BEFORE THE COMPETITION AND MARKETS AUTHORITY

IN THE MATTER OF AN APPEAL UNDER SECTION 23B OF THE GAS ACT 1986 – ENERGY LICENCE MODIFICATION

BETWEEN:

WALES & WEST UTILITIES LIMITED

Appellant

- and -

THE GAS AND ELECTRICITY MARKETS AUTHORITY

Respondent

APPLICATION FOR PERMISSION TO INTERVENE MADE BY ELECTRICITY NORTH WEST LIMITED

TUPPERS LAW
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1 OVERVIEW OF APPLICATION

(1) On 3 March 2021 the Competition and Markets Authority (**CMA**) received various appeals in relation to the price control determinations of the Gas and Electricity Markets Authority (the **Authority** or **Ofgem**) for the period 1 April 2021 to 31 March 2026 for gas distribution networks (**RIIO-GD2**) and electricity and gas transmission networks (**RIIO-T2**) (collectively the **ELM Appeals**). Ofgem is also in the process of setting the price control for electricity distribution networks for the period 1 April 2023 to 31 March 2028 (**RIIO-ED2**) (these price controls are collectively referred to as **RIIO-2**).

(2) This application to intervene (the **Application**) is made by Electricity North West Limited (**ENWL**) in accordance with Rule 10 of the CMA rules for Energy Licence Modification Appeals (**CMA Rules**)[1] in support of the appeal brought by Wales & West Utilities Limited (**WWU**) under s23B of the Gas Act 1986 (the **WWU Appeal**) against Ofgem's decision to make certain modifications to WWU's licence to give effect to the RIIO-GD2 price control (the **RIIO-GD2 Decision**). In particular our Application relates specifically to WWU's ground of appeal regarding Ofgem's cost of debt allowance (**WWU Head A**) as detailed in WWU's Notice of Appeal dated 3 March 2021 (**WWU Notice of Appeal**).

(3) The CMA published its decision granting permission to WWU to appeal on 31 March 2021 (**WWU Permission Decision**) which confirmed that WWU Head A relating to the cost of debt allowance will be considered by the CMA as a standalone appeal.

(4) **Part A** (**Section 2**) of this Application sets out the basis on which ENWL considers that it satisfies the criteria for intervention as set out in Rule 10.3 of the CMA Rules.

(5) **Part B (Sections 3 to 9)** of this Application sets out the basis for ENWL's support for WWU Head A and the evidence and arguments that ENWL requests should be taken into consideration by the CMA during this process.

(6) ENWL's Application is supported by witness statements from Paul Bircham, Director of Regulation and Communications at ENWL[2] and David Brocksom, CFO at ENWL.[3] Mr Bircham's witness statement considers the RIIO-2 regulatory framework and how it applies with respect to the gas and electricity distribution sectors. Mr Brocksom's witness statement provides some background information on ENWL's debt portfolio, the impact of Ofgem's approach to the cost of debt allowance in the current price control, and the anticipated impact in RIIO-2. As such, these witness statements provide additional evidence to primarily support ENWL's standing as an intervener (i.e. why and how the CMA's decision on WWU's Appeal will affect ENWL), as well to illustrate the substantive issues addressed in the Application.

1.1 Summary of ENWL's application to intervene

(7) Ofgem applies a single percentage rate for the cost of capital allowance to each regulated sector (slightly modified for specific circumstances such as infrequent issuer costs). This includes setting a single rate for the cost of debt allowance, based on a benchmark derived from the average actual cost of debt for the sector as a whole. In doing so that average cost is effectively being treated as a proxy for efficiency. This could only ever be the case if all licensees were identical in all relevant respects. The reality, however, is that one size does not fit all, particularly with respect to licensee's actual and efficient costs of embedded and likely future debt.

(8) As is to be expected for companies that were privatised over 30 years ago, and which are not uniform in all their characteristics, each individual company's debt portfolio is distinct as

1 Energy Licence Modification Appeals: Competition and Market Authority Rules, October 2017, CMA70.
2 ENWL-001 First Witness Statement of Paul Bircham (ENWL).
3 ENWL-002 First Witness Statement of David Brocksom (ENWL).

regards factors such as the form, age, tenor, and refinancing dates of the different debt instruments that a company has issued and, hence, the resulting annual interest cost. This is particularly true for the smaller licensees, such as WWU and ENWL, who will issue benchmark-size debt less frequently (resulting in lumpier refinancing needs) than larger companies with multiple licences and higher debt requirements.

(9) Ofgem's approach when setting the allowed cost of debt is designed to match the actual costs paid by the industry as a whole with revenue from GB customers. Ofgem chooses not to match costs to revenues on a company-by-company basis. Instead it is content for there to be a match of costs and revenues only at a sector-level, with each company receiving an allowance for all its debt (embedded and new) based on the average sector-wide cost.

(10) As the sector's average costs are not a proxy for efficient costs, this inevitably means that some companies, including WWU and ENWL, are significantly underfunded with respect to their actual individual costs of debt which can raise financeability concerns. Others over-recover from customers enabling them to achieve a return to equity in excess of the allowed equity return, before any wider regulatory performance incentives are applied. This under and over funding is not shared with customers.

(11) This level of over/underfunding has a material impact on returns to regulated equity (**RoRE**), amounting to up to 1.9% in RIIO-1. If this were repeated in RIIO-2 it would represent over 40% of the 4.3% base equity return allowed in RIIO-GD2.[4] Importantly, the gains and losses that individual companies experience are not, have never been and cannot be attributed to efficiency. Rather, they are a direct consequence of a 'one-size-fits-all' policy which fails to recognise that there will necessarily and unavoidably be differences between companies' efficiently incurred debt costs.

(12) The RIIO-2 framework confirmed a continuation of Ofgem's RIIO-1 approach. It has been applied in the RIIO-GD2 price controls for the GDNs (including WWU) and is Ofgem's chosen approach for the RIIO-ED2 settlement (hence ENWL's intervention). This is neither acceptable for this price control, nor sustainable for the future. Current, and most importantly new, equity investors need to know that all the efficiently incurred costs of the licensee will be met by allowed revenues, in all future price control periods, and for all aspects of cost – whether expenditure or financing. This is not that the case with Ofgem's approach to the cost of debt in the RIIO-2 framework. Indeed, the current policy could result in the continued underfunding of efficiently incurred debt over many price control periods – both for embedded debt already in place at the start of the GD2/ED2 price control periods, and for new debt issued over the next five years.

(13) The penalty for the companies with higher debt costs, which must in these circumstances be subsidised by lower returns to equity, is unmerited and, most importantly, incompatible with Ofgem's obligations under the statutory duties, including the financing duty. The benefit to any company with debt costs lower than the average is also unmerited and results in consumers in those licence areas paying more than is necessary to meet the actual costs of the licensee.

(14) Ofgem can exercise discretion in determining the appropriate methodology for setting the cost of debt allowance for each licensee. That discretion must be informed by the requirements of the statutory duties. As WWU has argued in its Appeal, Ofgem's understanding of the financing duty, and how it relates with the other statutory duties, is flawed. This has allowed Ofgem to conclude that it's cost of debt methodology and the resulting allowance discharges its duties, but it does not.

(15) Whilst it may be legitimate for Ofgem to look at average actual sector debt costs as a starting point for its assessment of the allowed cost of debt for a licensee, it is required to test whether

4 *ENWL-015 Ofgem Regulatory financial performance data file – Annex to RIIO-1 Annual Reports_-_2019-20, RoRE 2019-20 (worksheet), row 30.*

this is a good proxy by reference to the actual circumstances of that individual licensee. Where there is a material divergence from the licensee's actual costs and the proposed allowance, the burden is on Ofgem to demonstrate why, by reference to the licensee's individual circumstances and any inefficiency (assessed without the benefit of hindsight) of its debt, restricting the allowance of the individual licensee to the average is appropriate in light of the financing duty. Ofgem's current approach, which ignores company specific circumstances fails to sufficiently discharge Ofgem's obligations under the duties.

(16) Ofgem's rationale for its debt allowance approach is that it incentivises licensees to be efficient and manage (i.e. reduce) debt costs to beat the average, which it presumes to be the most efficiently incurred cost of debt. It does this through the calibration of the notional company's debt costs to the sector average, which benefits GB consumers, in theory, by lowering the long-term average cost of debt. Unlike other price control mechanisms designed to promote efficiency for the benefit of consumers, however, customers do not benefit from outperformance within the period (e.g. totex cost sharing).

(17) In order to promote efficiency it is uncontentious that all companies should be encouraged to issue debt at the lowest cost, taking into account relevant concerns such as inflation risk or liquidity risk. Under Ofgem's approach, however, efficient debt costs are those which, in hindsight, have a lower cost than, or at least a cost in line with, others in the sector. To achieve this in practice companies would need perfect foresight over the timing and tenor of present and future debt issuances. Clearly, not even the most efficient companies can anticipate these future trends.

(18) In the main, the timing of debt issuances will be determined by the combination of refinancing requirements of old maturing debt and the need for new investment. In practice, companies have almost no discretion over the timing of debt issuances. If interest rates happen to be higher than they have been over the past or they will be in the future, compared to the average sector cost, that debt will under Ofgem's approach be treated as inefficient. However, in promoting efficiency it should be possible for the companies to improve their efficiency through their knowledge at the time. If, for instance, interest rates continue to rise the new debt will then become, over time, efficient as other companies are forced to issue debt at higher interest rates still. Ofgem's approach, therefore, neither reflects, nor promotes, efficiency.

(19) Any incentive "*to issue debt efficiently and prudently*"[5] can only deliver that aim if it is capable of being achieved through management decisions. The ability of any licensee to outperform the average depends more on market interest and credit rates at the time of necessary issuance rather than any particular skill, expertise or judgement of the licensee. Those that benefit from lower market rates will either be the lucky or the large (with higher frequency of issuance). Put in the simplest of terms, debt issued in 2017 is not automatically more efficient or prudent merely because it was issued at a lower price than debt issued in 2007.

(20) It is important to note that, for future debt issuances in the next price control period, there is a risk that these could be underfunded for a significant period of years in the event of a rise in interest rates from recent historic lows over the period of issuance. The extent of this underfunding will depend on the tenor of the issuance and the pattern of future interest rates over the duration of the indexation period.

(21) The financing duty is owed to each individual licence holder. Where there are inescapable differences in companies' borrowing costs, it cannot, as a matter of principle, be discharged by simply identifying an appropriate cost of debt for the sector as a whole. When the financing duty is properly interpreted and applied, it is clear that to further the interests of current and future customers the regulator must be prepared to take due account of the individual licensee's actual efficient costs. Not doing so will mean that the regulator has not

5 *ENWL-010 RIIO-ED2 SSMD Finance Annex 3, para 2.18.*

discharged its burden to have regard to the need to secure that the licensee is able to finance its functions.

(22) WWU's challenge to Ofgem's approach to the cost of debt raises, therefore, fundamental questions about the proper interpretation and application of the statutory duties in general, and the financing duty in particular, which Ofgem (and the CMA) must comply with in determining price controls.

(23) We consider that to address this one option the CMA could consider is some form of indexation weighted for issuance date and adjusted for specific circumstances, such as infrequent issuance and non-index costs.

(24) ENWL has applied to intervene in support of this issue because it has been during ED1, and expects to be during ED2, similarly very adversely affected by Ofgem's approach. ENWL considers that is in an ideal position to assist the CMA in its understanding of the drivers of companies' interest costs and the consequences that Ofgem's policy towards the setting of the allowed cost of debt has on licensees that so happen to have higher-than-average efficient costs. As such, ENWL's intervention, which focuses on the interpretation and application of the financing duty in the context of setting a cost of debt allowance, including the principles that should inform the cost of debt methodology, will assist the CMA in considering these important cross-sectoral issues as a matter of principle.

PART A: ENWL'S STANDING TO BE AN INTERVENER

2 REQUIREMENTS FOR INTERVENERS

(25) Rule 10.1 of the CMA Rules provides that the CMA may grant permission to intervene to any person on application. The CMA's Rules 10.3 state that in considering whether to grant permission to intervene, the CMA "*shall take account of all the circumstances*". Relevant circumstances for these purposes include but are not limited to: *"(a) whether the applicant is materially interested in the outcome of the appeal; (b) whether the applicant's intervention in the appeal will assist the CMA to determine the appeal; and (c) whether the nature and extent of the intervention sought is proportionate to the matters to be determined*".[6]

(26) ENWL is a licensed electricity distribution network operator (**DNO**) serving the North West of England. ENWL is responsible for maintaining and upgrading 13,000 km of overhead power lines and more than 44,000 km of underground electricity cables in a region spanning from Carlisle in the north, down past Stockport in the south, including rural areas such as the Lake District and major cities such as Manchester.

