nationalgrid

National Grid House
Warwick Technology Park
Gallows Hill, Warwick
CV34 6DA

Hannah Nixon
Senior Partner, Smarter Grids and Governance: Distribution
Ofgem
9 Millbank
London
SW1P 3GE

Paul Whittaker
Director, UK Regulation

paul.whittaker@nationalgrid.com
Direct tel +44 (0)1926 653190

www.nationalgrid.com

10 January 2014

Dear Hannah,

Consultation on Ofgem's methodology for assessing the equity market return for the purpose of setting RIIO price controls

National Grid welcomes the opportunity to respond to your recent consultation on the methodology for assessing equity market returns for RIIO price controls. Whilst the consultation makes clear that it will not affect the established RIIO-T1 and RIIO-GD1 controls, it raises the possibility of a change in Ofgem policy with longer term implications. This response is not confidential.

Before considering the specific consultation questions, it is important to make a number of important comments on the consultation and on the relevant context and background within which the matters it raises need to be considered. These address the key underlying question raised by the consultation, namely "*the relative merits of [Ofgem's] existing approach to the equity market return versus a move to one that gives greater weight to contemporary market evidence.*"

Ofgem published the RIIO-ED1 strategy decision in March 2013 and this included a decision on the cost of equity range (6.0% to 7.2% for RIIO-ED1) that was based on long-term evidence, consistent with the approach used in previous price controls. However, triggered by the Competition Commission's provisional determination for Northern Ireland Electricity (NIE) that was published in November 2012, Ofgem is now consulting on whether to change the approach used in assessing equity market returns to one which gives greater weight to contemporary market evidence. The stated aim is "*to reach an enduring evidence-based conclusion on the methodology we [Ofgem] should adopt.*"

We consider that such a change to the methodology would be unjustified and would not be in consumers' interests for the following reasons:

- It would not be consistent with the underlying thinking behind the RIIO framework for regulating energy networks, which was introduced just 3 years ago after extensive consultation and careful deliberation with the aim of "*deliver[ing] long-term value for money network services*". In relation to network financing and financeability, RIIO sought to introduce clear ex-ante rules and principles for various components in order to give greater certainty, transparency and predictability in relation

to each element.[1] Ofgem clearly set out as a defined principle that they would take a longer-term view of financeability, and in December 2010 confirmed that "*relying on long-term historical trends to set the cost of equity*" was a "*key mechanism*" within the RIIO framework to help mitigate uncertainty.[2] As recently as March 2013 Ofgem confirmed in the RIIO-ED1 Strategy Decision that the "*preferred approach is to rely on the well-established long-term ERP estimates provided by Dimson, Marsh and Staunton (DMS)*", which Ofgem have used in the past. There is no case to revisit the approach used for an important element of the RIIO framework, particularly after such a short time and in the absence of any strong evidence that such a change is either merited or would, when seen over the long term, bring any benefits for consumers.

- Energy network assets are long-lived assets and are seen as such by investors. It is therefore entirely appropriate that a long term view is taken of the equity market returns, even though it can be expected that these values will sometimes be higher and sometimes lower than values based on short-term evidence. Allowed returns should continue to be derived from long-term values of Total Market Return, which is the most stable of the observable equity market return parameters and so, as noted in the consultation letter, this gives a better and more objective basis for a longer-term forward-looking view.
- Ofgem have previously adopted long-term estimates of Risk Free Rate (RFR) and Equity Risk Premium (ERP)[3] in setting price controls (both for RPI-X and now under RIIO). Regulatory consistency and predictability are important and so values for these parameters should continue to be based primarily on long-term evidence.
- Changing the approach so soon after the adoption of the RIIO framework would, in any case, undermine the framework and any prospect that it could be seen as providing the stability that was hoped and intended, and so would be inconsistent with the stated aim of the current consultation of reaching "*an enduring evidence-based conclusion on the methodology [Ofgem] should adopt*." In addition investors might perceive that whilst Ofgem might choose to give more weight to short term data when this gives a lower value of market return, Ofgem would revert to a longer-term approach in the future if short-term data then pointed to higher values. Ofgem could thus be accused of opportunism, undermining and risking Ofgem's hard-won reputation for fairness, predictability and consistency. For these reasons a change to the approach for assessing equity market returns would increase regulatory risk and, as a result, the cost of capital and future charges to consumers.
- Changing the approach to give more weight to short-term evidence would also be misguided because of the "*considerable methodological and judgemental uncertainty in assessing contemporary market evidence*" that is noted in the consultation letter. As a result a changed approach would give too much discretion to regulators, expose them to political pressure, and increase the scope for asymmetric risk, further increasing the impact that such a change would have on the overall regulatory risk faced by networks.

