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Bringing energy to your door

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Dear Ofwat

Response to 'Financial resilience in the water sector: a discussion paper'

Electricity North West is the electricity distribution network operator (DNO) covering the north west of England serving 5 million customers in 2.4 million premises, across a diverse range of locations, from urban Greater Manchester to rural parts of Cumbria, Lancashire and Cheshire. We, like water companies, operate in a regulated sector where the function and form of regulation are essential to ensuring that customers receive the outcomes and levels of service which they require.

Central to this objective, and the framework in regulated sectors by which it is achieved, are financial parameters and considerations including how these are assessed by economic regulators such as Ofwat and Ofgem. We welcome open discussions on how these are set, assessed and governed to ensure resilience for companies and customers, including ensuring that companies can execute their vitals duties in providing essential services and infrastructure to the communities we serve.

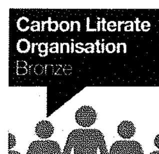
We recognise that Ofwat's paper is focused on financial resilience in the water sector. Given, however, that the points identified for discussion do, at a framework level, have some read-across to other regulated sectors we consider it can be helpful to reflect on that. To that end, we provide our views on the areas and topics included in the published discussion paper drawing upon our experience from operating in the regulated electricity distribution sector, as well as some of the challenges we face such as 'leading the north west to Net Zero'.

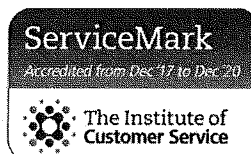
Overview

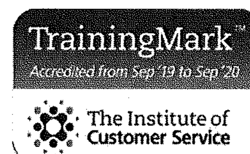
Fundamentally, we agree with the broad sentiment of the consultation – that the financial resilience of regulated utilities is very important.

It is clearly in the interests of customers that regulated utilities do not get into financial difficulties or are placed in any position where they need to be managed from a cash or funding perspective, rather than a customer service perspective.

It is equally important that the long-term interests of customers are protected by ensuring companies can retain access to the lower cost, patient capital that supports long-term investment. For this to be







achieved, it is critical that investors are confident that their interests will continue to be looked after across multiple price controls.

For these reasons, we consider that it is appropriate to consider additional protections for customers and stakeholders, including both debt and equity investors. We do not have sufficient information about the financial situation of the regulated water companies to offer any view as to whether any such additional protections are, in fact, required in that sector. Instead, we have focused on the principles raised by the discussion paper.

In particular, we do not believe that the role of the regulator in securing financial resilience is considered in sufficient depth in this consultation. This is despite the CMA stating in its PR19 decision that the allowed return on capital, which is a factor within the control of the regulator, was the primary factor in ensuring that an efficient firm can finance its functions.[1]

The discussion paper is instead focused on the discretion currently awarded to companies over their financing and capital structures and its policy of focusing on notional company financeability. As a consequence, any concerns around weakness or deterioration in financial resilience are attributed almost solely to the decisions of management and shareholders, and this is then reflected in the suggested remedies and/or mitigation measures.

In practice, the decisions of a regulator in setting and managing price controls play a very significant part in financial resilience. The premise of the financing duty, which appears in similar formulations in energy and water legislation, is, in effect, to impose a duty on the regulator to have a proper level of regard to the interests of consumers by ensuring that licensees are able to remain sufficiently attractive to investors and can therefore fund their obligations.

We do not consider that it is consistent with best regulatory practice to dismiss financeability challenges as a shareholder problem without undertaking a comprehensive analysis of the root causes from all perspectives. This must include considering the appropriateness of the regulatory framework, methodology and permitted allowances in greater detail, taking into account the individual characteristics of the regulated companies.

Should Ofwat conclude that it would be appropriate to introduce any additional oversight or limitation on financial policy, the amount of discretion afforded to the licensees in regard to financing will be explicitly reduced. Any such outcome must go hand in hand with the regulator taking even greater responsibility for its role in delivering financial resilience for all companies.

We also note that by focusing only on the theoretical notional company, without reference to the actual circumstances or actual companies, regulators can enhance the **apparent** financial resilience of the sector by simply reducing gearing in the notional model, thereby reducing its financing costs. If weighted average cost of capital (WACC) is held constant, then this will mathematically deliver improved financial metrics and improved implied credit ratings for the notional company.

While the use of a notional company approach is legitimate, but only to the extent that the circumstances and obligations of the actual licensees reflect that assumed by the notional company.

The supporting paper by Mason and Wright serves to highlight that competing financial theorems require simplifying assumptions to "work" and often ignore the contradictory evidence that does not support the theorems' "fit" to real world market data. Given these difficulties and simplifications, regulators should be very cautious in accepting the recommendations put forward by Mason and Wright, for example the recommendation that the WACC can be considered invariant to capital structure[2], unless these can be clearly supported by empirical evidence at a high degree of confidence.

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[1] CMA Water Redeterminations 2021, para. 10.72.

[2] WACC is invariant only under Modigliani-Miller assumptions. Pricing of embedded debt costs is an example of regulatory policy which results in divergence from the Modigliani-Miller world. Any Interventions to 'force'

We consider that observed gearing levels provide a more objective indicator of optimal gearing levels for the sector, on which greater weight should be placed.