(27) For the reasons set out in the following sections, ENWL requests permission from the CMA to intervene in the WWU Appeal. ENWL is in a similar position to WWU in that, like WWU, its cost of debt is higher than the industry average and, like WWU, it suffers a penalty under Ofgem's industry-average approach to setting the allowed cost of debt. ENWL is therefore well-placed to assist the CMA as it experiences, first-hand, how Ofgem's policy can penalise an efficiently financed licensee and, in turn, how the disadvantage that a licensee suffers can adversely affect the interests of customers. Accordingly, ENWL considers that it has real and critical evidence and insight on this issue that the CMA can and should take into account in considering the WWU Appeal, and that this intervention will materially assist the CMA in reaching its decision on WWU Head A.

(28) It is also clear that the outcome of this appeal, which addresses fundamental questions about the interpretation of the statutory duties, will have a direct effect on Ofgem's approach to setting the cost of debt allowance for RIIO-ED2 and, therefore, on ENWL's financeability under the anticipated RIIO-ED2 determination.[7] As we set out in this Application, whilst

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6 *CMA Rules 10.3.*

7 *ENWL-002 First Witness Statement of David Brocksom (ENWL), Section D.*

WWU's Head A relates to the statutory duties under the Gas Act 1986 (**GA86**) and RIIO-ED2 will be set in accordance with the Electricity Act 1989 (**EA89**), the statutory duties under each Act are substantively the same. For this reason, ENWL is materially interested in the outcome of the appeal.

(29) If ENWL is denied the opportunity to participate in this process, it will deplete the evidence and arguments presented to the CMA in support of the important points of principle raised by WWU's Appeal. ENWL's credit ratings are affected by Ofgem's policy on the cost of debt allowance as applied in RIIO-GD2. As Ofgem has indicated its intention to follow a similar approach for RIIO-ED2, ENWL believes it is both important for it to have a voice in this process, but also prudent for the CMA to consider the wider application of the principle as this may preclude the need for ENWL to bring a similar appeal in due course. As such, it is appropriate and proportionate for ENWL to be accepted as an intervener in this process.

2.1 The outcome of the Appeal will have a material impact on ENWL

(30) WWU's Appeal arises from proposed modifications to its licence that regulates its activities as the owner and operator of a regional gas distribution network. It challenges certain aspects of Ofgem's RIIO-GD2 Decision, including Ofgem's approach to and conclusions on the cost of debt allowance, with a particular focus on the compatibility of Ofgem's approach with the statutory duties applicable to Ofgem under GA86. As WWU articulates in its Notice of Appeal, in its RIIO-GD2 Decision Ofgem has "*set an allowance that falls short of what was required to enable the company to recover its efficiently-incurred financing costs*",[8] resulting in a "*significant shortfall in its efficient cost of debt … [which] has a material impact on financeability*".[9]

(31) The economic regulation of the gas distribution (**GD**), gas transmission (**GT**), electricity transmission (**ET**) (with gas and electricity transmission collectively referred to as **T**) and electricity distribution (**ED**) sectors, as implemented through the price controls, is governed by the overarching RIIO framework.[10] Within that framework, Ofgem also issues sector-specific methodologies for each of GD, T and ED which confirms how the framework will be applied in each sector. Whilst RIIO-ED2 is a separate process from RIIO-GD2/T2 and is clearly on a different timetable, core aspects of Ofgem's approach are established for RIIO-2 at a framework level and apply to all the sectors, with any differences in the practical application being addressed through the sector-specific methodologies. Ofgem's RIIO-ED2 framework decision and its ED2 Sector Specific Methodology Decision (**ED2 SSMD**) are explicitly clear that the approach to assessing returns and financeability is, and will be, consistent across GD2, T2 and ED2.[11]

(32) As WWU identifies in its Notice of Appeal, Ofgem's approach to setting the cost of debt allowance is based on its fundamental error in its understanding and interpretation of the financing duty as set out in Section 4AA(2)(b) GA86. That financing duty is mirrored in Section 3A(2) EA89 (see Section 5).[12] Based on its discussions with Ofgem, ENWL is not currently aware of any factors that would cause Ofgem to alter its approach to the interpretation and application of the relevant statutory duties for ED2.[13] The methodological approach taken by Ofgem in setting the cost of debt allowance for RIIO-GD2 can, therefore, be expected to be mirrored in RIIO-ED2. If that is the case, ENWL anticipates that its efficient cost of debt will be underfunded during ED2 [✂], as it will be underfunded by up to £110m (nominal) during RIIO-ED1, resulting in a material negative impact on ENWL's financeability.[14]

8 *WWU Notice of Appeal, para. A3.2.*
9 *WWU Notice of Appeal, para. A3.3.*
10 *ENWL-006 RIIO-2 Framework Decision, July 2018.*
11 *ENWL-001 First Witness Statement of Paul Bircham (ENWL), Section C.*
12 *ENWL-001 First Witness Statement of Paul Bircham (ENWL), Section A*
13 *ENWL-020 Letter from ENWL to Ofgem 23 February 2021, p.1.*
14 *ENWL-002 First Witness Statement of David Brocksom (ENWL), Section C-D.*

(33) We understand that the CMA's decision on WWU Head A will apply to WWU, as a Gas Distribution Network (**GDN**) operating within the framework of the GA86, with respect to its GD2 price control. The CMA's decision will not have automatic read across to the rest of the companies subject to GD2 price controls. This is a unique scenario because of the time lag between GD2 and ED2 and Ofgem's stated intent to apply the same approach to ED2 (and ENWL) as it has to GD2 (and WWU). Although the ED2 sector-specific methodology has been published, Ofgem will have adequate opportunity to reflect on the CMA's decision in this Appeal and adapt its approach to the cost of debt in advance of its ED2 final determinations and the associated licence modifications. If the CMA supports WWU's appeal and concludes that Ofgem's GD2 approach to the cost of debt is incorrect in principle and practice but this is not reflected by Ofgem in the RIIO-ED2 decisions, ENWL would likely seek to appeal its ED2 licence modifications on a similar basis to WWU, on the basis of similar arguments to those set out in this Application, with the anticipation of a similar outcome. The CMA's decision, therefore, although specifically relating to WWU, will directly impact on ENWL (and ED2 more broadly). For the avoidance of doubt, ENWL reserves its right to appeal Ofgem's RIIO-ED2 determination for ENWL in respect of this and/or other issues.

(34) As we set out in this Application, ENWL's intervention is focused on Head A of WWU's Notice of Appeal, namely the interpretation and application of the financing duty in the context of setting a cost of debt allowance. Our comments in that respect, which will assist the CMA in considering these important cross-sectoral issues as a matter of principle, reflect an appropriate continuation of our engagement with Ofgem during the development of the RIIO-2 framework and the various sector specific methodologies, [15] as well as our engagement with the CMA during its recent redeterminations for four water companies.[16]

(35) Given the strong likelihood that the CMA's decision on WWU's Appeal, particularly on WWU Head A, will establish regulatory precedent for Ofgem's RIIO-ED2 decision for ENWL, it is self-evident that the outcome of the appeal will have a direct and material impact on ENWL. It is important for ENWL, therefore, to be involved in the CMA's consideration of the underlying issues and the discussion about the appropriate remedies.

2.2 ENWL's intervention will assist the CMA in determining the appeal

(36) ENWL considers that if permission to intervene is granted, its submissions and evidence will amplify, support and build on the points of challenge raised by WWU, including providing the CMA with ENWL's specific perspective as an efficiently financed licensee on the issues raised by WWU, which will assist the CMA in understanding the legal issues in question, the factual basis for the challenge and the consequences that will flow from the CMA's decision.

(37) In contrast to the multiple challenges to Ofgem's cost of equity (a ground of appeal in each of the Appeals) WWU is the only appellant that has challenged Ofgem's approach to funding efficient costs of debt. For the reasons set out in WWU's Notice of Appeal and in Section 3 below this is unsurprising given that Ofgem's approach to setting the cost of debt creates winners and losers:

> *"If a sector average is taken, particularly among companies exhibiting widely divergent costs of embedded debt such as those of the GDNs, it is inevitable – a logical and unavoidable consequence of this policy that some companies will be over- and some under-remunerated. Some will get more than their actual cost of debt and some less. Windfalls and shortfalls are features of the policy, and are unrelated to the relative efficiency of the debt when it was issued."*[17]

(38) It is to be expected that most of the potential appellants from within the GD&T licensee population either actively benefit from or are neutral about Ofgem's approach to the cost of

15 *ENWL-001 First Witness Statement of Paul Bircham (ENWL), Sections C-D.*

16 *ENWL-001 First Witness Statement of Paul Bircham (ENWL), Section E.*

17 *WWU Notice of Appeal, para. A5.27.*

debt. As such, the relative lack of challenge from within the sector or the lack of an Energy Networks Association (**ENA**) view on the subject should not be seen as an indication that Ofgem's approach is legally or methodologically robust.

(39) ENWL considers that it will assist the CMA to receive and consider evidence from a licensee that through no fault of its own finds itself in a very similar position to WWU. In addition, our evidence on the interpretation and application of the statutory duties, supported by an opinion provided by Thomas Sharpe QC,[18] will further assist the CMA's consideration of the core aspects of WWU Head A. This includes: the interpretation and extent of the financing duty; the relationship between the duties; the relevant factors to be taken into account in developing a cost of debt methodology to ensure that the financing duty is discharged; the appropriate approach with respect to the inclusion or exclusion of derivatives in the assessment of the cost of debt; and the principles that should inform any remedies.

2.3 The nature and extent of ENWL's intervention is proportionate

(40) ENWL agrees with many aspects of the challenges raised by the Appellants to Ofgem's RIIO-2 decisions. For instance, ENWL broadly agrees with the grounds set out in the joined appeals relating to the errors and other flaws within Ofgem's approach to the cost of equity and the misapplication of an outperformance wedge. ENWL also agrees with the Appellants that have challenged Ofgem's apparent circumvention of the licence modification process through the reservation of certain aspects of the price control for future directions.[19] These and other matters appealed are undoubtedly serious issues that threaten to undermine regulatory certainty and predictability, as well as impacting on investor confidence, all of which in turn damage the long term interests of consumers.

(41) Having taken into account the range and nature of the issues, the volume of submissions already received by the CMA, the particular significance of the debt allowance issue for ENWL, the adverse impact of Ofgem's current approach to consumers and the CMA's guidance for interveners, ENWL concluded, however, that it was not necessary or helpful to intervene on all those issues specifically.[20]

(42) ENWL has focused this Application on what it considers to be the most important issue in the ELM Appeals in terms of the direct implications for ENWL and our customers (taking into account the aspects of RIIO-GD2 most likely to be replicated in RIIO-ED2) and where we consider that we will genuinely be able to assist the CMA in its decision-making process. As such, we consider that we have been targeted and proportionate in the scope of this Application, on a single ground raised by a single appellant.

(43) To offer the most effective assistance to the CMA in its conduct of the Appeals, ENWL is willing to engage with the CMA in its capacity as an intervener throughout the conduct of the process in whichever way the CMA considers to be appropriate. As such, ENWL would be willing and able to attend hearings (both as a participant and observer), respond to appropriate requests for information and make written submissions as required by the CMA (including, for instance, on the CMA's provisional findings).

PART B: SUPPORT FOR THE WWU HEAD A APPEAL

3 OVERVIEW OF WWU HEAD A

(44) In its Notice of Appeal WWU identifies the general principle that Ofgem should set price controls that include reasonable allowances for a company's cost of debt. WWU also points

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18 ENWL-003 Opinion of Thomas Sharpe QC.