---

[1] "RIIO: A new way to regulate networks – Final Decision", Ofgem, October 2010, and the RIIO Decision City Presentation on 4 October 2010: "*Providing greater transparency and predictability about the way we approach each element of financeability should provide comfort to investors and make the sector more attractive to both equity and debt investors*"

[2] "*RIIO-T1 and GD1 Financial Issues Strategy Consultation*", Ofgem, December 2010, Paragraph 3.9

[3] It would perhaps be more accurate to describe the approach that has been adopted in the past – and which should be retained – as one which attaches significant weight to long-term evidence in estimating an appropriate value of Total Market Return (TMR). This value is then used, together with the estimated Risk Free Rate (RFR) for the price control, in estimating an appropriate value of Equity Risk Premium. For equity beta values close to 1, it is the value of TMR that is important in estimating the cost of equity rather than its constituent components RFR and ERP.

- In setting a price control a sector regulator or, as the appeal body, the Competition Commission, must take decisions within the relevant context and framework. It cannot be presumed that in the circumstances of the RIIO-ED1 price control Ofgem (or the Competition Commission) should (or would) take the same view as the Competition Commission in the case of NIE, particularly on matters where there is no definitive, objective argument in favour of one approach over another. This would apply in relation to the methodology used for assessing equity market returns[4], but also in relation to other elements of the price control[5]. For example, Ofgem have, for good reasons which we agree with, adopted a different approach to cost of debt under RIIO from that which the Competition Commission adopted in their provisional determination for NIE. There are also important differences between the 2 regimes which should be taken into account in choosing the approach for setting equity market return in each case, for example:
    - there is greater uncertainty in relation to cost of equity in a 8 year RIIO price control being set in advance than in the 5 year NIE control that is being considered part way through the period;
    - there is a need to pay due regard to past precedent in a sector;
    - whether any statements have been made by the relevant sector regulator which define or create a clear expectation regarding the approach that will be adopted (- the CC, as well as the relevant sector regulator, would attach due weight to these in recognising the importance of regulatory stability and predictability). Retaining a long-term view of equity market return parameters is therefore the right approach where this has been previously signalled, has been applied consistently in the past, and can be retained for future price controls;
    - the need to take account of the relative risk exposure of a company under the proposed price control, and the need to test the final, resulting estimate of cost of equity against a number of "sense-checks".
- It is far from clear that there is any new evidence since Ofgem's March 2013 decision document that would support a change to the approach decided on for RIIO-ED1 at that time. Ofgem explicitly said in the March 2013 RIIO-ED1 Strategy Decision document that the cost of equity range was consistent with observed market trends, and there is no suggestion in the new consultation that there is any substantive new evidence since March 2013 that would justify a change to the approach. It follows that if Ofgem were to change the approach now in the absence of such evidence, this would significantly increase uncertainty and regulatory risk both now and in the future.
- It is not clear whether, over time and were it not for the impact on regulatory risk, either approach would give higher or lower average market returns. However, it is clear that:
    - An approach which gives greater weight to short term evidence would give greater volatility from one price control to the next (which is undesirable from consumers' perspective because of its impact on the stability of charges); and
    - A change to the approach would increase regulatory risk and the required cost of equity (and could also increase the cost of debt as explained below) where these effects would increase charges to consumers and would be long-term (i.e. last for several price controls).
- This increase in (perceived) regulatory risk would also be expected to be wide-ranging, and could affect other sectors outside of energy such as the regulated networks in water, telecoms and

[4] We consider, though, that the observed relative stability of long-term values of Total Market Returns weigh heavily in favour of an approach based on this measure, as in previous regulatory settlements in the sector, as the most objective and appropriate approach.

[5] In this regard it is notable that the Competition Commission adopted a different approach from that in the NIE provisional determination in a number of areas, including in relation to equity return parameters and cost of equity as well as some other financial issues, in the Bristol Water price control appeal just 3 years earlier.

transport, as well as harming the prospects for (and increasing the cost of capital for) investment in other parts of the value chain in energy.

For all the reasons above, we continue to believe that the approach adopted by Ofgem in the past for assessing equity market returns, which attaches significant weight to long-term evidence, should be retained for RIIO-ED1 and for future price controls in the sector.

