Equity market return

Consultation on methodology

Ian Rowson

Tuesday 7 January 2014

Equity Market Return Methodology Consultation: **Agenda**

7 January 2014, 9 Millbank, London, SW1P 3GE   Start 13:30, Finish by 16:00

Time	Speaker	
13:30	**Ian Rowson**, Ofgem	Introduction and Ofgem commentary on the issue
(interleaved with Ian Rowson)	**Richard Hall**, Consumer Futures	Consumer perspective
14:00	**Stephen Wright**, Birkbeck College	Academic advisor to Ofgem
14:15	**Phil Burns**, Frontier Economics	Advisers to NIE
14:50	Tea/Coffee break	
15:00	**Peter Hope**, Oxera	Advisers proposed by ENA
15:20	**Keith Noble-Nesbitt**, Northern Powergrid	DNO representative proposed by ENA
15:30	Panel: Q&A session and wrap-up	

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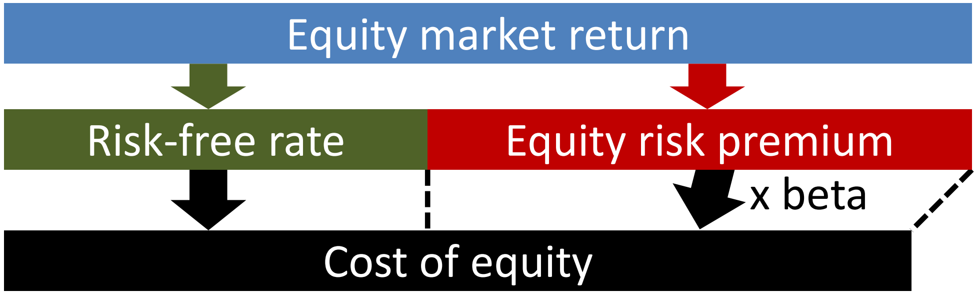
Consultation on our methodology for assessing the equity market return

- The equity market return is an important driver for company profits



- Current methodology for equity market return :
  - 6.5-7.5% (Smithers & Co for joint regulators, 2003)
  - "a robust long-term estimate" (CEPA, 2010 RPI-X@20)
  - 1994 Offer PES draft determination: 7%
  - 2012 Ofgem GDNs final proposals: 7.25%
  - 2013 DNO RPI re-calibrated: 6.85%

What happened on 12 November 2013

- Competition Commission provisional determination for Northern Ireland Electricity (NIE)
  - Equity market return = 6.0%

- NIE CoE = 4.8% → DNO equivalent = 5.5% *(Ofgem calculations)*

- Ofgem interpretation
  - Greater weight on contemporary evidence
  - Question: should Ofgem change its methodology for equity market return?

Consultation

- Announced at fast track business plan assessment (22 November 2013)
  - Consultation letter issued 6 December 2014
  - Responses due by 10 January 2014
- Choice between:
  - Continue to adopt long-term estimate
  - Move to a methodology that places more emphasis on contemporary evidence
  - Potential impact: 0.8% reduction in the cost of equity
- Initial impact for Electricity DNOs, from 2015
  - Transmission and gas distribution will be affected from 2021
- Bill impact per household: decision criterion is consumer protection
  - Change in cost of equity, other things being equal: £2 short term; £? long-term
  - Other things will not be equal, i.e. overall: £? short-term; £? long-term

Purpose and structure of today

- Inform responses to consultation letter (due by 10 January 2014)
  - Opportunity to hear perspectives, discuss and raise questions
- Structure:
  - Introduction: **Ian Rowson**, Ofgem
  - Consumer perspective: **Richard Hall**, Consumer Futures
  - Academic perspective: **Stephen Wright**, Birkbeck College
  - Consultant perspective: **Phil Burns**, Frontier Economics (advisers to NIE)
  - Industry perspective: **Peter Hope**, Oxera
    Keith Noble-Nesbitt, NPg

The consumer perspective

- Richard Hall, Consumer Futures

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Our interpretation of CC arguments

- Historical returns exceeded investor expectations (lots went right)
- Those expected returns were falling over time . . .
- . . . and have fallen further since the credit crunch

Informed by the DMS thesis
'Triumph of the Optimists'

Context: a falling risk-free rate

Real yield 10-year zero coupon government securities, source: Bank of England

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Should we expect growth?

Source: Gregory Clark, Farewell to Alms - A Brief Economic History of the World, 2007; ONS; indexmundi.com

Pointers towards lower CoE

- Exceptionally low risk-free rates
- Persistently high transaction/share values vs. RAV
- Perception that networks are a suitable destination for “flight to quality”
- Noises from other regulators (CC and Ofwat)

Required: a calm interpretation of the evidence

Fundamental questions

- Is the evidence for a lower CoE reliable?
- If so, is it the risk-free rate that is driving it lower?
- If so, what, in CAPM terms, are the mechanisms at play?
  - i.e. is equity risk premium relatively constant, or
  - is effective beta lower than 1.0
- Would a lower CoE revert to its long-term level within RIIO-ED1?

Evidence, and how do we interpret it?

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Risk issues

- Would variable market return assessments introduce beta risk?
- Would variable market return assessments introduce regulatory risk?
- What are the implications for lenders and financeability?
- What are the implications for investment incentives?
- How can we best mitigate these issues?

Consumer is affected by the risk/incentive environment

Practical questions

- Can we express a methodology as a formula?
  - or a broad review of evidence?
  - could we formulate a methodology that helps avoid additional beta and regulatory risk?
- Could/should other components of the regulatory regime adapt?
  - To mitigate risk or financeability issues?
- How could companies adapt financially?
  - transition to new gearing?

Ofgem’s in listening mode

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