*19 WWU Notice of Appeal; Scottish Hydro Electric Transmission (trading as SSEN Transmission) Notice of Appeal Transmission Licence Modification RIIO-T2 Price Control (**SSEN Appeal**); SP Transmission plc Notice of Appeal Energy Licence Modification (**SPT Appeal**).*

20 For the avoidance of doubt ENWL reiterates that its decision not to intervene on other issues should not be interpreted as, in any way, a waiver of its rights to challenge any future Ofgem determinations on these or related issues insofar as they impact ENWL.

out that in order for an allowance to be reasonable, Ofgem must enable each company to recover its efficiently incurred financing costs in full.[21]

(45) WWU's appeal focuses on Ofgem's failure to adhere to these principles in its RIIO-GD2 Decision. Ofgem's RIIO-2 approach allows for the recovery of Ofgem's view of total industry debt costs from GB consumers as a whole. However, the match that Ofgem secures between revenues and costs at sector level does not translate down to a match between revenues and costs at an individual company level. Instead, Ofgem sets a single cost of debt allowance for all licensees, meaning that some companies receive less than their cost of debt while other companies receive more than their cost of debt.

(46) As a company that happens to have the highest cost of debt among the gas distribution and transmission licensees, and so suffers from an underfunding of its cost of debt, WWU has challenged multiple aspects of Ofgem's approach to the cost of debt under Head A of its appeal:

"Ofgem has erred in both law and policy in that it has failed to provide an adequate cost of debt allowance for WWU. It has misdirected itself in law and failed to give effect to its financing duty, and as a result has determined an allowance for all GDNs based on an average of the actual cost of debt of a group of companies in circumstances where the effect of that approach is to over-remunerate some companies while penalising others. The approach discriminates against WWU. In addition, Ofgem has adopted an irrational and inconsistent policy of not taking account of derivatives in assessing the cost of debt."[22]

(47) WWU's challenge raises important points of principle about the interpretation and application of the statutory duties in general, and the financing duty in particular, in relation to the setting of a cost of debt allowance. In particular, it is WWU's case, that in setting the cost of debt allowance Ofgem has made a series of errors of law and policy, which fall outside the proper scope of Ofgem's exercise of its regulatory judgment, and give rise to a determination which is: wrong in law (s23D(4)(e)); based on errors of fact (s23D(4)(c)); fails properly to have regard to Ofgem's statutory duties (s23D(4)(a)); and fails to give the appropriate weight to relevant aspects of its statutory duties (s23D(4)(b)).[23]

(48) ENWL agrees with, and supports, WWU Head A with respect to the interpretation of the financing duty under GA86, which is equivalent to the financing duty under EA89, and the principles that should, therefore, inform the appropriate methodology for setting the cost of debt allowance.

(49) WWU's Notice of Appeal necessarily raises concerns both about points of regulatory principle (e.g. the interpretation of the financing duty) and how it has been applied to WWU in practice, taking into account its specific circumstances. We consider that in approaching its consideration of the Appeal, the CMA needs to determine the correct legal meaning of the applicable statutory duties. The CMA should also determine the proper approach to the setting of the cost of debt allowance by reference to the correct understanding of the applicable legal framework. Having established those principles, the CMA can then engage with what that means in practice for individual licensees, including WWU as the appellant, by reference to its specific circumstances. In carrying out this assessment the CMA should, we respectfully suggest, focus on the legal and regulatory requirements in the first instance, with matters that are purely about practicality being a significantly subsidiary consideration.

(50) Given this natural split, our intervention focuses on the points of principle relating to the interpretation of the statutory duties and the relevant considerations for the methodology used to set the cost of debt allowance. Sections 4 to 8:

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21 *WWU Notice of Appeal, para. A3.1.*
22 *WWU Notice of Appeal, para. 3.2(a).*
23 *WWU Notice of Appeal, paras. A3.6-A3.10.*

(a) provide relevant background context with respect to the assessment of returns generally, and the cost of debt specifically, from the perspective of financing (both in debt and equity terms) and incentivising investment in the energy sector;

(b) confirm that the statutory duties as set out in EA89 are the same as the statutory duties regarding financeability set out in GA86 which are the subject of the WWU Appeal;

(c) address the flaws in Ofgem's interpretation and application of the financing duty;

(d) set out ENWL's thoughts on the relevant points of principle that should be reflected in the methodology for the assessment of the cost of debt allowance in light of a proper interpretation of the financing duty, such as the inclusion of derivatives; and

(e) consider the implications of this for the application of the financeability assessment.

(51) In particular, we demonstrate that:

(a) interpretation of the statutory duties is a matter of law. The duty to have regard to the need to secure that a licence holder is able to finance its functions is clearly owed to each individual licensee independently. This must, therefore, inform the setting of the debt component of the cost of capital allowance and any assessment of financeability of the overall price control settlement;

(b) to further the principal objective of protecting the interests of consumers, Ofgem must have regard to the concurrent duties which address the need to secure supply and the need to secure that licensees can finance their functions, and do so in the manner which is best calculated to take due account of its subsidiary duties to promote economy and efficiency, inter alia. As such, it is accepted that a straight pass through of actual embedded debt costs, without any consideration of the underlying efficiency of those costs, would be inconsistent with the duties;

(c) the burden on demonstrating that the financing duty has been discharged rests with Ofgem. Ofgem is afforded regulatory discretion in its choice of methodology for the assessments which determine the appropriate allowances within the regulatory period, but in applying that methodology it must ensure that that it is, at all times, consistent with, and adequately allows it to discharge its obligations under, the applicable statutory duties, including having regard to the need to secure supply and financing of functions;

(d) Ofgem has chosen as a matter of policy to adopt a methodology for setting the cost of debt allowance based on a benchmark that begins and ends with consideration of the total costs of debt across the sector (excluding derivatives) and grants each licensee an allowance based on a partial view (excluding derivatives) of the sector's average cost of debt. This is based on mistaken presumptions that a sector average metric will reflect efficient costs and is necessary to preserve investment incentives. Whilst it is a legitimate exercise of Ofgem's discretion to consider/start with the overall industry position as part of its work, it is as a matter of law not sufficient to discharge its obligations under the financing duty so should not be the end of the process, in particular for those that are underfunded;

(e) the financing duty requires that the sector average approach must be tested to ensure that it reflects company circumstances (at the time of issuance) and does not penalise companies that have raised their debt efficiently. Efficiency should, however, not be determined merely because market interest rates have fallen subsequent to an issuance by a company;

(f) where there is evidence that demonstrates a significant mismatch between the average sector costs and a licensee's actual costs, to discharge its obligations under the duties Ofgem must interrogate that mismatch properly;

(g) an assessment of actual circumstances may show underfunding of actual embedded debt costs that were efficiently incurred (judged at the time of issuance), and which cannot be efficiently mitigated (e.g. by refinancing) as is the case for WWU and ENWL. In such a scenario the duty to have regard to the need to secure that the individual efficient licence holder can finance its functions means that Ofgem must show that it has actively considered the underfunding and taken appropriate measures to ensure that the company is financeable.

(52) In broad terms ENWL agrees with WWU's presentation of the statutory framework,[24] its exposition of the approach to the grounds of appeal,[25] and the standard of review that the CMA must apply in considering the Appeal.[26] We have not, therefore, sought to replicate those points in this Application.

4 BACKGROUND CONTEXT

4.1 Cost of capital and incentives to invest

(53) As WWU sets out in its Notice of Appeal, the energy sector faces substantial challenges in the coming years with respect to its role in delivering against the policy and legal commitments regarding climate change and the Net Zero Carbon targets.[27] Significant innovation and notably new investment within an appropriate timeframe is required if these targets are to be met. It is clearly in consumers' interests, therefore, to take steps to ensure that investment in UK energy infrastructure, in this and future price control periods, remains attractive compared to national and international capital markets, through allowing an appropriate level of expected returns.[28] As a result, the cost of capital allowance must, as a matter of principle, be set at a level which "*ensures appropriate levels of investment within the sector without overcompensating investors at the expense of customers*".[29]

(54) Both debt and equity are required to fund regulated utilities, particularly in times of heavy investment. It is axiomatic, therefore, that each component of the cost of capital should be set so as to provide an appropriate return for the risks run by debt and equity investors.[30]

(55) Continued confidence in the UK regulatory framework relies on all licensees, and their investors, knowing that the regulator will allow all efficiently incurred costs to be funded in full by customers. If investors, including new equity, do not expect to be fully compensated for investments over their life – i.e. if the expected return on investment falls short of the cost of capital – then they will/may be unwilling to invest in the future to meet these requirements, with resulting adverse effects on consumers.[31]

(56) It is imperative, given the importance of any decision here in the context of financeability, that Ofgem conducts a full and fair overall efficiency assessment of the underlying financing costs. It cannot be appropriate to conclude on efficiency based only on a simple divergence from the sector average. The efficiency of financing costs can only be judged by reference to the circumstances and considerations at the point in time that the financing was raised. It must not be judged with the benefit of perfect hindsight in the light of subsequent events over which the investors cannot realistically have foresight or control.

(57) Ofgem has acknowledged this overarching point of principle applies as much to the allowance it sets for the cost of debt as for any other expense. At the outset of the RIIO-2 process, Ofgem set out the following principles for setting a cost of debt allowance:

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24 WWU Notice of Appeal, Section 2.

25 WWU Notice of Appeal, Section 3.

26 WWU Notice of Appeal, Section 5.

27 See, for example, WWU Notice of Appeal, Section 4.

28 ENWL-016 CMA Water Redeterminations 2021, para. 9.1273.

29 ENWL-016 CMA Water Redeterminations 2021, para. 9.6.

30 As the CMA itself acknowledged in the water redeterminations "the current context of a material reduction in the cost of equity at the same time as a growth in investment points to a need to proactively address the risks associated with setting the cost of capital too low" (ENWL-016 CMA Water Redeterminations 2021, para. 9.1282).

31 ENWL-016 CMA Water Redeterminations 2021, para. 9.1269 (c).

"consumers should pay no more than an efficient cost of debt;

the cost of debt allowance should be a fair and reasonable estimate of the actual cost of debt likely to be incurred by a notionally geared, efficient company;

companies should be incentivised to obtain lowest cost financing without incurring undue risk; and

the calculation of the allowance should be simple and transparent while providing adequate protection for consumers."[32]

(58) In its 2019 RIIO-GD2/T2 sector specific methodology decision, Ofgem affirmed that:

"The cost of debt allowance is an estimation of the return debt investors expect from an efficiently run company (including both embedded debt raised prior to the price control period and new debt raised during the price control period). " [33]

(59) As further exemplification of Ofgem's position, ENWL notes that Ofgem was sharply critical of the CMA last year when it perceived that the CMA's provisional PR19 cost of debt allowance was not aligned to actual interest costs. Ofgem urged the CMA to reconsider the match that it was securing between costs and revenues, as follows:

"Ofgem stated that if customers were to pay more than average actual debt costs, this implied a subsidy to equity returns which means they will exceed the estimated cost of equity (and vice versa). Ofgem considered it important that actual data is considered as getting this measure wrong could be extremely costly to either water consumers or to regulated companies."[34]

4.2 The determinants of a company's borrowing costs

(60) It is common ground between Ofgem and WWU, and between regulators and companies more generally, that the cost of debt allowance should match only efficiently incurred interest costs. ENWL considers that defining 'efficient' costs properly is absolutely key to the CMA's determination of WWU's appeal.

(61) Ofgem's position in its RIIO-2 reviews (and previously) is, in effect, that there is one single identifiable level of efficient cost which could/should be attained by every notionally geared, efficient licensee. ENWL fundamentally disagrees with this characterisation.

(62) The licensees in the energy network sector cannot be assumed to have built identical portfolios of debt instruments in which every company borrows at the same time, in the same way and achieves the same cost of debt. Instead, there needs to be a recognition that the interest rates that each individual company pays during the RIIO-2 period will be a function of, inter alia:

(a) the profile of the company's historical and future capital programme (influencing the size of the debt requirements) and the consequent timing and frequency of the company's debt-raising activity;

(b) the exact dates at which debt was issued;

(c) the available markets into which the debt could be issued;

(d) the company's choice of the tenor of debt, based on the appetite of the market at the time for that tenor of debt;

(e) whether debt was issued in floating-rate, fixed-rate or index-linked form;

(f) whether index-linked debt was issued in index-linked form, or whether it was issued in nominal form and swapped into index linked form; and

(g) whether debt was issued in sterling, or whether it was issued in other currencies and swapped into sterling.

