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

15 January 2021

Dear Sarah,

Ofwat PR19 Price Determinations: Working Paper consultation on cost of capital

Electricity North West Limited (**ENWL**) has made various submissions to the CMA in respect of these redeterminations and we appreciate the opportunity to provide our observations on the CMA's additional round of consultation on the cost of capital, as set out in its Working Papers of 8 January 2021 on specific aspects of the cost of equity (**CoE**) and the cost of debt (**CoD**). Noting that points of detail arising from the CMA's emerging thinking will be thoroughly addressed in the submissions of the main parties and their respective economic advisors, there is one important point of principle that we would like to highlight in our response.

We welcome the CMA's acknowledgment that its final decision on allowances will take full account of all evidence including company specific characteristics in reaching a determination, including the final analysis of financeability.

As the CMA states, the Financeability Duty requires a cost of capital that is sufficient for an efficient firm to finance the performance of its statutory functions. As we set out in our 26 October 2020 letter to the CMA, if the cost of capital results in a significant underfunding of a company's actual debt costs, this will inevitably erode projected equity returns during the price control period. Subject to the important caveat that the actual debt costs have been efficiently incurred, such an outcome is inconsistent with that duty and can result in a feedback loop with respect to the impact on credit ratings. Most importantly, it cannot be considered to be an outcome that is in the long term interests of consumers or other stakeholders, a point which has been recognised by Ofgem in its submission to the CMA.[1]

[1] Ofgem's response to the Provisional Findings, paras 12-14 as referenced in the CMA's Working Paper on cost of debt, para. 137.

We note and agree with the CMA's sentiment that if the cost of capital is set too low this will have a negative impact on the long-term incentives to invest. We also agree that this is particularly significant when seen in the context of the expected scale of investment to address climate change and deliver net zero commitments – an issue that is pressing in the water sector but even more exaggerated in the energy sector.

In that context we consider that the financeability cross check on the cost of capital must take account of, and make appropriate mitigations for, scenarios where actual efficient debt costs are underfunded to the extent that a reasonable return cannot be earned by equity investors. That scenario is clearly distinguishable from one where the cost of capital being set too high results in excess returns to shareholders. Where the one-size-fits-all approach fails to secure financeability for an individual company, it is essential for the long term interests of consumers that appropriate adjustments are made to address this. If not, then there will be a significant shift in the perceived risk of investment in the sector, which cannot fail to pass through into either deferred investment or increased long term return requirements, or both.

Yours sincerely

[redacted]

David Brocksom

Chief Financial Officer