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By email only

Competition and Markets Authority
The Cabot
25 Cabot Square
London
E14 4QZ

23 April 2021

Non-sensitive version

Dear Competition and Markets Authority,

Application for Permission to Intervene in Energy Licence Modification Appeal

A. Details of the appeals in which the applicant seeks to intervene

This is an application for the Competition and Markets Authority (“CMA”) to give permission for the applicant to intervene in the appeals against the decisions by the Gas and Electricity Markets Authority (“Ofgem”) dated 3 February 2021 on the proposed modifications to certain electricity and gas transmission, and gas distribution, licences brought by:

- Cadent Gas Limited;
- National Grid Electricity Transmission plc and National Grid Gas plc (which appeals the CMA has decided will be considered together);
- Northern Gas Networks Limited;
- Scottish Hydro Electric Transmission plc;
- Southern Gas Networks plc and Scotland Gas Networks plc (joint appeal);
- SP Transmission plc; and
- Wales & West Utilities Limited

This application is made under Rule 10 of the Energy Licence Modification Appeals: Competition and Markets Authority Rules (“the Rules”). The contents of this application are not sensitive and it can be published on the CMA’s website.

B. The applicant's name and address

The applicant is the Water Services Regulation Authority ("Ofwat"). Documents relating to the application or the appeals may be sent to Ofwat at:

Address: Centre City Tower, 7 Hill Street, Birmingham B5 4UA

Email: PR24@ofwat.gov.uk

C. Statement as to the matters in Rule 10.3 of the Rules

Ofwat is the economic regulator of the water industry in England and Wales. Similar to Ofgem's role in the regulation of the energy sector, every five years Ofwat determines price controls for regional network operators. The CMA's consideration and decisions in its assessment of these current appeals will not be determinative for our future regulatory decisions. However, the CMA group's views on the methodology and appropriate level to set the cost of capital are clearly relevant to future considerations of the cost of capital in the water sector. We and other regulators across different regulated sectors carefully consider past CMA decisions when reaching our view on matters of cross-sectoral relevance such as the allowed return on capital. The submissions made by the appellants in the current appeals raise important points of principle that may influence how water companies and their investors expect us to approach regulatory determinations in the future.

The intervention we are seeking is limited to the grounds of appeal in relation to certain aspects of the cost of debt and the cost of equity, to the written submissions set out in this application and to such further written or oral submissions on those grounds of appeal as we may consider it appropriate to make during the appeals process, if permitted or invited to do so by the CMA.

We consider that our intervention in the appeals will assist the CMA by providing a broader regulated utility context in relation to arguments on the cost of debt and the cost of equity. As the water industry regulator, Ofwat has given these issues recent, detailed consideration, both during the course of our 2019 price review (PR19) and in the subsequent references involving four water companies to the CMA, which submitted its final report in March 2021 (cost of debt and cost of equity having been a substantial aspect of those references).

D. Statement of whether the applicant supports or opposes the appeal and the facts and reasons on which they rely

The applicant opposes the appeals with respect to the grounds of appeal identified above and relies on the facts and reasons set out in section E below.

E. Matters to which the CMA should have regard in determining the appeals

In this section we set out matters to which we consider the CMA should have particular regard in determining the appeals. We have not responded to all of the relevant points raised by the appellants, as it would not be practical or proportionate for us to do so, and it should not be assumed that we agree with points just because we have not commented on them.

Ground of appeal: Head A: Cost of debt raised by Wales & West Utilities Limited

Regulatory approach – the notional capital structure and the cost of debt

Wales & West Utilities Limited (“Wales & West”) raises three principal challenges with respect to the cost of debt in its ground of appeal. Firstly, it challenges the notional approach and the way in which Ofgem interprets its financing functions duty. Secondly, it argues that Ofgem’s specific approach to indexation, in the gas distribution sector, is fundamentally flawed. Thirdly, it argues that Ofgem should take account of its derivatives position. The company proposes a remedy where it requests the CMA take full account of the company’s derivative portfolio but at benchmark rates at the dates of issuance or (if lower) at actual rates. We comment on each of these issues in turn below.

Wales & West argues that Ofgem has misinterpreted its statutory duties by ensuring that its determinations are financeable for a notional licence holder. This challenge is to the regulatory approach adopted in regulatory determinations since privatisation.

In each of our price reviews since the privatisation of regional water authorities in 1989, we have adopted a consistent methodology of setting our determinations on the basis of a notional capital structure and a sector wide approach to the cost of capital. Our determinations have been underpinned by a consistent interpretation and application of our statutory duties under the Water Industry Act 1991 (“WIA91”). Importantly, we interpret our financing functions duty in section 2(3)(c) of the WIA91 as a duty to secure that an *efficient* company with the notional capital structure can finance its functions, in particular by securing reasonable returns on its capital.

We consider that setting a determination by reference to a notional capital structure and notional financing costs is wholly consistent with the application of regulatory duties and the application of an incentive based regulatory regime. The notional approach incentivises companies to secure efficient costs of finance and protects customers from the risks of companies’ financing decisions.