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32 *WWU Tab A1.1 RIIO-2 Framework Consultation, March 2018, para. 7.11.*

33 *WWU Tab A3.4 Ofgem – RIIO-2 Sector Specific Methodology Decision – Finance, para. 2.1.*

34 *ENWL-016 CMA Water Redeterminations 2021, para. 9.564.*

(63) There is no reason to think that each and every licensee will be completely homogenous in the above respects. Points (a) and (b), for example, mean that the timing with which different companies will have historically accessed the debt markets will be different. The heterogeneity that this generates is then further compounded by points (c) (g) because there is never going to be a single 'right' way of packaging debt. Efficient companies can therefore reasonably make different choices about the timing, tenor and form of their borrowing, leading to variation in debt costs across the sector, even when these are incurred efficiently relative to market conditions at the time.

(64) In this context, debt has to be viewed with reference to the circumstances at the time at which it was taken out. A company should not be considered inefficient if it raises debt a week, a month or a year after another company at an increased cost, if the markets have moved significantly since the first issuance. Licensees have, in practice, limited flexibility, without risking other consequences, when it comes to determining the timing of debt issuance. This means that they do not have the discretion to either hold off, or bring forward, issuances just in case interest rates change. In particular, refinancing of maturing debt should take place within around 12 months of maturity in order to avoid concern from credit ratings agencies, while new issuances unavoidably need to be made in advance of investment requirements. The timing of such decisions is often compounded by the cost of carry (double handling), availability of short term bank finance and, particularly for smaller operators, the relative efficiency of issuing in market benchmark sized issuances of around £250m.

(65) Similarly, it can be quite wrong to judge retrospectively with the benefit of hindsight that the choices one particular company made in the past about tenor or fixed vs floating vs index-linked are better or worse than the choices that another company when faced with the same information.

(66) In practice, debt issuance pricing is only very marginally influenced by the efficiency of the debt issuance process given the depth of global bond markets resulting in all borrowers being market takers. Instead it is far more influenced by benchmark market rates and credit spreads on the day of issuance itself, with the issuer credit rating, covenants and investor appetite/sentiment being the most important variables after the benchmark. 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 funding being shown in returns.

(67) Any supposition that lower-than-average costs indicate that the operator must be particularly efficient, or that higher-than-average costs represent inefficiency (i.e. the company 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) would, therefore, be wholly misconceived.

4.3 Size of company as a factor affecting the cost of debt

(68) It would also not be correct to assume that, over a sensible timeframe, all efficient companies will tend to the average: the larger the company, the more likely it is to tend to the average, just as the smaller a company is the more likely it is to diverge from the average.[35] This is a weakness of any benchmark based on averages particularly where a single company is a material proportion of the index.[36] In particular it is not correct to assume that all companies can mitigate the risk of deviation from the average through future refinancing activity:

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35 *The CMA acknowledged the risks of making such an assumption in a debate around the setting of the cost of capital point estimate in the water redeterminations, noting that "The use of a single, average cost of capital assumes that these effects will balance out over time, but there is no evidence to show that this will be the case in practice" (ENWL-016 CMA Water Redeterminations 2021, para. 9.1283).*

36 *For example, in the gas distribution sector Cadent is more likely to tend to the average given that they are the largest company in the sector and its costs represent half of the costs that count towards the average cost.*

(a) 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;

(b) however, in practice companies issue debt infrequently either based upon the timing of investment and/or the maturity of older debt. Most smaller companies are especially infrequent issuers and their ability to match, or outperform, the industry average will be a matter of luck of timing rather than any inherent ability to issue debt more efficiently;

(c) any timeframe in which costs might possibly tend to the average would, especially for smaller companies, be significantly beyond a single five-year price control period, given average debt tenors on issuance in excess of 10 years; and

(d) 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 (the cost of issuing in advance of the maturity of existing debt and holding two debt instruments less cash on deposit until maturity) become significant.[37]

(69) Therefore, in taking an industry average approach there is a sense that Ofgem is particularly disadvantaging smaller companies with irregular financing requirements. This will be noted by the ratings agencies in assessing the relative risk of large vs small companies, even if Ofgem does not differentiate between these companies in the equity returns setting mechanism. As a result, Ofgem is permanently disadvantaging companies that are unable to reach and manage risk to be able to meet or beat the average, or have to rely on the luck of issuance timing to be able to do so.

(70) Another particular feature of Ofgem's approach to the cost of debt is that its single allowance makes no distinction between the costs associated with embedded and new debt. Whilst the focus of WWU's Appeal is primarily on the impact of this approach on the funding of embedded debt costs, it can also have negative consequences for the funding of new debt, given the current economic climate, that outweigh the positive incentivisation properties. In particular, at a time when interest rates could potentially rise, a long trailing index, which essentially assumes an even spread of debt issuance over the trailing period, means that these costs may not be met. This could be the case if interest rates rise for a period then subsequently fall, or even if they remain relatively stable at those higher levels, given that interest rates that fall out of the index are at so far above today's levels..

(71) For larger licensees or groups, which make market benchmark sized debt issuances on a regular basis, this is less likely to be an issue. For smaller and/or 'singleton' licensees, which have less frequent and consequently 'lumpier' financing requirements, this is a major concern and serious risk to the attractiveness of investing in the licensee. This will be exacerbated by the pattern of future investment for net zero which will be higher in future price controls, resulting in the risk of a level weighted index picking up proportionately more years of low interest rates than is fair based upon the average of debt issuance over the index period.

4.4 Ofgem's approach results in a postcode lottery for equity, where returns are determined for reasons beyond performance for consumers and efficiency

(72) Ofgem nevertheless forces uniformity by, inter alia, setting the allowed cost of debt in line with the industry-average cost of debt.

(73) To be clear, this is not a regime in which Ofgem typically makes disallowances for inefficient costs. ENWL is not aware of any occasion in recent reviews when Ofgem has declared that a company's debt has not been efficiently incurred and, hence, that the associated cost

37 *ENWL-004 Transaction Cost Premium for Infrequent Debt Issuers, Frontier Economics, 29 September 2020.*

should not be passed on to customers. Instead, Ofgem has set the allowed cost of debt in such a way that the total interest costs incurred by all companies, including relatively higher cost companies like WWU, are recovered from GB customers in full.

(74) A key oddity of the industry-average policy is the way that the match between industry costs and industry revenues is secured. Under Ofgem's one-size-fits-all approach, customers of companies with relatively low costs of debt are asked to pay revenues that exceed the companies' actual interest costs, while customers of companies with relatively high costs of debt pay revenues that fall short of their companies' actual interest costs. GB customers, in aggregate, pay an appropriate amount overall that reflects the debt costs of the sector (subject to the inclusion of derivative costs), but the wrong customers pay the wrong companies for the various components of debt that licensees have assembled to deliver their own customers investment needs.

(75) Adopting this 'postage stamp', single WACC approach for the sector, based on the actual industry average cost of debt, might avoid creating a post code lottery for the cost of capital. However, it achieves this at the expense of the creation of a much more damaging post code lottery for equity returns.

(76) In GD1/ED1[38] equity returns for some companies have been significantly squeezed as a result of higher debt costs than were allowed for in the GD1/ED1 settlements.[39] Conversely, in other parts of the country some licensees have earned excess equity returns as a result of Ofgem's policy of asking customers to pay for costs that are ultimately the responsibility of neighbouring companies. With lower proposed cost of equity in RIIO-2 compared to RIIO-1 these divergences in equity returns have become more pronounced.

(77) Looking at relative equity returns, post financing, investment in Manchester (i.e. in ENWL) might in future pay out 2.6% of RoRE[40] whereas investment in Liverpool (i.e. in SPEN) pays out 6.3%, boosted by over funding of debt costs.

(78) Consequently, from an equity perspective, a utility operating in one region of the UK is less than half as attractive for equity investment as its immediate neighbour, with those equity returns bearing no relationship with the relative operational performance of the company, or the actual true efficiency of debt. To be clear once again, this disparity comes about not because of efficiency/inefficiency but because some customers are being asked to pay their DNOs more than they either need or deserve, whilst consciously leaving other DNOs underfunded. This is not consistent with Ofgem's stated aims for RIIO-2, as highlighted above (see para. (57)).

(79) It is also inconsistent with Ofgem's statements about the distribution of returns that it wishes to see across the sector:

"an effective price control should also create a natural dispersion of returns corresponding to the dispersion of company performance on measures that matter to consumers, with the best performers making the highest returns, and the worst performers the lowest".[41]

(80) If avoiding a postcode lottery for WACC is a legitimate aim, it is only because it is in the interests of customers to do so. It cannot, however, be in the interests of consumers to arrive at a settlement which awards different net equity returns on a regional basis, for reasons other than operational performance or actual true inefficiency in debt issuance.

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38 *ENWL-015 Regulatory financial performance data file – Annex to RIIO-1 Annual Reports, RoRE breakdown*
39 *ENWL-002 First Witness Statement of David Brocksom, Section C.*
40 *Calculated at CPI, using proposed cost of equity for ED2, with ED1 average debt underfunding assumed to perpetuate.*
41 *ENWL-005 Ofgem open letter on RIIO-2, 12 July 2017, p. 7.*

5 INTERPRETATION OF THE STATUTORY DUTIES

(81) The basis of DNO regulation is set out in the licences of the regulated entities, and the relevant legislation. For WWU as a GDN (the gas equivalent of an electricity DNO) Ofgem is under a duty to carry out its gas functions in accordance with the principal objective and statutory duties set out in s4AA GA86 and described in Section 2 of WWU's Notice of Appeal (the **Gas Duties**). The Gas Duties are mirrored for the electricity DNO sector in Section 3A EA89 (the **Electricity Duties**). The Electricity Duties are set out in more detail in the First Witness Statement of Paul Bircham.[42]

(82) The Electricity Duties mirror the Gas Duties with one notable exception. Under the GA86 the s4AA(2)(a) duty to secure that all reasonable demands for gas are met is qualified by the statement "*so far as it is economical to meet them*". There is no equivalent qualification included in the s3A(2)(a) EA89 demands duty and, as a result, large areas of GB are unconnected to the gas network as it is deemed uneconomical to connect these areas.

(83) The financing duty under both GA86[43] and EA89[44] requires Ofgem to "*have regard to … the need to secure that licence holders are able to finance [their] activities*". In this Application the comments on the interpretation and the application of the financing duty should be construed as applying to the duty as set out in both the GA86 and the EA89, unless expressly stated otherwise.

(84) We agree with WWU that the interpretation and application of the statutory duties is not a matter for regulatory discretion, it is a question of law,[45] and that if "*Ofgem incorrectly interprets and applies its duties, it has 'misdirected itself' as to the law, and the decisions which flow from that misdirection will inevitably be unlawful*".[46]

(85) As WWU has identified in its Notice of Appeal, Ofgem has not set out a clear analysis of the proper legal interpretation of the financing duty.[47] In the recent RIIO-ED2 SSMD Finance Annex Ofgem states:

"4.17 Section 3A of the Electricity Act 1989 and section 4AA of the Gas Act 1986 set out Ofgem's principal objective and general duties. The relevant wording in relation to Ofgem's financeability duty in both Acts provides that "the Authority shall have regard to......(b) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed......".

4.18 The financeability duty requires us to "have regard to" the need to ensure that licensees are able to finance their activities, rather than a duty to ensure or secure the financeability of licensees. While financeability is an important consideration, and one that we take very seriously, it is not the only consideration to which Ofgem's attention is directed by statute. The relevant sections of the Electricity Act and Gas Act, and relevant CMA authorities, require Ofgem to weigh these considerations in the round.

4.19 We therefore believe that a continued focus on the notional company for setting price control parameters is appropriate in light of our financeability duty and our other duties. We will consider actual company debt positions and structures to inform the notional structure and to inform our views on potential increased monitoring of actual companies with a less comfortable credit profile. However, we do not believe that Ofgem is required to "ensure" or "secure" that all licensees are actually financeable in any and all circumstances (whatever risks they have taken or however inefficient they may be).

