Dear RIIO Team,

I am a fund manager working for Invesco in the UK managing client portfolios with investments in UK shares. This includes investments in National Grid and SSE. My client portfolios are also invested in other regulated utility companies. Invesco manages about $888bn globally, of which about $229bn is managed by Invesco EMEA (both figures as at 31 December 2018).

Having read the RIIO-2 consultation documents I would like to make some comments.

I will restrict my comments to an area where I believe I have an informed and practical insight – the cost of equity.

The consultation documents provide voluminous detail on the theoretical approach to setting cost of equity, but I would note that while it is a cost to any business, to my clients it is the return required for taking risk with their money. And any investment must compete with other alternative investments.

The focus of OFGEM's justification for the cost of equity range is the Capital Asset Pricing Model (CAPM). This may be well established and academically uncontroversial, but it is built on assumptions (such as market efficiency, rational behaviour, constant perception of risk, volatility as a measure of risk) that seem very far from my practical experience.

Even if I put aside my reservations about the model, some of the CAPM inputs are questionable. Specifically the assumed risk free rate, the total market return and the equity beta:

Nominal and real UK government bond yields are, with the exception of a brief period after the Brexit referendum, around the lowest levels ever recorded. The global bull market in bonds is one of the largest and longest ever experienced. The Bank of England Staff Working Paper No. 686 "Eight centuries of the risk-free rate…" gives some context. It is hard for this investor to view real gilt yields today of around -2% as "risk free". To borrow someone else's line: it is more like "return-free risk" than "risk-free return".

I am supportive of basing the assumed Total Market Return (TMR) on observed long run returns. But I find the route followed to justify a range of 6.25% to 6.75% to be somewhat arbitrary, and the range below my expectations.

Similarly, the assumption of an equity beta range of 0.6 to 0.7 also seems low.

On principle I do not support the idea of cost of equity indexation because it introduces uncertainty, and I fundamentally don't believe that the return required by my clients changes quickly. The proposed mechanism involves quite a few assumptions, not least on the relationship between RPI and CPIH, which weakens the robustness of this approach. There would be one benefit: it would at least protect my clients from the regulator locking in a return based on these extraordinarily low gilt yields.

Finally, the decision to take the allowed return (AR) derived from this CAPM-based process and then deduct an additional arbitrary 50bp to create an expected return (ER) is a regulatory innovation too far. It undermines confidence in the fairness of the whole regulatory process. The principle of incentive-based regulation is also undermined.

The culmination of this is a “working assumption” nominal allowed cost of equity (point estimate) of 6.12%.

This seems extraordinarily low.

At this level of equity return quoted companies would struggle to appear attractive to investors relative to alternative investments.

Consider the returns on offer elsewhere amongst FTSE 100 companies: one way of looking at potential returns from an investment is the sum of dividend yield and dividend growth (this is derived from the dividend discount model). Currently Morgan Stanley estimate that dividend growth over the next 3 years from the MSCI UK index will average 4%. Even if a lower rate of growth of 3% is expected for larger, more mature FTSE 100 constituents, this would mean 62 blue chip UK companies would offer a return greater than 6.1% nominal (based on expected yield plus 3%). Assuming 4% dividend growth, this would increase to 84 companies offering a more attractive return.

And the quoted companies covered by the RIIO-2 consultation do not appear particularly low risk: they are under ever greater public scrutiny; the Labour party plans to nationalise the industry (with compensation yet to be declared); and an investor would observe a regulator with what appears to be a downward bias to returns. The even lower return proposed for Hinkley-Seabank adds to the perception of a regulator keen to lower returns.

Clearly, the long term legitimacy of the industry requires that the companies provide good value to their customers and the regulator innovate as the industry develops. However, sectors like the government service outsourcers (for example Carillion) demonstrate that it is possible to drive down returns too far and create unforeseen and unwanted consequences.

One obvious outcome is that investors will encourage companies to invest elsewhere, where better risk-adjusted returns are available.

A settlement fair to all stakeholders in these businesses is possible, but I feel that on the cost of equity the regulatory pendulum has swung too far away from the companies and their shareholders.

Sincerely,

Ciaran Mallon

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Invesco