



Paul Jackson
Inquiry Manager
Competition Commission
Victoria House
Southampton Row
London WC1B 4AD

Sent via Email: nie@cc.gsi.gov.uk

Northern Ireland Electricity Price Control Review (RP5) (2012-2017)
- Hastings Funds Management Submission in Response to Provisional Determination

Dear Mr Jackson,

Introduction and executive summary

This submission is in response to the Competition Commission's (CC) Provisional Determination in relation to Northern Ireland Electricity's (NIE) RP5 price review. We welcome this opportunity to provide our views as a financial investor in the regulated utility sector.

Established in 1994, Hastings is a specialist infrastructure fund manager with a focus on long-term investing. It manages investments on behalf of a range of open-ended pooled investment funds and direct client relationships. Specifically Hastings recently acquired Phoenix Natural Gas (PNG), the largest natural gas distributor in Northern Ireland. Hastings also manages a significant interest in South East Water, which provides regulated water-only supplies to over 2.1 million customers in southern England.

The UK's regulatory regime for energy transmission & distribution assets, including the CC review process, is very relevant to Hastings and its many pension / superannuation, retail and institutional investors not only because of these existing utility ownership positions but also because of our desire to continue to invest in these and other UK regulated assets should the risk return and regulatory environment be supportive of future investment.

While we recognize differences between regulated utilities, such as PNG and NIE, we still wish to participate constructively in this regulatory process.

We believe that our perspective as an active and recent investor in the sector is relevant, as it is a perspective that is likely to be consistent with the thinking of many global investment firms, and one which should indicate to the CC how investors make investment decisions and decide whether to allocate capital. Hastings invests in debt and equity, and as such we often have to assess the relative merits of debt versus equity in various capital structures. Our perspective will also hopefully demonstrate how many investors like Hastings seek to balance the important combination of equitable and sustainable service and cost outcomes for consumers with our responsibilities to make efficient and fiscally verifiable investments.

In this regard, we advise that we have several concerns with the CC's Provisional Determination and the regulatory uncertainty that it may introduce. These uncertainty concerns, combined with the sharp trend towards lower rates of return, poses the risk of not adequately compensating equity or debt providers and therefore disincentivising necessary investment in regulated infrastructure across multiple sectors. These sector wide negative implications are in addition to any NIE specific issues that may occur due to the apparent lack of appropriate risk compensation being offered to NIE.

The low vanilla WACC of 4.1% that has been provisionally determined for NIE is concerning, as to date this WACC is the lowest allowed by any UK regulator and does not capture the relative apparent risk profile of

NIE. While we recognise the CC's discretion to vary determinations either positively or negatively relative to individual sector regulators, the scale of the negative difference in this instance is concerning.

Even Ofgem in their recent "Assessment of the RIIO-ED1 business plans" report pointed out that "The CC's point estimate for NIE's cost of equity is based on a prospective equity market return of 6.0 per cent, significantly lower than regulators have conventionally used."

In our opinion as an equity investor this determination if finalized would appear to introduce a new level of uncertainty into UK regulatory practice.

This submission provides some detailed comments from Hastings. Hastings would also like to express its full support of the points raised in the submission by Phoenix Natural Gas, dated 29 November 2013.

Detailed submission

There are currently six key aspects to the Provisional Determination which we would like to address.

1. Importance of regulatory certainty and consistency of regulatory approach

Regulated businesses are currently sought after by many infrastructure investors who seek investments with high return correlations with inflation and relatively low risk profiles. This move to more defensive assets has been a particular investment trend following the global financial crisis (GFC) and its impact on more GDP sensitive assets. Although this recent trend has provided debt and equity liquidity for regulated businesses, it is unlikely to be permanent given the cyclical nature of investor risk preferences. As global economies recover and growth expectations improve there is likely to be a shift in preferences back toward riskier assets at the potential expense of regulated businesses. This is already evident in many global listed equity and property markets.

Historically regulated assets, particularly in mature regulated markets such as the UK, Australia and much of Western Europe have been able to provide a high level of regulatory stability and therefore predictability of equity returns with a clear risk allocation among the regulated businesses, their customers and other market stakeholders.