4.20 An obligation to "ensure" or to "secure" actual company financeability would have the effect of the consumer underwriting all financing decisions of networks despite companies, their boards and

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42 *ENWL-001 First Witness Statement of Paul Bircham (ENWL), Section A.*
43 *S4AA(2)(b) GA 86.*
44 *S3A(2)(b) EA89.*
45 *WWU Notice of Appeal, para. A4.3.*
46 *WWU Notice of Appeal, para. A4.4.*
47 *WWU Notice of Appeal, paras. A4.13-A4.15.*

management being better placed to manage risks associated with these decisions and benefitting from additional returns if those decisions lead to outperformance."[48]

(86) This description of the financing duty under the EA89, which is the best available exposition from Ofgem as to its interpretation and application of the duty, mirrors Ofgem's description of the financing duty under GA86 as quoted in WWU's Notice of Appeal.[49]

(87) As set out in the First Witness Statement of Paul Bircham[50] Ofgem has indicated that it has received legal advice on the interpretation of the financing duty, but this has not been shared with ENWL. ENWL shared a legal opinion from Thomas Sharpe QC on the interpretation of the financing duty with Ofgem in 2018. That advice has been updated and reissued for the purposes of this Application and is attached as ENWL-003. The key conclusions from that advice, which are expanded on in the sections below, clearly support WWU's ground of challenge that Ofgem's misinterpretation of its financing duty is "*at the root of its other flawed decisions*".[51] In particular Thomas Sharpe QC's opinion concludes that "*Ofgem's interpretation of the Financing Duty is completely untenable*".[52]

(88) In the following sections we break down the different aspects of the interpretation and the application of the financing duty, considering the clear meaning of the statutory words, and their purpose and effect. This includes:

(a) to whom is the financing duty owed (see Section 5.1);

(b) the interpretation of "*have regard to*" and the "*need to secure*" (see Section 5.2);

(c) each licensee must be "*able to*" finance its functions (see Section 5.3)

(d) the relationship between the statutory duties (see Section 5.4); and

(e) who bears the burden of demonstrating the duty has been discharged (see Section 5.5).

5.1 To whom is the financing duty owed?

(89) The financing duty refers to "*the need to secure that **licence holders** are able to finance the activities which are the subject of obligations imposed on **it***" (emphasis added). It is clear, therefore, that the duty is owed to the individual licensee:

(a) each company holds an individual licence which details the obligations and permitted activities that are specific to the individual licensee;

(b) this includes individual obligations to maintain investment grade credit ratings[53] and general licence conditions on the availability of financial and other resources to enable it to "*properly and efficiently*" carry on its business and meet all of its obligations;[54] and

(c) the reference in the financing duty to "*licence holders*" in the plural does not mean that Ofgem can discharge this duty by reference to the sector as a whole, rather than by reference to each individual license holder.

(90) As such it is clear that the statutory obligation on Ofgem to have regard to the need to secure the ability to finance functions is owed to individual licence holders. When the financing duty is read in conjunction with the other duties to which Ofgem must have regard, it can properly be interpreted as the need to secure that the licence holder, to the extent that it is efficiently

48 *ENWL-010 RIIO-ED2 SSMD Finance Annex 3, paras 4.17-4.20.*

49 *WWU Notice of Appeal, para. A4.15.*

50 *ENWL-001 First Witness Statement of Paul Bircham (ENWL), Table 1.*

51 *WWU Notice of Appeal, para. A3.11(a).*

52 *ENWL-003 Opinion of Thomas Sharpe QC, para. 13.*

53 *"The licensee must take all appropriate steps within its power to ensure that at all times it maintains an Investment Grade Issuer Credit Rating" Standard Licence Conditions of the Electricity Distribution Licence – 22 January 2021, Condition 40: Credit rating of the licensee (ENWL-017); Gas Transporters Licence: Standard Conditions – 01 February 2019, Condition 46: Credit rating of the licensee (ENWL-018).*

54 *ENWL-017 Standard Licence Conditions of the Electricity Distribution Licence – 22 January 2021, Condition 30: Availability of Resources*

managed, can finance its functions. A failure to have sufficient regard to the actual financial position of the individual licence holder is, therefore, an error of law.[55]

(91) There is an inherent inconsistency between the proper legal interpretation of the financing duty and what it is intended to achieve, and the manner in which Ofgem considers it is entitled to apply it which, effectively, aggregates the assessment of the efficient cost of debt and financeability to a sector-wide consideration:

*"The cost of capital allowance should be set so that **the sector on average**, has sufficient but not excessive funding to meet its forecast actual efficient and verifiable costs of debt. Companies that are more efficient than the sector on average in raising finance should expect to outperform the sector average, while companies that are less efficient should expect to underperform it."* [56]

(92) The licence clearly indicates a bilateral relationship between the licence holder and the regulator. Whilst this sector-wide view might be one of a range of acceptable starting points for Ofgem's cost of debt methodology, the financing duty cannot be discharged by reliance upon reference to the financeability of the sector as a whole, or by concluding that a notional licence holder is financeable without being satisfied that the actual licence holder shares the same, or sufficiently similar, characteristics.[57]

5.2 Interpretation of "have regard to" and "need to secure that"

(93) WWU's case is that Ofgem's undue (almost exclusive) focus on its obligation to "*have regard to*" the financing duty, leading it to conclude that it is legitimately entitled to trade it off against the other statutory duties as part of weighing those considerations in the round,[58] is a fundamental misinterpretation of the financing duty by Ofgem that leads to subsequent errors of law and policy in how it is applied in setting the cost of debt allowance.[59] This understanding is consistent with the advice ENWL has received from Thomas Sharpe QC on the interpretation and application of Ofgem's financing duty.[60] .

(94) The financing duty requires Ofgem to "*have regard to … the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed on it*". 'Need' is a stronger word than 'desirability', and 'secure' is a stronger word than 'allow', 'promote', 'contribute to' or similar. Taking into account the natural and ordinary meaning of the words and terms used, the imperative language demonstrates Parliament's recognition of the level of importance to be attached to the ability of each individual licence holder to finance its activities.[61]

(95) The financing duty is accompanied by its twin duty that requires Ofgem to "*have regard to … the need to secure that all reasonable demands*" for supply of the services are met. The financing duty and reasonable demands duty form a fundamental covenant that is at the heart of the framework of statutory duties – it is clearly in the interests of consumers that their reasonable demands for the services will be met and to facilitate that there is an obligation on Ofgem to ensure that each individual service provider with a licence can finance the activities necessary to deliver that reasonable demand and all other obligations to which it is subject.[62]

(96) This reflects the proper construction of the financing duty by reference to the language used and the underlying purpose and intent behind these provisions. When the energy sector was liberalised investors needed to be suitably incentivised to finance the utilities in both the short and long term, in the interests of consumers. To ensure this, and avoid it remaining wholly

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55 ENWL-003 Opinion of Thomas Sharpe QC, para. 19.

56 ENWL-008 Ofgem RIIO-ED2 Framework Decision January 2020, RIIO-2 Design Principles no. 18, p. 66.

57 ENWL-003 Opinion of Thomas Sharpe QC, para. 22; WWU Notice of Appeal, para. A4.9.

58 WWU Notice of Appeal, paras. A4.16-A4.17.

59 WWU Notice of Appeal, para. A4.23.

60 ENWL-003 Opinion of Thomas Sharpe QC, paras. 11-12.

61 ENWL-003 Opinion of Thomas Sharpe QC, para. 11.

62 ENWL-003 Opinion of Thomas Sharpe QC, para. 8.

within the discretion of the regulators, the statutes setting the framework for regulated utilities (electricity, gas, water) all included provisions to ensure that the businesses would be able to finance their functions. This enabled the utilities to be promoted as relatively safer long-term interests for investors to invest in. This forms part of the legitimate expectations of regulated utilities, their investors and, ultimately, is in the long-term interests of consumers.[63]

(97) Seen in that context, Ofgem is under an obligation to secure that each individual licensee can meet all reasonable demands for electricity/gas and that, if efficient, it is able to finance the activities which are subject to its obligations imposed by statute.

5.3 Each licensee must be “able to” finance its functions

(98) The ability of a licensee to finance its functions means that a licensee that is “*properly managed and efficiently financed, should be “able” to meet its obligations*”.[64] This reflects that the financing duty must be read in the context of the other statutory duties which, for instance, introduce the subsidiary obligation to promote efficiency.[65] Ofgem must, therefore, have regard to what funds (debt and equity, rather than just debt) each individual licensee needs to secure its ability to finance its activities, if operated efficiently. As set out in Section 4 above, this means that due consideration must be given to the various circumstances that might influence a licensees actual and efficient cost of debt. Contrary to Ofgem’s exposition[66] as quoted in para. (85) above, however, this should not be misinterpreted (and as a result dismissed) on the premise that it would oblige Ofgem to effectively underwrite inefficiency.[67]

(99) For the avoidance of doubt, we are not suggesting that the proper interpretation of the financing duty would require an unqualified pass-through of all debt costs, regardless of efficiency. We recognise that characterising it thus might be a convenient shortcut to justifying the notional sector average approach, but it is not supported by the proper interpretation of the statutory duties. Nor is it a justification for failing to have sufficient regard to the actual financing requirements, circumstances, efficiency and financeability of each individual licence holder.

(100) At the very least if, having used a methodology that focuses on the average actual costs of debt for the sector, it is clear that an individual licence holder’s cost of debt is different, Ofgem must examine the individual circumstances of the affected licence holder. By either failing to give any or insufficient consideration to each licence holder’s individual circumstances, Ofgem is manifestly failing to take into account all the relevant considerations that should inform the setting of the cost of debt allowance and is having regard to irrelevant considerations. This results in an unmerited penalty for the ‘losers’.

5.4 The relationship between the statutory duties

(101) The financeability duty sits in the midst of a matrix of overlapping but tiered interests which Ofgem must pursue. Ofgem’s foremost duty is to carry out its functions in a manner which “*it considers is best calculated to further*” its principal objective of protecting the interests of consumers. The construction of the GA86 and EA89 means that under the principal objective the interests of consumers must be pursued by first, securing that all reasonable demands for supply are met and secondly, but in equal standing, securing that each efficient licensee is able to finance its relevant activities.[68]

63 *ENWL-003 Opinion of Thomas Sharpe QC, para. 20.*
64 *ENWL-003 Opinion of Thomas Sharpe QC, para. 14.*
65 *E.g. S3A(5)(a) EA89.*
66 *ENWL-010 RIIO-ED2 SSMD Finance Annex 3, para. 4.20.*
67 *ENWL-003 Opinion of Thomas Sharpe QC, para. 13.*
68 *ENWL-003 Opinion of Thomas Sharpe QC, para. 3.*

(102) As Ofgem has itself acknowledged this clearly demonstrates that the objective under the financing duty of securing that efficient licence holders can finance their functions is aligned with the protection of consumer interests in the short and long term:

"In setting a price control we need to secure network licensees ability to finance their activities, whilst ensuring that the interests of existing and future consumers are protected. We do not see any conflict between these two difference aspects of our objectives as it is not in the interests of consumers for an efficient network to fail. However, we need to ensure that returns remain legitimate with stakeholders."[69]

(103) If an individual license holder cannot finance its activities (i.e. it cannot raise sufficient debt and equity financing to enable it to meet all reasonable demands) and therefore cannot meet the specific obligations placed on it under its licence, this would be contrary to the interests of future and existing consumers. Continuity and quality of service might deteriorate or potentially cease and important investment required be deferred. As such, it is accepted that consumers should bear the efficient costs of financing through the price control settlement.

(104) Even if there are safeguards in place in the event of a licensee failing completely, that does not mean it is an acceptable outcome, or one which Ofgem should knowingly contribute to through its decisions. The failure of an individual licensee, especially if it is through the accident of debt issuance timing relative to exogenous market swings and Ofgem's regulatory mechanism choices, rather than any inefficiency, would likely have adverse ramifications for consumers across the whole sector.

(105) When considering the point estimate for the cost of capital overall, it is accepted that the risks to consumers of underinvestment resulting from the cost of capital being set too low can be more damaging than any welfare that might be lost from bills being too high. Extrapolating this principle to the relationship between the debt allowance and actual equity returns, we consider that it is in consumers long term interests that equity investors are appropriately rewarded for their investment after all efficient debt costs are taken into account (including the all-in economic costs and benefits of derivatives).