Appendix 2 of the consultation explains the central reference point for equity market return that has been used by Ofgem in testing the DNO's RIIO-ED1 business plans. It is not directly relevant to the main substance of the consultation, although it is relevant to Ofgem's consideration of the cost of capital for RIIO-ED1. The discussion in Appendix 2 considers changes in the difference between RPI and CPI and the outcome of the ONS review of the RPI index in 2012/13, but a full analysis of the relevant issues and impacts is not straightforward. Whilst Ofgem have dismissed the impact of housing costs and focussed on an estimate of the change in the "formula effect" in recent years, other factors related to differences in coverage and in weighting between RPI and CPI may also relevant[6]. We do not agree with the 0.4% adjustment to market return that is described in Appendix 2 and do not consider that this reduction has been justified.

Turning to consider the specific questions that are raised in the consultation:

1) A direct translation of the Competition Commission's estimates to DNO cost of equity allowances - Do you agree with our direct translation of the CC's equity market return estimate to DNO cost of equity allowances?

There are no significant obvious errors in the calculations at a mechanistic level, although as explained above we do not agree with the input parameters being used[7] and do not agree that the overall cost of equity calculated in Table 1 is an appropriate value for the RIIO-ED1 control.

2) *Implications for risk - Can you provide evidence on the impact of giving greater weight to contemporary market evidence on perceived systematic and regulatory risk?*

Neither NIE nor any of the electricity DNOs are listed entities and as such there can be no direct market evidence of the increase in risk following the CC's provisional findings or Ofgem's new consultation. However, for the reasons set out above, if Ofgem were to change the approach to one which gives greater weight to short term market evidence this would result in increased regulatory risk. Moreover, as explained above, if Ofgem were to change their approach in this way the resulting increase in risk would be long-term, and would in addition be expected to affect other sectors both within and outside of energy.

---

[6] As examples, the Localism Act (2011) affects the expected growth rate in Council Tax and so will affect RPI but not CPI and so can be expected to reduce the expected future differences between the two measures, and the attribution by the ONS of the difference between RPI and CPI to "other differences and weights" has been larger during 2012 and 2013 than has generally been the case previously and if taken into account would tend to offset the change in the "formula effect" which the Appendix to the consultation considers important.

[7] In addition to the points raised earlier, given the need to apply sense-checks and cross-checks to the eventual calculated return on equity, it would be unlikely to be appropriate to combine the Competition Commission's values of risk free rate and equity risk premium with a materially lower asset beta.

There is also the possibility of a further unintended consequence, in that a change of approach and the resulting increase in volatility of market returns (from one price control to the next) would reduce the attractiveness of the energy network sector to long term investors who are important to the sector as Ofgem have recognised (e.g. during the RPI-X@20 review). Such investors would prefer a more predictable, less volatile approach which gives greater security of returns over the long term, consistent with the long term view that needs to be taken when investing in the long-life assets in the sector, which under RIIO are depreciated and so must be funded over 45 years.

3) *Financing issues - Do you think changing our methodology for the equity market return would impact on interest costs for DNOs? If so, how would this need to be accommodated in our approach to the financial package or the regulatory package more widely?*

There are a number of reasons why a change to the methodology for assessing equity market returns could be expected to increase interest costs, and these should not only be considered individually but also together because they have an exacerbating effect on each other.

We agree with the consultation that a reduction in cost of equity would have an impact on financeability and as a result on either cost of debt or gearing, which would tend to increase costs to consumers and cause an inappropriate change in capital structure at a time when debt costs (as measured by the cost of debt index) are falling[8]. Consumers would gain no benefit from networks facing such financeability challenges, nor from the changes needed to address or allow for these. These effects would be exacerbated by the mismatch between interest costs (typically considered on a nominal basis in credit metric calculations) and actual cash flows or income (which are based on real returns), given that in UK energy network regulation the RPI element of required return is added to the RAV (and so is deferred) instead of being funded in the short term. As a result any changes which reduce the cash element of return further will make worse any financeability challenges and may need a compensating adjustment elsewhere in the overall price control settlement (e.g. to the asset life or capitalisation rate) to restore the ratios and metrics.

A change to the methodology for estimating equity market return would also be likely to reduce the ratings agencies' assessments of the stability of the regulatory framework, which is one of the main qualitative factors taken into account by the ratings agencies in determining their rating of debt issued by regulated networks. As a result interest costs could increase, again acting against consumer interests, and this effect could be expected to last for several regulatory cycles. This would then need to be accommodated in future price controls either by basing the allowed cost of debt on an index of lower rated debt (e.g. BBB debt rather than an average of A and BBB) or by reducing the assumed notional gearing that is used by Ofgem in calculating the Vanilla WACC for a given cost of equity and cost of debt.