Consistent with Ofgem, we view an efficiently financed company as one that has a balanced portfolio of borrowing which diversifies risk effectively such that it ensures it

has sufficient flexibility to respond to changing market conditions. The notional approach maintains the principle that companies and their investors are best placed to bear the risks associated with those choices and the responsibility to maintain the financial resilience of the actual structure.

We are not best placed to comment on Wales & West's challenges to the application of an indexation approach to remunerating the notional cost of debt. We note that the application of indexation approaches is not unusual in regulated sectors, including in water, and is consistent with the application of a notional approach to setting the allowed return. Ofgem's approach, which adopts a trailing average of a benchmark index calibrated to benchmark data for the companies it regulates, provides protection to companies by allowing companies to meet efficient embedded debt costs.

We acknowledge that the use of derivatives can form part of a prudent treasury function. However, we do not consider it necessary to take account of post-swap financing costs when assessing the cost of debt using sector benchmarks. This is because swaps are essentially NPV neutral at the time of inception and so it is the underlying cost of direct debt issuance that is most informative for the purposes of setting the cost of debt. Furthermore, there is evidence in the water sector of companies making use of derivatives to manage cashflow risks between regulatory periods and to manage cash flow effects associated with financial structures that carry greater risk than the notional structure in order to manage company-specific risks.

There is limited narrative on the precise details of Wales & West's proposed remedy. However, we understand the remedy proposed amends the regulatory approach to remunerate the cost of embedded debt (including derivatives) based on the lower of (i) the instrument cost where it is less than the proposed iBoxx benchmark and (ii) the iBoxx benchmark at the time of issuance, calculated at the date of issuance of each debt instrument. We observe such an approach would significantly reduce or remove the incentive on a company to efficiently manage the timing and tenor of debt instruments, potentially providing companies with protections for risky debt issuance strategies where the risks should rest with equity investors.

Maintaining the principle of a notional approach to setting a single, sector wide, cost of debt would be consistent with the principles set out by the CMA in its recent report on water price control references under section 12 of the WIA91, which stated:

“An individual allowance based on the costs incurred by each company [...] would reduce incentives to ensure that companies drive best practice, ensure efficiency and do not take inappropriate risks in their treasury management practices.”¹

¹“[Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report](#)” (CMA, 17 March 2021), paragraph 9.633.

Ground of appeal: Common cost of equity ground raised by all appellants

The allowed return on equity

All appellants have raised a ground of appeal in relation to the cost of equity. It is not practical for us to carry out a detailed assessment of the evidence presented by all of the appellants, though we observe that the issues raised are similar to those raised by the four disputing companies in the recent water references.

We submit the following:

- Risk free rate – Placing weight on AAA-rated corporate bonds (as requested by some of the energy appellants) is inconsistent with the practical application of the CAPM. Placing weight on AAA-rated bonds challenges the concept that the allowed return should be set by reference to the CAPM and introduces significant distortions (e.g. driven by a limited number of observations, limited liquidity and default risk) that outweigh the imperfections in index linked gilts as a proxy for the risk free rate.
- Allowed return on equity – the cost of equity proposed by the appellants is significantly higher than the allowed return set in our PR19 final determinations. In part this is because of their views on total market return which produce ranges (7.0% to 7.5% in CPIH terms). These ranges are at the upper end of the range assessed by the CMA in its decision on the water references (6.15% to 7.46%) and well above the point estimate we considered reasonable at PR19 (6.5%). We consider judgements on the total market return should be informed by evidence and expectations that are relevant for the period of the determination, including for example, forward looking approaches, particularly as market returns for the period of the control are expected to be lower than historical evidence. Furthermore, we consider cross-checks should be used to inform the judgement on the overall cost of equity, including taking account of evidence from transactions and the traded value of regulated companies (after adjusting for expected cost, service and financing performance). Setting an allowed return significantly above the level that the market indicates as reasonable for the period of the price control would be inconsistent with a regulator's application of its duty to protect the interests of consumers.

Should the CMA group seek to draw comparisons with the water sector, it is important the CMA recognises the allowed return set for water (both by Ofwat and the CMA in its recent water references decision) includes a return for both retail and wholesale activities. It is the allowed return on water wholesale activities that is the appropriate point of comparison to energy. In the CMA's water references decision, the wholesale allowed return was 3.12%² The cost of equity input to the CMA's financial model for the

² After adjusting the Appointee allowed return of 3.20% for the retail margin. See "[Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report](#)" (CMA, 17 March 2021), table 9-37.

wholesale controls was 6.62% (nominal), 4.53% (CPIH real) and includes the effect of a 25 basis point aiming up to the cost of equity.

F. Other matters

If the CMA decides not to give Ofwat permission to intervene under Rule 10 of the Rules then we request that the CMA considers inviting representations from Ofwat under Rule 14.4(e) on matters relating to the grounds of appeal set out in this submission.

Statement of truth

The Water Services Regulation Authority believes that the facts stated in this application for permission to intervene are true.

**Signed for and on behalf of the
Water Services Regulation Authority**

[✂]

**Aileen Armstrong
Senior Director**