(106) Investors in regulated sectors need to have confidence that regulators are setting reasonable and robust price controls in accordance with the principles of regulatory best practice, including certainty and consistency, given that investors commit to investment for the very long term and price controls are typically only for five years. This confidence lowers the long-term financing costs of investment, to the benefit of consumers. If the underfunding of an individual licensee's actual efficient debt costs results in equity investors subsidising debt allowances, this might result in a repricing of equity risk to the longer-term detriment of consumers through increased charges with insufficient countervailing benefits. It would also provide a major disincentive to invest in these companies and/or the sector relative to investment returns in other sectors, regions or internationally. These are the risks that the financing duty is intended to manage and mitigate.

5.5 Who bears the burden of demonstrating that the financing duty has been discharged?

(107) The impact of the "*need to secure*" means that the legal burden falls on Ofgem to demonstrate that it has discharged its duties having regard to those obligations.[70] In practice this means that the burden is on Ofgem to show sufficient proof, based on the balance of probabilities and having regard to all the evidence, that the individual licensee, operating efficiently, is able to finance its functions. One way for Ofgem to achieve this is by demonstrating that the costs of capital will be met/rewarded at a fair level of returns for both debt and equity. This is, therefore a positive burden on Ofgem to demonstrate that it has discharged its duties in relation to each individual licensee as opposed to the legal burden

69 ENWL-005 Ofgem Open Letter on RIIO-2, 12 July 2017, p. 8.
70 ENWL-003 Opinion of Thomas Sharpe QC, para. 9.

falling on the licensee to prove that a proposed settlement has rendered it incapable of properly financing its functions.

(108) This reflects the significant consequences for consumers of any failure to secure sufficient funds to maintain the efficient discharge of each individual licensees' obligations regarding the provision of the underlying services, including the need to meet reasonable demand.

6 ENSURING THAT THE COST OF DEBT METHODOLOGY SATISFIES THE REQUIREMENTS OF THE FINANCING DUTY

(109) The interpretation of the financing duty is a matter of law. Ofgem may exercise its regulatory discretion as to the methodology it adopts to assess the cost of debt, but in doing so it must have proper regard to the requirements of the financing duty. The resultant allowance must, therefore, be sufficient to secure that the individual licensee is able to finance its functions, including through the recovery of its actual efficient costs of embedded debt.

(110) Ofgem's methodology for setting the cost of debt allowance for RIIO-GD2 was summarised by Oxera for WWU.[71] Ofgem settled on a full indexation approach having considered partial indexation and full cost pass through as alternatives in its consultation on the overarching RIIO-2 framework.[72] As set out in Paul Bircham's witness statement, Ofgem has confirmed its intention to utilise the same full indexation approach for ED2, calibrated to reflect the electricity sector's actual average debt costs.[73] Under this approach Ofgem assumes that the notional company can borrow at a rate consistent with that calibrated benchmark index and sets the cost of debt allowance accordingly.

(111) WWU's case is that, whilst indexation can be a valid mechanism to the extent that it provides a "*reasonable proxy for the cost of debt of each efficient company within the relevant sector*",[74] Ofgem's single industry-average approach fails to do so "*because it based its determination on a flawed indexation methodology, which was irrational as a matter of law and lacked any valid policy justification. This inevitably led to an outcome that was in error*."[75] WWU also argues that placing too much reliance on the industry average results in a failure by Ofgem to comply with its obligation to have regard to all relevant circumstances.[76]

(112) We agree that Ofgem's cost of debt methodology does not ensure, for all individual licence holders, that the financing duty is satisfied. Under the current settlement GB customers are, in aggregate, paying the industry's actual cost of debt, but the averaging approach means that some companies are receiving windfall gains and others are suffering losses that create serious financeability concerns. 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 and does not protect the interests of consumers in the short or longer term.

(113) The financing duty, read in conjunction with the other statutory duties, places on Ofgem an obligation to have regard to the need to secure that all efficiently managed individual licence holders are able to finance their activities.[77] As explained above this is consistent with, and furthers, the principal objective to protect the interests of current and future consumers. We agree with WWU that Ofgem's failure to have sufficient regard to all of the relevant individual

71 *WWU Notice of Appeal, para. A5.4.*
72 *ENWL-006 RIIO-2 Framework Decision, paras. 6.3-6.28.*
73 *ENWL-001 First Witness Statement of Paul Bircham (ENWL), Section D.*
74 *WWU Notice of Appeal, para. A3.11(b).*
75 *WWU Notice of Appeal, para. A3.2.*
76 *WWU Notice of Appeal, paras. A4.26-A4.27.*
77 *WWU Notice of Appeal, para. A4.25.*

circumstances of each individual licensee through its application of the sector-average cost of debt to all licence holders is an error of law.[78]

(114) In this section we identify the key principles that flow from the statutory duties which we consider should inform the cost of debt allowance methodology. In particular we demonstrate that, whilst Ofgem's current approach could be a legitimate starting point, it fails to have sufficient regard to all relevant circumstances required for it to discharge its obligations under the statutory duties with respect to individual licence holders. This does not necessarily mean that a wholesale rethink of Ofgem's current approach is required, but it should not be seen as the end point in the analysis that is required.

6.1 What does securing a licensee's ability "to finance its activities" mean in practice?

(115) As set out in Section 5 Ofgem is required by the financing duty to "*secure*" that each individual licensee has the financial resources to be "*able*" to finance its functions.

(116) While Ofgem's industry-average approach may be convenient and practical as a starting point in the cost of debt assessment, this approach does directly not answer the question of whether or not an individual license holder can properly finance its functions.[79] A cost of debt set with reference to the sector-average cost of debt would only satisfy the requirements of the financing duty to the extent that the average situation is fully representative and appropriate for the particular licensee. Where there are factors which a licensee, the commonalities will necessarily be reduced. This can have significant and adverse consequences for financeability.[80]

(117) The CMA has previously shown its willingness to consider the circumstances of individual licensees in order to ensure that the statutory duties are discharged. In its decision on SONI Limited's appeal against a price control decision of the Northern Ireland Authority for Utility Regulation (NIAUR), the CMA found that, in failing to take account of the specific risks faced by SONI, NIAUR had failed to discharge its financing duty. In particular the CMA acknowledged that "*the circumstances are complex for SONI*" and that NIAUR's approach which ignored SONI's specific circumstances was not "*sufficient or reliable*" and posed "*significant risks to SONI's financeability*".[81]

(118) If, therefore, any individual licensee can demonstrate that the industry-average approach leads to a cost of debt allowance which underfunds its actual efficient cost of debt, particularly as a result of that licensee's circumstances which differ from the average sector circumstances (e.g. pattern of debt issuance), the financing duty places Ofgem under an obligation to examine the evidence and form a meaningful and detailed conclusion for that licensee.[82]

(119) In finalising the cost of debt allowance for such a licensee Ofgem must, therefore, be prepared to properly allow for each license holder's distinct position, taking into account its size, debt tenor, date of issuance and other features including the use of derivatives.[83] Evidence as to these factors should prevail over the simplistic application of a hypothetical average company, with debt issuance assumed to occur evenly over the period of the index, simply because it is convenient.

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78 *WWU Notice of Appeal, para. A4.37.*

79 *WWU Notice of Appeal, paras. A5.13-A5.23.*

80 *WWU Notice of Appeal, paras. A5.17: "if the costs of debt of companies which are non-comparable because they have fundamentally different characteristics are used to calculate a single sectoral cost of debt, the outcome will necessarily be skewed against some companies and in favour of others. In those circumstances it is inevitable that some companies will be unable to recover their actual efficient costs of debt, with an adverse impact on their financeability.".*

81 *WWU Tab M17 CMA - SONI Limited v Northern Ireland Authority for Utility Regulation – Final determination, para. 7.380.*

82 *As WWU sets out in its Notice of Appeal, Ofgem's method only works if you make appropriate adjustments to the outturn allowance to ensure actual licence holders can finance their debt – otherwise it is irrational: WWU Notice of Appeal, paras. A5.5-A5.9.*

83 *The date of issuance may be of particular relevance when interest rates have changed significantly over a period, such as was the case in 2008/09.*

(120) This is not to endorse a cost pass-through approach: regard must clearly also be had to whether that historical debt has been raised efficiently and in a timely way and cannot be economically refinanced to reduce the embedded costs.

(121) However, the burden is on Ofgem, in line with its statutory duties, to show that the circumstances of the licensee claiming a higher cost of debt are, in fact, consistent with the average in the sector, or that its higher costs can be attributed to inefficiency. If Ofgem has no reason to think that the debt was not properly incurred, as to timing, volume and indexed-linking and that its use of derivatives was sound, given that no fault should attach to the licensee's capital structure, Ofgem should make a greater allowance for a higher debt rate for that licensee.[84]

(122) In its RIIO-2 documents Ofgem confirms that there "*may be some circumstances that warrant a different approach to calibrating a network's (or sector's) debt allowance*", referring in particular to what it terms "*unusual or exceptional circumstances*".[85] In that context Ofgem refers to its decision in 2012 to agree to a bespoke weighted cost of debt indexation in the RIIO-T1 price control for Scottish Hydro Electric Transmission Ltd (**SHETL**).[86] Ofgem notes that whilst SHETL did not request the same for RIIO-2 there are still "*unusual company-specific circumstances*" that mean the bespoke treatment remains "*appropriate and justified*".[87] Despite SHETL's objections that company-specific adjustments should only be made in circumstances where companies are underfunded by the average allowance, Ofgem confirmed this approach in its final determination for RIIO-2.[88] More broadly, Ofgem has acknowledged the potential need for such adjustments by making limited additional allowances for small company/infrequent issuer premiums (6bps to only some GD&T companies)[89] but some licensees have had these requests rejected.[90] In any event this limited acknowledgement of individual circumstances does not go far enough to address the concerns outlined in WWU's Appeal and this Application.[91]

(123) We note that, in the water redeterminations, the CMA expressed disagreement with the idea that each company's embedded debt costs should be separately reimbursed, absent evidence of inefficiency, citing that: the water industry is broad enough for its aggregate costs to provide a good indication of efficient costs; that a forensic assessment of the efficiency of all debt instruments would not be a good use of the regulators time; and that it would reduce incentives to drive best practice, ensure efficiency and avoid inappropriate risk taking.[92] We consider that the principles we have outlined are compatible with the CMA's approach:

(a) we agree that the sector average costs might be a good proxy for efficient individual costs, all things being equal. However, our view is that Ofgem cannot discharge its financing duty by simply looking at the industry average, particularly given that the sample size for electricity is smaller than it is for water, and the impact of the larger companies on the average costs is greater. There is a necessary second step for Ofgem to show that in the circumstances in which the individual licensee finds itself, it can indeed finance its functions. It cannot be right that if, in the past, a licence holder took reasonable and appropriate debt decisions which, owing to the special circumstances of that licence holder, mark it out as differing from the average licensee, shareholders alone should have to fund the efficiently incurred difference to the average allowance;

84 *We note that if the regulator were so minded, the same principles could be applied with respect to any companies whose efficient costs of debt are significantly over-funded, thereby resulting in lower costs for their customers.*

85 *WWU Tab A4.3 Ofgem – RIIO-2 Draft Determinations - Finance Annex, para. 2.23.*

86 *ENWL-012 RIIO-T1: Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd, paras. 5.10-5.11.*

87 *WWU Tab A4.3 Ofgem – RIIO-2 Draft Determinations - Finance Annex, para. 2.28.*

88 *WWU Tab A5.9 Ofgem – RIIO-2 Final Determinations - Finance Annex (Revised), paras. 2.59-2.60.*

89 *WWU Tab A5.9 Ofgem – RIIO-2 Final Determinations - Finance Annex (Revised).*

90 *See, for example Ofgem's rejection of SGN Scotland's request for small notional company (Scotia only: WWU Tab A4.3 Ofgem – RIIO-2 Draft Determinations - Finance Annex, paras. 2.30-2.33.*

91 *Ofgem has indicated it might consider similar adjustments for ED2 (ENWL-010 RIIO-ED2 SSMD Finance Annex 3, para. 2.41).*

92 *ENWL-016 CMA Water Redeterminations 2021, para. 9.633.*

(b) if the review of the debt portfolio and the efficiency of individual instruments is only being carried out for those under-funded circumstances, in order to ensure that the financing duty is discharged, the concerns about it being a good use of regulatory time either diminish or fall away entirely; and

(c) given that the debt allowance would only be increased from the industry average in circumstances where the company could show that it was incurred efficiently, the incentives would not be damaged.