4) *Investment incentives - How do you consider that the choice of methodology for determining the appropriate equity market return impacts on investment incentives? Is there any evidence that you can provide?*

[8] New consultation on methodology for assessing equity market returns, Appendix 1, paragraphs 1.22 to 1.24, Ofgem, 6 December 2013

Both Ofgem and the CC have previously recognised the importance of creating a regulatory framework that encourages investment. Setting a rate of return that is too low is likely to be more harmful to consumers than one that is too high because "*the consequences of setting too low a figure for the cost of capital (lack of investment) were worse than the consequences of setting too high a figure (higher charges)*."[9] After carrying out a number of cross-checks and bearing in mind the uncertainties in the financial markets, the CC used their view of the upper limit of expected market return in setting the cost of equity for Bristol Water.

The allowed return not only provides a fair return to existing investors in network companies but is also the value which facilitates investment in new infrastructure. Given the long-term nature of network assets it is important that networks, investors and lenders have confidence that adequate returns will continue to be allowed in the future. This was recognised in the final decision document which introduced RIIO in October 2010, which explained that "*Providing greater transparency and predictability about the way we [Ofgem] approach each element of financeability should provide comfort to investors and make the sector more attractive to both equity and debt investors*". This included giving commitment to the principles of the RIIO model for future price control reviews, including the principles on financeability, with the aim of providing network companies and investors with more certainty about how plans and delivery decisions will be treated over time, to promote longer-term thinking and to encourage network companies to identify ways of delivering better value for money over the longer term.[10]

For these reasons a change to the methodology for determining equity market return to attach greater weight to shorter term evidence would be expected to have a harmful effect on investment incentives.

5) *Eight-year RIIO price control period - To what extent do you think the merits of the alternative approaches to the assessment of the equity market return are affected by the eight-year RIIO control period?*

Longer price controls make short term trends and values less relevant. They increase the likelihood of larger movements in the cost of capital during the control, so making it more appropriate to give greater weight to longer term evidence, especially given evidence of mean reversion for certain key return parameters. In addition, contemporary data will be less relevant and more out of date by the end of an 8 year control than a shorter control[11], making it more likely that there could be significant financeability issues and/or over/under investment concerns. A similar issue in relation to cost of debt under 8 year price controls was recognised by Ofgem and led to the introduction of the cost of debt index mechanism for the RIIO framework. Whilst it is not obvious whether equity market parameters based on an approach that gives more weight to short-term values will on average over time be higher or lower than if based more on longer-term parameters, estimates of networks' cost of equity which rely on shorter-term market values would be more volatile, and would also need to be higher in recognition of the increased regulatory risk associated with the change in approach (and resulting

[9] See Competition Commission report on Bristol Water plc, August 2010, pp N20/21, and Competition Commission report on Stansted Airport Ltd (Q5 price control review) October 2008

[10] "*Handbook for implementing the RIIO model*", Ofgem, October 2010, Paragraphs 5.5 and 5.6.

[11] Particularly where, as in the case of the CC's provisional determination for NIE, the price control is being set part way through the 5 year period, and so the end of the price control is only 3 to 4 years away, rather than the 8 to 10 years that applies in the case of RIIO depending on when in the process the allowed return is finalised.

perceptions of greater regulatory discretion, exposure to political pressure and increased asymmetric risk) and the break with past precedent.

Concluding Remarks

In conclusion, a change to the methodology that is used in assessing equity market returns from that which has previously been used by Ofgem and has been strongly signalled for RIIO-ED1 would not be in consumers' interests and should not be made:

- it would not be appropriate under the RIIO framework, which sought to introduce and commit to a stable approach only 3 years ago, and which introduced 8 year long price controls;
- it would be inconsistent with the important regulatory principles of predictability and consistency;
- price controls need to take account of the relevant context and industry framework, and so a "read-across" from the Competition Commission's provisional determination for NIE can't be presumed, even in relation to market parameters;
- as well as past precedent, this industry context in energy networks includes prior statements made by Ofgem which give clear signals regarding the approach that would be used and create legitimate expectations;
- it is not obvious that attaching greater weight to short-term evidence will, over time and if applied consistently, give higher values for market return parameters: market return could increase or fall in the future, and it would clearly be unacceptable for Ofgem to "cherry-pick" the approach which gives lower values at each price control;
- if the approach were changed now in the lead-up to RIIO-ED1 it would be not be possible for Ofgem to build credibility and belief that a consistent approach would be applied in the future. This would further increase the cost of capital needed to reflect the increase in regulatory risk that would be caused by a change in approach;
- the increase in regulatory risk would increase the cost of equity and could also increase the cost of debt, and thus increase charges to consumers.

Yours sincerely

[by email]

Paul Whittaker
Director, UK Regulation