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10th January 2014

Dear Hannah,

Thank you for the opportunity to respond on these issues.

The methodology for assessing the equity market return for the purpose of setting RIIO price controls is a key part of the RIIO toolkit and has a material bearing on the regulatory risk contained within a RIIO price settlement. That said, there are a number of other equally important factors such as the cost debt, cost allowances and output levels that also influence the overall package and subsequent impact on consumers and network operators.

The RIIO principles are still relatively new and untested; therefore a broader review of RIIO with all other aspects in scope would be more appropriate in the fullness of time, as opposed to a specific review on the methodology for the cost of equity now. In summary, it does not seem appropriate to use a very condensed timescale to determine such a strategic change of approach on one specific factor that would have impacts on all the RIIO price controls.

Given the evidence provided in the consultation, WWU does not believe that the methodology used by the Competition Commission (CC) in its provisional determination for NIE is a suitable methodology for assessing equity market returns for all the RIIO price controls for the following reasons:

- The consultation for change is based on a provisional determination by the competition commission (CC) whose approach is not clearly defined. This is too important a decision to be rushed and should fully consider, scrutinise and challenge all the available evidence.

- The CC decision is based on reviewing all components of the cost of capital not solely equity market returns. Therefore the methodology used by the CC on equity returns cannot be considered in isolation and must be considered in the wider context of their decision including cost of debt and beta. For example, the CC has taken a radically different approach to the determination of the cost of debt compared to that used for the RIIO price controls. The impact of this approach on the cost of equity has to be considered.

- It is also clear that the CC decision is influenced by the specific circumstances of Northern Ireland Electricity (NIE) including the short duration of its residual price control (three years). Therefore it is not appropriate to use the CC decision as a precedent for the entire regulated network sector and in particular over a considerably longer time period than applies to the CC decision.

In addition to the above we understand the various presentations and contributions at the 7th of January workshop highlighted concerns with some of the technical information and factual comparisons within the consultation document. These included:

- Evidence on the stability of market returns over a long period

- Concerns that the CC has used narrow data ranges for future forecasts

- The lack of evidence to support the argument that a fall in the risk free rate equates to a fall in the equity risk premium. Consequently the assumption that the ratio between equity returns and equity risk premium is constant is not proven.

Given the weaknesses, differences and inconsistencies outlined above we do not believe that the consultation or the limited “contemporary” information justifies a change to the cost of equity methodology for RIIO Price Controls.

Please do not hesitate to contact me if you wish to discuss any aspect of our response.

Yours Sincerely

Steve Edwards
Head of Regulation