6.2 The methodology must take account of all actual costs of debt, regardless of the form of the financing instrument

(124) We agree with WWU that treating index linked derivatives as a special distinct category of financial instruments is fundamentally wrong as a matter of fact, and that their exclusion from the assessment of the cost of debt allowance is inconsistent and irrational as a matter of law.[93] The use of index linked derivatives is a relevant consideration that should be taken into account by Ofgem "*in accordance with its legal duty to have due regard to all relevant circumstances of the companies that it regulates*".[94]

(125) If it is accepted as a matter of principle that the financing duty requires Ofgem to have regard to actual costs of debt, then it follows that this should include all relevant forms of debt financing.[95] Even if the cost of debt is looked at using Ofgem's notional sector average approach, at the very least Ofgem is under an obligation to reflect the actual financing costs of the sector as a whole, including traditional means of financing (e.g. nominal bonds), more recent means (e.g. index linked bonds) and other mechanisms that achieve the same outcome (e.g. derivatives coupled with nominal bonds), as well as the non-index costs such as the cost of carry which can be significant.

(126) Derivatives constitute a commonly used and well-understood form of financing,[96] used in particular for debt cost minimisation. Derivatives and similar instruments are designed to mitigate the risks associated with debt and, usually, are taken out at the same time as the debt and may well condition the terms and tenor of any debt. At its simplest, an index linked derivative, coupled with a nominal bond, is economically equivalent to an index linked bond.[97] Derivatives used in those circumstances perform the same function as indexation in mitigating certain risks. It is perverse as a matter of economic principle, and irrational and inconsistent as a matter of law,[98] to take into account one type of risk mitigation (i.e. inflation linked borrowing) but not its economically equivalent alternatives (i.e. a nominal bond plus a derivative), or to create a systematic bias in favour of one means over another.

(127) Ofgem's approach assumes that as derivatives appear not to be widespread at a sector level that they should not constitute a necessary feature of funding a notionally efficient operator. This is not a satisfactory reason for disallowing consideration of derivatives for any calculation of debt costs and indeed when looking at an individual licensee, derivatives may be key.

(128) Ofgem's approach here is also inconsistent.[99] As WWU argues in its Notice of Appeal, Ofgem: excludes derivatives to convert nominal debt into index linked debt whilst allowing

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93 WWU Notice of Appeal, paras. A3.11(c), A6.27-A6.28.

94 WWU Notice of Appeal, para. A6.5.

95 Ofgem is clear about the importance of using actual costs of embedded debt in these calculations in order to protect the interests of consumers: "We believe that not taking the time and effort to calibrate in this way [using actual average debt costs rather than broad assumptions] risks systematically over-or under-compensating networks on average. We do not consider this we be in the best interests of consumers as it would lead to consumers either paying more than an efficient average cost of borrowing or under-compensating companies on average, which may lead to financeability constraints and push up network borrowing costs (and subsequent cost to consumers) over time." (ENWL-010 RIIO-ED2 SSMD Finance Annex 3, para. 2.25).

96 Derivatives are recognised by credit rating agencies in their assessments of interest costs and interest cover ratios.

97 ENWL-002 First Witness Statement of David Brocksom (ENWL), para. 23.

98 WWU Notices of Appeal, paras. A6.6-A6.11.

99 Ofgem is required to carry out its functions in a way which is, amongst other things, consistent (S3A(5A) EA89).

derivatives used to convert non-sterling debt into sterling debt; uses derivatives to estimate the cost of mitigating the basis risk between RPI and CPI debt; and includes derivatives in its calculation of the tax clawback.[100]

(129) Focusing on the comparison of currency-linked derivatives to the swaps intended to mirror index-linked debt, the former is accounted for by Ofgem despite being at least as complicated as the latter. As it is feasible for Ofgem to assess and account for cross-currency swaps, there is no reason of principle why it cannot do the same for other derivatives. It is, therefore, unclear why it would only include certain derivatives, but not others.

(130) It is also relevant that, in its instructions for actual company modelling for assurance of actual company financeability Ofgem directs that account is taken of the "*actual cost of of debt for each year (which will incorporate actual debt issuance forecast for each year). This should include the impact of derivatives*".[101]

(131) This issue has been recognised in the CMA's recent redeterminations in the water sector. The CMA referred to the significant degree of disagreement amongst all parties about what represents the 'actual' cost of debt for the sector.[102] The CMA used the information reported in Ofwat's Annual Performance Reports about companies actual costs of debt, which does not distinguish between the different types of instruments used, and concluded that this allowed it to reach a sufficiently accurate estimate of the actual costs of embedded debt across the industry.[103] As such, the CMA's view of the sector's cost of debt included the cost of derivatives that were included within the reported figures. The CMA also stated that its broad interpretation of 'debt', which included the non-pure instruments excluded from Ofwat's balance sheet approach negates much, but not all, of the disagreement on the correct measurement of actual costs.[104] Using that evidence the CMA was able to undertake a range of analysis of actual costs to consider the indicative cost of debt from various different perspectives and calculative methods, including factors such as cash adjustments cost of carry allowance and legal and banking costs.

6.3 The methodology should ensure that companies are incentivised to take efficient and appropriate financing decisions

(132) One aspect of Ofgem's rationale for use of an industry average is that it will incentivise companies to achieve an efficient cost of embedded debt:

"we remain of the view that setting the cost of embedded debt allowance based on individual company actual debt costs would dilute incentives to issue debt efficiently and prudently. This is because there would effectively be no long-term financial reward to networks for doing so, and no penalty for failing to do so because at each price control reset new debt from that price control would become embedded debt when assessed at the next price control."[105]

(133) Incentivisation is an appropriate regulatory goal, but the targets must be achievable with individual licensees able to meet them in practice in order for those incentive properties to have an impact (there is no point having incentivisation mechanisms in place if consumers don't benefit in practice). This is not being achieved by Ofgem's indexation methodology. A cost of debt allowance that is derived from an index then calibrated to actual costs of debt within the sector just pays the sector's average cost for embedded debt. It is not an index at all.

(134) Whilst a common risk premium might provide the incentives required to ensure an efficient capital structure, this may not apply if the adverse differentiating features are exogenous and

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100 WWU Notice of Appeal, para. 3.2(f); paras. A6.12-A6.15.

101 ENWL-010 RIIO-ED2 SSMD Finance Annex 3, para. 4.51.

102 ENWL-016 CMA Water Redeterminations 2021, para. 9.551.

103 ENWL-016 CMA Water Redeterminations 2021, paras. 9.552 – 9.553; 9.624.

104 ENWL-016 CMA Water Redeterminations 2021, para. 9.552.

105 ENWL-010 RIIO-ED2 SSMD Finance Annex 3, para. 2.18. Whilst this was stated by Ofgem in its SSMD for ED2, Ofgem was clear that these "reasons are consistent with those set out for GD&T" (ENWL-010 RIIO-ED2 SSMD Finance Annex 3, para. 2.24).

incapable of remedy by management action. It is also relevant that licensees are price takers in the global corporate bond market with only limited opportunity to outperform. They can and should be made to try and access the most competitive markets at the time financing is required, but individual licensees may have only limited control over the timing of those requirements. It is only those with larger, more regular, debt issuance programs that have some potential to control these risk (i.e. the larger network groups).

(135) It is also relevant that embedded debt is a sunk cost. There is clearly a benefit for consumers for incentivisation with respect to new debt to be taken out, and some benefit to consumers to ensure that debt management doesn't just focus on the current regulatory period. To the extent that embedded debt goes beyond one or two regulatory periods, however, there are very few, if any, benefits to consumers from continued incentivisation, particularly where there are significant regulatory or economic market changes.

(136) It is worth noting that in the CMA's decision in 2020 for NATS (En Route) Limited (**NERL**) the CMA's allowance for the cost of embedded debt was set with reference to NERL's actual cost of debt, and the new debt allowance was set with reference to a fixed reference value that NERL cannot influence through its actions.[106] At no point during the NERL inquiry did any party question NERL's incentives to raise new debt efficiently. ENWL therefore submits that it is a red herring to bring incentives in as a reason not to permit GDNs to recover their efficiently incurred embedded debt costs.

(137) We recognise that Ofgem may have legitimate concerns about companies adopting extreme financing decisions (e.g. zero-coupon bonds) which sit alongside concerns about customers being required to fund inefficiency. Allowing individual licensees to recover their actual efficient embedded debt costs is not inconsistent with measures to drive prudent and efficient management behaviour, but failing to give due account to efficient embedded debt being underfunded as a result of a sector-average indexation approach is inconsistent with the financing duty. There are other, more proportionate ways, of ensuring that consumers' interests are properly protected that would be more consistent with the statutory duties when seen in the round.

6.4 Practical/logistical considerations should not prevent consideration of individual company circumstances

(138) To place this discussion into context we note that, leaving aside the question of derivatives, Ofgem's current practice requires GB customers to pay for a sector's total interest costs. Ofgem does not currently undertake a detailed review of efficiency, nor has it typically made any disallowances for inefficient costs. Nobody is arguing, therefore, for an overall increase in the amount that GB customers pay. WWU and ENWL are simply asking through this appeal only for a reallocation of revenues, so that the right customers pay the right companies their actual costs of debt. This requires some consideration of individual company circumstances.

(139) Various regulators have, at different times and to varying degrees, raised concerns about the practicality of considering, in any detail, the circumstances surrounding the taking out of a large number of debt instruments at different points in time. Ofgem, for instance, has referred to the practical or logistical considerations that justify its approach, in particular the difficulties with assessing the efficiency of individual instruments and/or management decisions.[107] In relation to derivatives, Ofgem has pointed to the perceived difficulty in assessing potentially large volumes of information about individual derivative transactions, and in predicting future derivative use.[108] The CMA has also commented that an individual allowance based on the costs incurred by each company would likely require the regulator

106 *WWU Tab M18 CMA – NATS (En Route) Plc /CAA Regulatory Appeal – Final report.*

107 *See, for example WWU Tab A4.3 Ofgem – RIIO-2 Draft Determinations – Finance Annex, para. 2.52.*

108 *WWU Tab A4.3 Ofgem – RIIO-2 Draft Determinations - Finance Annex, para. 2.54.*

to conduct forensic assessment of the efficiency of each debt instrument used, which would not be a suitable use of the regulator's time or resources.[109] We consider that these concerns are misplaced and overstated.

(140) To the extent that Ofgem or any other party seeks to rely on this 'regulatory burden' as a rationale for not taking full account of individual company circumstances, or the full range of debt instruments actually used within the sector, the difficulties they claim in carrying out these assessments must be demonstrated rather than just assumed.

(141) It is also the case that if the review of the debt portfolio and the efficiency of individual instruments is only carried out for those circumstances where there is significant over- or under-funding in order to ensure that the financing duty is discharged, the concerns about it being a good use of regulatory time either diminish or fall away entirely.

(142) Whilst it is true that derivatives, and the way in which they are used, can be complicated as the recent decision of the CMA in the water sector demonstrates, it is practically feasible for a regulator to undertake a review of all debt instruments, including derivatives, within a reasonable timeframe. In that redetermination, the detail on the debt portfolios was gathered during the course of the redetermination, notably in the period between the CMA's provisional findings and its final decision.

(143) As WWU notes Ofgem has already collected sufficient data to assess and benchmark derivatives.[110] Much of this work has already been carried out and could be reviewed or extended as necessary. This is especially the case given that the detailed assessment is only required to the extent that an individual licensee's debt costs differ from the average. Complex analysis is part of the regulators activities and there are clear examples where Ofgem already does this – such as doing a reasonableness review into pension deficit repair costs and fund management in respect of the deficit arising on pre-2010 service.

(144) Regulators should clearly be capable of factoring this into price control methodologies given that the cycle from drafting of the methodology to reaching the final determination is typically 2-3 years or longer. If it is asserted as a justification for disallowing derivative costs, or not looking at the actual costs of each individual company, in circumstances where the failure to do so gives rise to underfunding, the burden should be on Ofgem to demonstrate the impracticability of including such costs.