While the UK has had a good track record there are many countries where sovereign risk, as well as specific regulatory or geographic risks, have greatly increased the level of equity returns and debt margins required to attract growth capital and liquidity for regulated businesses. The UK should ensure that, through its regulatory processes and determinations, it maintains its strong global reputation which has resulted in relatively low costs both of capital and of pricing for customers. Returns from UK regulated businesses have tended to reflect the relative stability of the UK regulatory system, where low returns have not been disproportionately misaligned with risk levels. This equilibrium should not be jeopardized.

Moving away from a consistent and predictable practice of relying on historical and objective data when determining market returns and other regulatory WACC parameters and instead placing too much reliance on near term forward looking estimates appears to be introducing a significant element of volatility, subjectivity and uncertainty into the process. This uncertainty over time could lead to less competitively priced equity and debt to the detriment of customers and regulated businesses.

2. Global competition for attracting investment and foreign capital

Notwithstanding that responsible regulated business owners will always continue to invest to support maintenance and essential reliability requirements, it can become difficult in a capital constrained environment, particularly if the regulated business is not providing a return on capital commensurate with the risk profile of the business or comparable global opportunities on a risk adjusted basis.

Most sophisticated institutional investors have wide investment mandates and consider a range of competing investments from international regulated opportunities, listed equities, other infrastructure sectors (transport, energy, social PPPs, etc) and even other asset classes (government debt, corporate bonds, high yield debt, private equity, hedge funds, etc). They generally have professional and moral obligations to find the best risk return opportunities for their investors, shareholders or pension recipients. As such regulators and regulated businesses need to be able to provide a competitive

investment return on a global comparative basis, taking into account the risk profile and level of return stability that the regulated investment is able to provide.

With mobile capital, regulated infrastructure assets need to provide an adequate equity risk premium commensurate with the risk profile and sufficiently in excess of debt returns in order to encourage investors to allocate equity capital and support capital expenditure programs (particularly if they cannot be funded organically from operational cash flow).

3. Our view on risk free rates and equity risk premium

Given the importance of providing an adequate equity risk premium we believe that the CC and regulators in general should seek to adopt approaches consistent with investor decision making criteria and industry practice when setting individual WACC parameters.

Hastings takes what we believe is a relatively widely shared view that infrastructure assets are long-term investments. We therefore believe that a long-term view is appropriate when estimating key parameters such as the risk free rate and market risk premium, with these views influenced more by 10, 20 or even 30 year historical trends than current market spot rates.

During the valuation of our existing portfolio assets over the last 18 years, including participation in new investment auctions, we have not seen a systematic shift towards investors estimating risk free rates or market equity risk premia based on spot market observations. Likewise, in our experience, most professional independent valuation firms, accounting practices and auditors continue to draw strongly not on spot government bond pricing or market volatility measures but rather on long-term average rates. We believe that mean reversion and a view that infrastructure investments are long-term investments result in long-term rates and long-term measures of risk remaining as the benchmarks for decision making by investors and industry practitioners.

The CC's latest parameter setting approach appears prone to short term market distortions. Hastings believes the approach places too much emphasis on recently realised returns and market volatility measures rather than focusing on the longer term data and actual investor expectations in regard to required returns necessary to promote the desired level of investment. As mentioned in our introduction, the proposed equity market return of 6.0 per cent is significantly lower than expected.

The compression of short term market returns due to excess market liquidity does in no way mean that investors will be willing to invest in long-term regulated businesses with illiquid capital at the same low short term realised returns. Investors will continue to require regulated assets to deliver long-term returns consistent with their long-term benchmarks for assets with comparable long-term risk profiles. It is for these reasons that long-run data series should be used to estimate the required market return and Beta estimates for regulated businesses.

4. Our view on NI risk premium / company specific risk premium

Aside from these market-wide views on the use of long-term data to set critical market-wide WACC parameters, we also believe that local and firm specific factors are relevant to the regulatory pricing process. This is particularly the case given the potential for large differences in the relative sizes of regulated businesses, their risk profiles and their geographic locations or network densities.

