade the ratings of the affected companies. In turn, this makes new debt issuance more expensive for those that are underfunded for debt and, conversely, new debt issuance cheaper for those that are overfunded, all other things being equal. This embeds under or over funding into the long-term cost base.

(24) This ensures that the difference in issuance costs is not so much driven by the "efficiency" of the issuer, but rather by the regulatory framework and the application of the debt allowance mechanism itself. We commissioned work by Frontier Economics that demonstrates how debt transaction costs are impacted by frequency of issue.[5]

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[3] PFs, para, 9.343.

[4] PFs, para. 9.345

[5] See https://www.enwl.co.uk/globalassets/regulation/documents/ssmc/enwl-ssmc-full-response.pdf appendix 5 pg 116 onwards for Frontiers report

Can debt underfunding be adequately mitigated by company action?

(25) The CMA's provisional findings on debt funding assume that in the long run all companies can match an index: "*Rather than suggesting that this means companies should be compensated for their actual debt costs, we take the view that this simply means that these companies can, at some point in the future, roll their debt book at lower than average costs and will move (potentially significantly) below the benchmark used to calculated the notional cost of debt*".[6]

(26) Whilst this suggests that companies can mitigate the risk of persistent underfunding through future refinancing, in reality regulatory reliance is being placed upon flawed assumptions:

- theoretically a larger company annually issuing debt of market size which matches the tenor of the index, from a starting position of being properly funded within the regulatory settlement (i.e. with a credit rating in line with the index), would experience costs that match the index over time; but
- in practice, however, companies issue debt either based upon the timing of investment or the maturity of older debt. For most the ability to match, or outperform, the debt index will be a matter of luck of timing, rather than any inherent ability to issue debt more efficiently; and
- the index does not in itself factor in the full costs of debt issuance. In the case of smaller and/or infrequent issuers these costs, particularly cost of carry, become significant. In this regard, we have commissioned Frontier Economics to review these costs in the context of ENWL's discussions with Ofgem.[7]

(27) A debt allowance structure that benefits the lucky and the large whilst simultaneously creating financeability issues or under reward for equity investors in the others is not a sound basis for a regulatory settlement. This creation of random winners and losers is not consistent with an efficient market outcome.

(28) We also consider that further precision of the CMA's views underpinning the CMA's comment "*at some point in the future*" is necessary in managing the expectations of ratings agencies. Similarly, it is not at all clear what might constitute an "*inappropriately long period of time*" on the wrong side of the benchmark.

(29) If the CMA is to rely on this view, the CMA's final determination should take the opportunity to explain how this can be achieved, and over what timescale, especially by companies that are currently underfunded for efficient debt costs given the impact that this has on future debt costs through the ratings. The CMA should also explain how its views interact with the forward view period utilised by the rating agencies.

Trailing index

(30) We note that a trailing index was used in earlier price control periods and could be taken to represent established precedent as it has not been challenged. We note, however, that at previous price controls, the fundamental change in long term interest rates that took place in 2009 was seen as a more temporary situation. The expected rate reversion has not occurred. We also note that, prior to 2009, regulatory guidance in respect of tenor focussed on the establishment of long dated stable financing structures.

(31) We would contend that equity has not been pricing in this level of exposure to material market movements, nor have regulators adequately taken this into account.

(32) Given that the market environment and regulatory policy has fundamentally changed since 2009, we request the CMA to reconsider whether the trailing index approach represents an appropriate transfer of risk (and reward) to equity for these large market movements. If a trailing index is to be used, we would welcome the CMA proposing a more representative and appropriate index

[6] PFs, para. 9.344.
[7] See https://www.enwl.co.uk/globalassets/regulation/documents/ssmc/enwl-ssmc-full-response.pdf appendix 5 pg 116 onwards for Frontiers report

period, that takes into account the pre 2009 period sufficiently for each and every company to be able to recover their efficiently incurred debt costs.

(33) We also note that the index is based upon an average of two indices, aimed up towards the higher end of the credit spread. Again, this implies that all companies are able to achieve this rating, and follow the index, which has not been proven to be the case. It leaves those companies that are not achieving this rating at a semi-permanent disadvantage, without any suggestion of inefficiency on their part.