7 WHAT DOES THIS INTERPRETATION OF THE FINANCING DUTY MEAN FOR THE APPLICATION OF THE FINANCEABILITY ASSESSMENT?

(145) The financing duty is the legal requirement on Ofgem to secure that individual licence holders are able to finance their functions. The financeability assessment is the means by which Ofgem assesses whether that is achievable in practice, taking into account the various elements of the proposed price control allowance:

"We use a financeability assessment as a last check that, when all the individual components of our Determinations are taken together (including totex, allowed return, notional gearing, depreciation and capitalisation), a notional efficient operator can generate cash flows sufficient to meet its financing needs."[111]

(146) Ofgem is explicit that this financeability assessment is carried out with respect to a notional company (although it also requires "*network companies' boards to provide assurance related to notional and actual company financeability*"[112]) and takes into account various design principles, including that:

109 ENWL-016 CMA Water Redeterminations 2021, para. 9.633.

110 WWU Notice of Appeal, paras. A6.22-A6.24.

111 ENWL-010 RIIO-ED2 SSMD Finance Annex 3, para. 4.2

112 ENWL-010 RIIO-ED2 SSMD Finance Annex 3, para. 4.50.

> *"the cost of capital allowance should be set t**o enable a notional efficient operator to maintain an investment grade credit rating**, and generate an expected return to equity that fairly reflects the risk facing investors in the price control settlement."*[113]

(147) The CMA has recognised that "*the WACC is the primary factor in the redetermination ensuring that an efficient firm can finance its functions*."[114]

(148) In practice, Ofgem's approach to assessing financeability reflects the same fundamental flaws and errors identified in the preceding sections with respect to the interpretation of the financing duty itself. For those companies whose efficient costs of debt are underfunded by Ofgem's allowance the resulting WACC will **not** be set a level which reflects their cost of debt and, as a result, neither debt nor equity investors will be able to earn sufficient returns to cover the costs of financing. It may also be that the cash flows that the licensee generates are incompatible with a solid investment-grade credit rating.

(149) In carrying out their assessments of financeability the credit rating agencies will gauge risk to debt investors based on actual debt underfunding. It is essential, therefore, that the regulator has regard to the actual efficient cost of debt, and the actual resulting returns to equity and the ability of each individual licensee to earn them. It will not always be sufficient to have confirmed, for instance, that credit metrics will be hit as that might be achieved in circumstances where embedded debt is still subject to material underfunding. The outcome of a price control settlement should not be that equity subsidises debt, or vice versa.

(150) It is also insufficient to take the view that financeability is fulfilled as, at the margin, 'new' equity will always receive the allowed return. If existing equity is not receiving the allowed return, other than for reasons of demonstrable inefficiency, then 'new' equity will not be confident of receiving the allowed return in the future, once it has become 'old' equity.

(151) Similarly, having only a marginal headroom above investment grade levels makes the licensee vulnerable to stresses arising from external sources and, significantly, reduces the ability to fund investment above allowances, whilst waiting for uncertainty mechanism to generate cashflows.

(152) For illustration, we consider that Ofgem's cost of debt methodology for RIIO-GD2 has led to WWU being underfunded by approximately 1.9% of RoRE[115] (resulting in an effective allowed return to equity of 2.4% compared to Ofgem's allowed return to equity of 4.3%), yet it has concluded that WWU's RIIO-GD2 settlement is financeable. As shown by WWU's decision to raise this Appeal, WWU disagrees. The same will be true for ENWL if this approach is carried through into the ED2 decision.[116] This is a direct consequence of the errors and flaws in Ofgem's interpretation of the financing duty and how it has influenced its setting of the cost of debt allowance and its assessment of financeability. In both cases it is primarily because of the timing of issuance of the debt portfolio, including associated derivatives.

(153) Ofgem notes that "… *actual company financeability issues are not necessarily for Ofgem to address*"[117] and that if companies face financeability problems "*due to capital structure and/or financing choices they have made*" the solutions lie in greater equity injection or reduced dividend payments in order to mitigate the problem.[118] This conventional approach is entirely consistent with the analysis above: that if problems are essentially a result of past management decisions and such management decisions were unreasonable at the time that they were made, then the appropriate solution is to turn to shareholders to alleviate the problem through capital issuance and/or dividend restraint. It does not, however, alleviate

113 ENWL-010 RIIO-ED2 SSMD Finance Annex 3, para. 4.3.

114 ENWL-016 CMA Water Redeterminations 2021, para. 10.72.

115 This amount has been derived by ENWL based on WWU quoting £122m debt underfunding in its public hearing with Ofgem on 20 October 2020 and Ofgem's Draft Determination Financial Model.

116 ENWL-002 First Witness Statement of David Brocksom, Section D.

117 WWU Tab A4.3 Ofgem – RIIO-2 Draft Determinations - Finance Annex, p. 211.

118 WWU Tab A4.3 Ofgem – RIIO-2 Draft Determinations - Finance Annex, p. 215.

the need for Ofgem to demonstrate that there has been inefficiency or, if there has not, to consider other solutions where the financeability issues arise in the ways outlined in WWU's case, such as the timing/tenor of debt.

8 CONCLUSIONS ON THE FINANCING DUTY AND COST OF DEBT

(154) In summary, Ofgem is under a duty to have regard to the need to secure that each individual licensee can properly finance its functions. The burden is on Ofgem to demonstrate that this is achieved with respect to each individual licensee, taking into account its specific circumstances, rather than by reference just to the industry averages, or to the sector as a whole. In carrying out that assessment, debt and equity should be considered separately. Ofgem must ensure both that equity returns are adequate and that each licensee's cost of efficient debt is covered, but not over-compensated.

(155) Ofgem's one size fits all approach to the cost of debt allowance results in significant underfunding of efficient debt costs for some licensees, creating debt financeability issues and resulting in equity in those companies failing to achieve the reasonable rate of return envisaged by the cost of equity allowance. For other licensees it results in overfunding with negative impacts on their customers – both directly in terms of their bills and indirectly as it results in reduced incentives to improve operational efficiency and performance. As such, the wrong customers are paying the wrong amounts to fund efficient debt costs that vary by company from the average.

(156) Whilst it might be acceptable to use industry averages as a starting point for the analysis, that is only acceptable relative to the requirements of the statutory duties to the extent that the individual licence holder in question bears a reasonable relationship to the average company, in terms of size, ability to access capital markets, the date and tenor of any debt it can raise, its use of indexation and derivatives, movement over time in yields and other features, especially its existing debt portfolio. Where there is a divergence, the burden is on Ofgem to demonstrate that it is nevertheless appropriate to apply that methodology to a licensee which bears insufficient relationship to that in the model, or to make appropriate adjustments to the allowance.

(157) In practice, the regulator's approach should ensure that all licensees have an equal opportunity of recovering their efficiently incurred debt costs and, by implication, all have the same base equity returns and chances of outperformance. The debt allowance mechanism should, therefore, have regard both to whether licensees have different chances of meeting the allowance (average), but also different likelihoods of exceeding or underperforming the allowance (outturn standard deviation). In assessing efficiency, hindsight should not be employed.

(158) In the first instance, therefore, we consider that to discharge the financing duty Ofgem must take account of actual company individual circumstances. This would mean that the cost of debt allowance is set for each individual licensee based on its efficiently incurred cost of embedded debt. To the extent it is considered that a notional average approach is an acceptable starting point it must be acknowledged that one size will not fit all and that some companies will be affected disproportionately. This does not necessarily indicate inefficiency or poor management choices on the part of that company. Where there is a difference between that average and the company's actual cost of debt, then that company's specific circumstances must be given due consideration (which can and should include consideration of the appropriateness of the debt portfolio) and suitable steps taken to ensure that that individual company can finance its functions. This could include upward adjustments from the average to allow companies to recover their actual efficient cost of embedded debt, as well as downward adjustments to prevent inappropriate over-funding.

(159) Conversely, if it takes an approach which rewards licensees that are large or lucky enough to have lower than average debt costs by allowing them to recover amounts in excess of

their efficient cost of debt, Ofgem is failing in its primary objective to protect the interests of consumers in those licence areas.

9 REMEDIES

(160) Any remedy that the CMA concludes is appropriate for WWU in light of its specific circumstances should, we respectfully contend, be based upon the following principles:

(a) offer certainty that, within a reasonably practical margin, efficiently incurred debt costs will be paid by consumers;

(b) be based upon a definition of efficiency that is capable of being achieved by the licensee in that it is judged based upon the circumstances that were extant at the time of issuance;

(c) ensure that consumers' interests are protected by incentivising companies to raise new finance efficiently (within an overall sensible framework of tenor and risk);

(d) recognise that actual opportunities for licensees to outperform the global debt market are limited. Whilst licensees may be better placed to manage some elements of financing risk than consumers or Ofgem, the underlying risks are ones which, by their nature and the circumstances in which they arise, offer limited scope for any management or mitigation regardless of whom seeks to exercise it;

(e) recognise that the benefit for incentivising debt issued well in the past has no further real value to consumers;

(f) take into account fairly the circumstances of individual licensees where their costs will tend to be different from others, including for example an infrequent issuers' premium, as well as recognising where there has been or will be a past or future debt issuance programme concentrated within a future time period to fund significant investment (e.g. SHETL for TI) or refinancings falling due;

(g) include the economic impact of all derivatives;

(h) include ancillary costs not included in the index, such as issuance costs and cost of carry;

(i) make an appropriate adjustment to reflect the notional gearing level, rather than the actual gearing level; and

(j) finally confirm that the actual licensee's debt costs are financeable, save as to demonstrable inefficiency, to ensure that equity receives the allowed return.

(161) Acknowledging that we are not privy to WWU's specific circumstances, we do not consider it is appropriate to propose any particular solution. In the interest of trying to assist the CMA, however, we have given some thought to the options, consistent with the principles above, that the CMA might consider.

(162) One possible way, amongst many, that this might be achieved, would be to weight the application of an index calibrated to the sector average costs (including derivatives) to individual licensees to the points in time (days) when licensees issued debt (again adjusting for the impact of derivatives to ensure that the date that debt is economically entered into is used). For instance, if a licensee issued a significant amount of debt on a day, appropriate weighting would be given to the value of the index for the actual date of issuance in the calculation of its debt allowance. Similarly, no weighting would be given to the index at times when no debt issuances were made.

(163) This approach would benefit licensees as they would know that, provided that their bond costs met or were better than the index on the issuance date, they would be reimbursed for their efficient debt costs, regardless of what interest rates do in the future. This would reduce the unmanageable risk to equity, giving equity more confidence to invest in years in which interest rates appear higher than they have been in the past, without the risk that rates fall significantly in future years, and they are then judged inefficient in hindsight.

(164) This proposed approach would benefit the financeability of those operators, such as WWU, who have been unlucky to have had to issue debt at times when interest rates were, in hindsight, high in comparison to subsequent years.

(165) Similarly this approach would benefit consumers in those areas where licensees have been lucky enough to have issued significant amounts of debt at low interest rates in the past. Overall costs to GB consumers would not alter materially, rather the allocation of those costs would be based upon actual licensee efficient debt costs.

(166) As the debt allowance would still be based on an index, this approach would maintain the incentive for licensees to be as efficient as possible. A sharing factor, along the lines of the totex sharing factor, would both reduce the risk to equity and provide a benefit to consumers for over-funding.

(167) In respect of older debt, over two price controls old for example, recognising that there is no further value to consumers for retaining an incentivisation regime, a pragmatic approach could be adopted on a pass-through basis, subject to a reasonableness review. This would mirror the approach taken by Ofgem when managing the licensee liabilities arising from pension deficits – the pre 2010 liabilities are allowed as a pass-through cost, subject to a reasonableness review. This recognises that it is a lower cost for consumers to meet these liabilities directly rather than increase the risks, and therefore cost, to equity to manage them.

(168) In taking such steps the CMA could ensure that the overall settlement does not result in equity subsidising or illegitimately gaining from the under- or over-funding of debt allowances.

(169) It is in the long-term interests of consumers that equity investment is attracted to the energy sector, confident that when debt is issued the cost will be allowed by Ofgem, provided that, of course, the costs are minimised as much as possible. It is not in the long-term interests of consumers to see licensees encounter financial difficulties solely because of the timing of their debt issuance.

PART C: STATEMENT OF TRUTH

Electricity North West Limited believes that the facts stated in this application for permission to intervene are true.

Signature of Authorised Representative: [✂]

Name of Authorised Representatives: David Brocksom

Date: 23 April 2021

For and on behalf of Electricity North West Limited