As one of the most recent large investors into Northern Ireland (NI), Hastings views and has observed country risk and specific business risks as relevant in the pricing of equity and debt. We understand previous regulatory submissions have evidenced that a real world risk premium exists for NI debt and from our experience this was a relevant factor when raising debt capital to support the acquisition of PNG.

Likewise when we priced our equity investment we needed to consider NI country risk, regional economic situation, social and demographic trends, growth projections and regulatory practices. While there are many attractions of investing in NI, there was still the perception that as an investment destination it was riskier relative to GB and an expectation that an NI equity premium would be available to compensate appropriately for this increased relative equity risk (much as the debt market requires and receives a NI debt premium). The recent confusing and somewhat logic defying arguments that attempt to ignore an NI equity premium appear to be a worrying sign of increased regulatory risk and inconsistency relative to regulatory precedent and investment requirements.

We do not see it as credible to assume that there is not an NI equity premium when a NI debt premium exists. Likewise there is no evidence that there is any form of transfer of risk between equity and debt as postulated by the CC. In Hastings' experience the debt terms for NI businesses, and NI license and ring fencing requirements, are not materially different from GB comparators and certainly not to the extent which would be necessary to significantly transfer risk or nullify need for a NI equity premium where a debt one exists.

Hastings would therefore support a reconsideration by the Commission of its WACC determination.

5. Financeability – stand alone ability to raise debt and equity

Financeability is important not only due to its role in preventing system shocks, company distress and potentially even service disruptions, but also because of its part in promoting investor confidence in the liquidity of regulated businesses, which in turn supports investors' decisions to invest capital.

Regulated companies should, on a stand-alone basis, be able to raise finance on reasonable terms in order to support necessary investment programmes. These investment programmes are funded on an ongoing basis by both debt and equity. Consequently, financeability should involve consideration of both debt and equity, not just debt. Equity subsidising debt is not sustainable and amounts to a deterioration in financeability which ultimately could leave regulated utilities lacking necessary capital.

Regulatory regimes should promote financeability to ensure the sector is robust and able to withstand economic shocks and other system wide events. Not to promote this financeability objective introduces preventable systematic risk within the sector - to investor returns and the smooth and reliable operation of regulated businesses and efficient service provision to customers.

Financeability is a critical assumption which supports competitive procurement of debt and equity capital for regulated businesses. Capital invests on the assumption that fair returns will be provided on an ongoing long-term basis. When investors weigh the risk-return characteristics of an investment, the risk profile of the investment including the expected probability of debt default or distress is highly relevant. If financeability ignores equity and assumes it will always be available to alleviate cases of credit metric stress or debt default, when allowed returns are set at insufficient levels, then by definition equity risk is considerably increased and equity financeability has not been achieved.

Even if equity could be relied upon to freeze distributions or provide equity cures to solve any debt financeability issues, there would be a cost to any such solutions. Equity would need to be compensated for additional risk and for any capital deployed or provisionally committed. Even then the solution would not fully solve debt financeability risk and the potential capital pricing impact. Debt providers are unlikely to be convinced to rely on equity support unless such equity support was guaranteed. However, equity is unlikely to be able or willing to provide guarantees in all circumstances particularly in difficult economic times or periods of high competition from alternative investment opportunities. This condition required by equity providers highlights how some of the equity solutions proposed by the CC could themselves introduce systematic risk.

Debt providers and credit rating agencies also keenly track the potential credit metrics of regulated businesses under a variety of economic and operating scenarios. This scenario analysis and stress testing is a critical part of determining and assigning credit ratings (formal or internal bank ratings) and in the process of setting debt pricing for each lender.

It is inconsistent to assume investment grade ratings and investment grade debt pricing without also providing revenue and return rates that deliver metrics and levels of debt and equity financeability that support such ratings and pricing.

The move by Fitch, rating agency, in placing NIE on Rating Watch Negative on 17 May 2012 appears a case in point. This negative watch has been retained in subsequent reviews on 16 November 2012, 31 January 2013, 30 April 2013 and 16 July 2013 due to continued regulatory uncertainty and credit metric pressure. In Hastings' experience, rating agencies give little credence to theoretical and discretionary equity support and we would recommend that regulators also take this view and ensure debt and equity financeability and robust credit metrics remain a determination objective. Failing to do so is likely to result in gradual deterioration of credit ratings and debt pricing with ultimate consequences flowing to customer costs.