Should regulators seek to impose any additional limitations or influence on capital structure, then this would interfere with market forces. In the context of seeking to improve the financial resilience of the sector and the associated value benefit to customer stakeholders, that, in itself, should not be a barrier, but it is also not appropriate for any regulator to simply force networks to reduce gearing without taking into account the time required to achieve this (given currently extant debt) and/or little recompense to the cost.

The wider economic value gained through enhanced financial resilience must be considered against the cost of transition and, if applicable, long-term sub-optimal capital structures.

We set out below our views on the key considerations needed when considering additional protections.

Establishing a target level and an acceptable level for financial resilience

We agree that it is important for all regulated utilities to have adequate levels of financial resilience to meet customers' needs at all times and under all circumstances. This should also enable companies to raise capital, to finance the investment that is necessary to deliver their obligations and commitments to customers now and into the long term. We further support transparency and disclosure with respect to financing structures.

We believe that company credit ratings should be the primary metric to assess financial resilience. While gearing is an important consideration in the rating assessment, it is one of several factors and should not be the sole focus for regulators when considering how financial resilience can be improved.

With respect to the economic cost of failure, we agree it is critical to consider the gap between social and private costs arising directly from failure, but also the indirect social costs relating to the *risk* of failure. Most importantly, this includes delays to key consumer and environmental improvements such as Net Zero that require significant levels of investment, and also the contagion risk associated with failure of regulated entity (it is incorrect to believe that if a regulator allows any entity to fail it will have no impact on the credit ratings or the costs of funding for the wider sector and associated regulated sectors within the UK).

It is also too simplistic to assume that there is a single threshold at which financial resilience is 'met' or indeed that materially improving the financial resilience of the sector by reducing gearing can be delivered at no cost.

There is ultimately a trade-off that needs to be evaluated between the risk of failure and, as determined, the cost of improving financial resilience.

As set out in our ED2 business plan submission[3], we have proposed that BBB+/Baa1 was an acceptable *minimum* rating for the baseline (i.e. 'minimum target'), with BBB-1/Baa3 an acceptable *minimum* for the plausible stress scenario (i.e. 'minimum acceptable').

We note that feedback received from the Ofgem Challenge Group on our Business Plan submission suggested that our baseline target of BBB+/Baa1 was at the upper end of an acceptable target range. This feedback is contrary to the direction of this consultation and we believe that BBB+/Baa1 is the bottom of the acceptable range.

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constant WACC where Modigliani-Miller assumptions do not hold will create distortions – for example, adopting raw equity betas violates the core Modigliani-Miller concept that equity returns increase with leverage.

[3] https://www.enwl.co.uk/about-us/regulatory-information/our-business-plan-2023-2028/

Role of the regulator in delivering the target financial resilience

As acknowledged by the CMA in its PR19 decision, the allowed return on capital is the primary factor in ensuring that an efficient firm can finance its functions [4].

As such, it is the duty of the regulator to set a WACC at an appropriate level that makes it possible for the target level of financial resilience to be achieved. Any calibration of WACC must also consider adjustments to the notional company model and/or allowance methodologies so that all efficient, notionally geared licensees can also achieve target financial resilience.

Financeability and fair returns are fundamental to monopoly regulation and ensuring that regulated businesses can attract the finance needed. This includes both debt and equity financing and there is a need for them both to be equally attractive in the future. There should be no perception of favour over either type of financing in the regulatory framework and both should be assessed independently and fairly with one not subsidising the other. This is of increasing importance given the challenges and large-scale levels of investment needed to deliver the outcomes our customers and stakeholders want from our respective sectors (for example Net Zero transition and management of water scarcity issues).

The progressive and material cuts to equity returns faced by utility companies over successive price controls has undoubtedly had an impact on the financial resilience of the sector. Interest cover can be crudely approximated to a WACC allowance divided by interest costs[5]. Irrespective of the justification for reducing equity returns, it is indisputable that these reductions would have an impact on credit metrics and perceived financial resilience.

It is sensible for the regulator to first consider the implied rating of the notional company model, however, in doing so, it must include sufficient headroom when calibrating financial metrics and returns. Any calibration must consider both the baseline position and that under a plausible stress scenario. It is not appropriate for the notional company to 'scrape' a desired credit rating, as through simple averages this would be likely to be insufficient for half of the sector companies to hit target ratings.

The regulator must also consider factors beyond the notional company, including the individual characteristics of businesses should these be sufficiently different from the sector average position.

While it is tempting for regulators to make changes to the notional gearing level in order to improve financial resilience – this should only be considered in two instances. Firstly, when there is strong evidence that the notional gearing level is sub-optimal and disjointed from that observed in the market for unrestricted, comparable companies. In the second instance, as a conscious decision by the regulator to move the sector away from the optimal gearing level, in order to reduce the risk of failure, at a cost that is acceptable to customers.