The role of Company Specific Adjustments

(34) We welcome the CMA's acknowledgement that certain company specific circumstances should be taken into account in setting the appropriate cost of capital. In particular, we note the CMA's provisional decision to award a Company Specific Adjustment (**CSA**) to Bristol Water to uplift its cost of debt. We agree that this reflects the reality that smaller companies do have higher costs of debt generally and is consistent with the CMA's regulatory precedent.

(35) Looking specifically at the CSA made for Bristol Water, we are concerned about its scale and, in particular, the assumption that it can be phased out in the future. As we set out above, any assumption that additional costs of debt can be phased out over time ignores important realities about access to, and activities in, the debt markets. As the CMA stated in its 2015 redetermination for Bristol Water, if the CSA were removed "*without evidence of changing market conditions* [this would run] *contrary to the reasonable expectation of investors that they could, on average over time, recover the cost of efficiently incurred debt*".[8]

(36) To the extent that the sector-wide cost of debt is assessed by reference to a notional, rather than actual, embedded cost of debt we consider that CSAs can be an important tool for addressing the issues we have outlined above. We ask the CMA to acknowledge a wider use for CSAs to compensate companies for structural considerations (e.g. infrequency of issuance) or for companies having debt maturities (and inextricably linked derivative structures) that are not reflected, or sufficiently represented, in the choice of index being made.

(37) All companies will incur non-index related costs of debt in running treasury operations efficiently (e.g. cost of carry and other issuance costs). These will vary across companies depending on their size and the frequency of issuance. Smaller companies that are not accessing the financing markets in market benchmark sized issues will incur additional costs of carry. If they chose to access debt more frequently in non-benchmark sized issuances, they will incur increased debt costs through an illiquidity premium in the market. A CSA could be used to reflect the variance in these costs for those companies that are materially underfunded.[9]

[8] CMA Redetermination for Bristol Water PR14, para. 10.72(c).
[9] See https://www.enwl.co.uk/globalassets/regulation/documents/ssmc/enwl-ssmc-full-response.pdf appendix 5 pg 116 onwards for Frontier's report

Summary

(38) The CMA rightly recognises that consumers are not well served by regulators setting company price controls that result in an expectation of under rewarding equity investors. This is a robust finding and a vital principle. It is important that equity shareholders have a reasonable expectation of achieving a sufficient return to be incentivised to invest. This is acknowledged as critical to ensuring that sufficient investment takes place to provide essential infrastructure services for consumers and deliver government policy objectives.

(39) The CMA should apply the same rationale to adequately fund efficient debt costs for each company when considering the company specific impact of the CMA's debt allowance proposal. Appropriate debt funding across a price control period is not just a matter for equity but for the economy and society as a whole. Should any company fail as a result of underfunding of its actual efficient costs of debt (which includes derivatives) this would undoubtedly negatively affect the cost of capital for all regulated utilities at the expense of customers over the long term. The CMA should not depart from its previous finding that a price control should meet a "*reasonable expectation of investors that they could, on average over time, recover the cost of efficiently incurred debt*".

(40) As such it is vital for regulators to meet their financing duty on a company specific basis, for both equity and debt, which we believe was envisaged by the legislation through the financeability duty. It follows, therefore, that debt and equity financeability must both be met for each individual company within each price control settlement. Within this, derivatives are an intrinsic element of the costs of debt that must properly be considered by regulators and, if necessary, the CMA.

(41) We ask, therefore, that the CMA extend its analysis and consider the implications of having a simple trailing debt index (subject to CSAs) on the long term financeability of those companies who are significantly underfunded through this approach over more than a regulatory period. The CMA should not just assume that any such underfunding is as a result of inefficiency or will even out in the long run. The CMA should analyse why underfunding or overfunding is occurring and more explicitly develop solutions to fund debt and equity fairly, as this is in consumers' long term interest. Where evidence confirms that a company faces material underfunding despite having efficiently incurred debt, the CMA should develop a mechanism to fund a company properly. This might be the use of a CSA to ensure that the financing duty is met with respect to that individual company.

(42) We would welcome the opportunity to discuss these and the other points raised in our submission with the CMA as a means to assist the CMA in reaching its PR19 determinations.

Yours sincerely

[redacted]

David Brocksom

Chief Financial Officer

Electricity North West Limited