Likewise other proposed solutions such as issuing index-linked debt, or raising finance in the form of equity or equity-like instruments also introduce new systematic risks or are inconsistent with other regulatory assumptions, such as overall leverage. In fact, the issuance of index-linked debt does not have a beneficial impact on the creditworthiness of a company in the view of rating agencies as it is explicitly adjusted for in credit metric calculations to be consistent with debt facilities that pay the full coupon upfront.

6. ARR approach

As an investor we were also surprised by the adoption of an Accounting Rate of Return (ARR) approach in calculating the return on capital.

$$\text{RAB} \cdot \text{ARR as opposed to WACC} \cdot \text{RAB where } \text{ARR} = \text{WACC} / (1 + \text{WACC})^{0.5}$$

As an asset owner and infrastructure investor we are constantly seeking to make prudent investments but we are also aware that this outcome is not always possible. Investments require considerable due diligence, planning and time to execute in an effective and responsible manner. Infrastructure investments are also lumpy and have transaction costs associated with the making of any new or organic investment decision. During this period when suitable investments are sourced and due diligence and decision making occur, capital often sits within a company or within investor holding entities or investment funds.

Returns are therefore not continuously compounded as capital is not immediately and always reinvested and cannot be assumed to be as such.

The ARR approach and assumption of continuously compounded investment understates required returns and under-delivers on required revenue. Although this factor has a relatively small revenue impact compared to the WACC determination and other issues raised in this submission, we consider this issue to be relevant, nonetheless. It is a further worrying example from an investor's perspective where the CC appears to be adopting a particularly aggressive position which we view as not consistent with global regulatory trends and general precedent.

Re-investment decisions are considered on a case by case basis weighed up against competing opportunities (including lower risk and lower return options). Investors consider each re-investment opportunity, its timing, expected returns and overall risk profile relative to their risk tolerance at the time of re-investment. Many of these factors are subjective, time dependent or investor specific. Any assumption made by the CC that investors would choose to or would have the opportunity or ability continuously to reinvest to earn their required WACC is incorrect.

We suggest the CC reconsider its proposed approach on an ARR approach and instead revert to more traditional WACC*RAB approach.

Conclusion

Hastings is concerned about the signals that the Provisional Determination sends to investors and to the market in general.

We believe there is a danger that regulated businesses, faced with an increased uncertainty of regulatory approach and aggressive reductions in allowed returns without compensating reductions in risk, may not be able to attract capital in today's competitive and liquid global financial markets. Debt or equity investors may simply choose to redirect capital to other investments with superior risk-adjusted returns.

Introducing regulatory uncertainty, inadequate risk compensation for debt or equity investors or introducing systematic financeability risk is not in the long-term interests of the industry and consumers.

Although, in the near term, such moves may hold down regulated returns, the outcomes will also have longer term negative consequences due to reduced capital attractiveness, increased pricing for the sector and discouraged necessary investment. Under-investment can cause cascading negative implications for UK regulated businesses, system reliability, safety and consumer costs in general.

Hastings has been a strong supporter of UK regulated businesses and we hope to continue to support our investments and to invest further in the sector.

We hope that the CC reconsiders its provisional determination, particularly to address areas outlined in this submission. Specifically

- Promotion of regulatory certainty and positive market messaging
- Increased reliance on long-term historical information when setting Risk Free and Market Risk Premium estimates
- Appropriate inclusion of country specific or business specific risk premia
- Protection of financeability as key regulatory consideration
- Removal of ARR approach to setting return on capital.

Hastings would be happy to discuss any aspect of this submission with the CC or other interested parties. The relevant contact details for communicating with Hastings regarding this submission are below:

Andrew Day
Chief Executive
Hastings Funds Management Limited

Andrew Fellowes
Investment Director
Hastings Funds Management Limited

Valeria Rosati
Executive Director
Hastings Funds Management Limited