The aim of economic regulation should be to mimic competitive market conditions through proportionate regulatory intervention. Going beyond this aim would place increased burden on regulated businesses. We therefore do not support increased regulatory intervention where this is not supported by strong evidence and by an assessment of the costs and benefits through a detailed impact assessment. Setting a process for further engagement and the proposal of a resilience plan at lower levels could be reasonable whilst also providing sufficient customer protection where the regulator is able to challenge the company on its plans to avoid falling into the lowest investment grade.

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[4] CMA Water Redeterminations 2021, para. 10.72.

[5] Assuming no incentive reward or penalty

We also believe the regulator has a responsibility to understand the financing structures of networks and to use this information fairly when setting allowances and methodologies. This should be aided by transparent reporting of financial instruments and an open dialogue with companies.

For example, if a company has gearing at around the notional company level but still faces financeability challenges, the regulator cannot simply dismiss the issue as a shareholder problem and must consider the appropriateness of its methodology and the resulting allowances in greater detail.

The consultation makes reference to *"short term financing decisions can have long term impacts, ... and so it follows that companies and investors, rather than customers, should bear the risks and long-term consequences of risky financing choices."*. This statement is equally true for regulatory decisions and settlement. It is important that regulators in making choices around key financial parameters have due regard to the impact of these for companies in the short and long term as well as assessing companies' ability to manage the additional risks being introduced through regulatory decisions.

We also note that the discussion paper characterises derivatives primarily as financial instruments that shift the timing of cashflows to the sole benefit of shareholders. We believe this is an incorrect representation that does not fairly reflect the full range of reasons for the use of derivatives. A primary use of derivatives by regulated companies is to manage risk inherent in the regulatory framework, such as to convert nominal public debt into inflation-linked debt so that interest payments are more closely aligned with the real debt allowance. This reduction in financial risk in regulated companies is of benefit to customers and other stakeholders.

The large mark-to-market liabilities on such swaps are more likely representative of the unprecedented collapse in interest rates since the financial crisis, as opposed to additional financing and/or indicators of companies engaging in financial practices that may not be in the interest of customers. This apparent misapprehension is a clear indicator as to why it is so important for regulators to have a comprehensive understanding of the positions of the businesses that they regulate and do not apply a one-size-fits all approach to its assumptions and/or methodology where it is not appropriate to do so.

Role of the regulated businesses in delivering financial resilience

We agree that regulated businesses have a responsibility to maintain an expected level of financial resilience and credit rating. Combined with a proportionate and steady state regulatory framework, this will ensure business can attracting the inward investment needed.

As set out earlier, we believe that BBB+/Baa1 is an acceptable <u>*minimum*</u> rating for the baseline, with BBB-1/Baa3 an acceptable <u>*minimum*</u> for the plausible stress scenario.

In this instance, if a business was going through a period of stress, such as operational underperformance, then it would be anticipated that ratings would be lower than the BBB+ target. In itself this should not be viewed as problematic, providing it is in the bounds of the defined acceptable range.

If regulators and companies both agreed that the risk of failure was too high for a stressed company at BBB-, then both the baseline target <u>*and the*</u> acceptable target should be increased. Importantly, assuming a two-notch differential from baseline to stressed rating, this would involve the regulator increasing the implied credit rating of the notional company to be commensurate with <u>*a comfortable A- rating*</u>.

With regards to the role of regulated business in delivering financial resilience, we believe that there needs to be distinction between direct actions taken by businesses that increase the risk of financial failure and the consequences of external circumstances, including regulatory policy.

As an example, we would consider actively increasing gearing above the notional level to pay dividends would be a direct action that increases financial risk and we would consider it fair that protections are put in place to protect customers in that scenario.

Alternatively, a company that actively sought to minimise financial risk for the benefit of its customers, for example by taking out long-term debt, and now finds itself significantly under-funded on a sector-average debt allowance (and thereby showing signs of stressed financial resilience), particularly where this is the result of unforeseeable market interest rate changes, should not be faced with additional restrictions.

We believe this is a fair and legitimate principle that should govern policy in this area. Without such a safeguard, there is a risk that any further limitations or restrictions imposed on the capital structure could be viewed as hindsight regulation, undermining investor confidence and likely increasing costs for customers over the long-term

We would also support increased transparency in reporting of financial positions and policy. However, as noted earlier, this must go hand in hand with the regulator taking even greater responsibility for its role in delivering financial resilience for all companies and it must not simply dismiss financeability challenges as a shareholder problem. Examples of additional transparency measures could include sharing treasury policy with regulators or, in certain appropriate circumstances such as company specific allowances for embedded debt, by extending to periodic 'Reasonableness Reviews' with regulators on financing structures and decisions (similar to those undertaken in the RIIO framework for Pensions). We believe this enhanced transparency and openness would allow the regulator to identify any actions that were not in the long-term interests of customers and stakeholders.

We trust this will be helpful, should you have any questions or would like to discuss our response in greater detail, please do not hesitate to contac[redacted] Head of Corporate Finance and Investor Relations [redacted] r myself.

Yours sincerely,

[redacted]

[redacted]

Head of Economic Regulation