

# Consumer Futures

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Dear Hannah

## Response to “Consultation on methodology for assessing the equity market return for the purpose of setting RII price controls”

Thank you for providing us with an opportunity to comment on your consideration of the equity market return to be used in the ED1 price controls. This submission is entirely non-confidential and may be published on your website.

The average household dual fuel energy bill approximately doubled between 2006 and 2013<sup>1</sup>. Inflation in energy costs outstripped wage growth resulting in deteriorating affordability; both the aggregate and average fuel poverty gap have materially widened in the last decade<sup>2</sup>. Unfortunately, energy affordability in the UK is unlikely to improve materially in the coming years – DECC’s most recent forecasts for bills in 2020 suggest that while they may be lower than they would be in the absence of its policies, they would nonetheless remain at similar levels to today (in real terms)<sup>3</sup>.

Network costs have not been the principal driver of unit price inflation in the past few years, nor are they likely to be in the coming years. However they do represent a significant minority of the end consumer’s power bill – about 16%. So it is right that consumers see the most cost-effective price control settlement possible.

The Competition Commission (“CC”)’s provisional determination in relation to Northern Ireland Electricity suggests that there may be some fat in the assumed cost of equity under ED1. Ofgem suggests that translating its judgement would reduce cost of equity allowances by approximately 0.8%, from 6.3% to 5.5%.

Our conversations with your team and with other stakeholders suggest this would appear to equate to approximately £2 off the annual power bill. Multiplied up by 25.8 million households in mainland Great Britain, and by the 8 years of the price control, the materiality becomes very substantive. A recent Utility Week article suggested that

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<sup>1</sup>The average annual dual bill, calculated using the at the time prevailing notional average consumption values of 3,300KWh/pa for electricity and 16,500KWh/pa for gas was £686 on 1 January 2006 and £1,322 on 1 January 2013.

<sup>2</sup> DECC statistics on fuel poverty can be found here: <https://www.gov.uk/government/collections/fuel-poverty-statistics>

<sup>3</sup> <https://www.gov.uk/policy-impacts-on-prices-and-bills>

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electricity distribution networks own estimate of the collective materiality may be in the order of £60m/year<sup>4</sup>.

The impact of any determination will have wider application than ED1, as we would expect any decision made in relation to it would also subsequently influence your decisions on the GD2 and T2 price controls. This knock-on impact could be significant.

As the appellate body for utility sector price controls, the CC's thinking should inform Ofgem's because it sets a precedent for what it considers a reasonable approach to be in calculating the cost of equity. Statutory bodies always need to be mindful of the need to be consistent with past decision making. In its simplest terms, we would anticipate that if the ED1 determinations were appealed to the CC, whether by suppliers or by any other body such as ourselves, we would expect it to abide by its NIE determination on cost of equity unless there were compelling reasons not to do so.

Looking more broadly across all the utility sectors, there may be impacts on regulatory certainty in the UK if the approach taken by sector regulators, both individually and collectively, drift too far away from that taken by the appellate body. It may call into question the credibility of the overall UK regulatory regime and create investment risk in its own right (i.e. if different approaches are being taken by statutory bodies with overlapping remits, investors will not know for certain which may be applied to their assets until the formal appeals window closes – long after the window for negotiation has effectively closed).

It appears that the key trade off being made in the time period over which required equity market returns are calculated is between relevance to current market conditions and volatility. There is the risk that use of data from any historic time period, including the short term, could provide a false reading of market conditions that may pertain across the price control period, but in many areas use of contemporaneous data is far more likely to represent plausible investor expectations than extremely long run averages. For example, debt refinancing will always take place based on the prevailing market conditions – longer term indexes of the cost of debt may bear little relation to this. We think that a rational investor will base decisions on their expected actual costs and the potential return that they could realise from alternative investments at the prevailing time they make an investment choice, not on the theoretical long run average costs and investment alternatives.

It should be considered whether structural breaks occur in market conditions that would set returns on a new path. To rely on historic returns for calculating the allowed rate of return for a regulatory period means you have to assume that there will be a reversion to the historic mean within a relatively short period of time, eg within the price control period<sup>5</sup>. The CC judgement provides, in our eyes, a plausible case for arguing that such a structural break has occurred.

The risk of an extremely long time series is that it becomes divorced from contemporary reality. The Smithers report was informed by equity returns since 1900; we rather doubt any investor bases their decisions on acceptable or likely returns over

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<sup>4</sup> "Ofgem finance change could cost DNOs £60m a year," Utility Week, 26 November 2013.

<sup>5</sup> See, for example, 'Utility regulation, the RAB and the cost of capital', Dieter Helm, 6 May 2009.

a 113 year period. It appears intuitive to use more contemporaneous data, though the impact on volatility does need to be understood.

Historic equity returns are used as a proxy for investor expectations in the absence of any way to firmly evidence investor expectations. Equity indexes are effectively baskets of stocks with different risk characteristics, and network stocks may differ in the characteristics from the average of that basket. Most obviously, networks are not subject to competition while most companies are; networks are effectively given statutory prevention from bankruptcy or material losses<sup>6</sup> whilst a 'normal' company faces such risks; and networks have a guaranteed market (energy is an essential service) while most companies do not.

In practice, monopoly utility stocks are close to "risk free" – or as close to risk-free as you can get whilst investing in equities, anyway. Given this incredibly low risk profile, we would expect network investors to be willing to accept a lower rate of return than they would be prepared to accept if they were investing in equities that were subject to some genuine risk. This perception of very low risk is reinforced by the propensity of investors to seek out such stocks in times of market turbulence – often referred to as the "flight to quality". It strongly suggests that investors see such stocks as providing more guaranteed returns than other classes of equities. In turn, this would appear to justify discounting required returns fairly heavily against the market mean equity return, to reflect the comparative lack of risk that the investor faces.

We note that more broadly risk-free rates have dropped markedly, recently – on occasion to negative levels, as highlighted in Chart 3 of your consultation response – and that we have also seen a trend towards network buy-outs taking place at a material premium to the RAV. As Ofgem highlighted in its presentation at the 7 January workshop, both could be considered pointers towards setting a lower cost of equity.

We recognise that use of more contemporaneous measures of required returns could introduce more systemic volatility, with required rates set varying more widely between price control settlements than they currently do. An argument may therefore be made that whilst in this particular price control period the use of short term measures of expected returns may run in consumers' favour (i.e. because they are below long term trend) that this could reverse in future price controls. There is logic to this argument, though how compelling this logic is depends on the extent to which the long term trend from 1900 is actually indicative of where future sentiment may lie. In simple terms: would consumers simply face the same costs but with more volatility between price controls (i.e. if future peaks and troughs would roughly cancel each other out) or would they face systemically different costs? We would find it useful if you could draw out your thinking on the likely trade-off between volatility around the mean rate of return and level of the mean rate of return across multiple price controls in your final decision. This ambiguity does not dissuade us from the view that investing in networks is fundamentally far less risky than investing in most other forms of equity however, and

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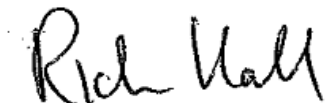
<sup>6</sup>Clause 3A(2) of the Electricity Act (as amended), requires Ofgem to have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by it or the Utilities Act 2000.

we would like to see Ofgem squeezing (consumer) value from the rate of return it agrees with networks.

We note that arguments have been made that a reduction in allowed return on equity could impact on the credit ratings of networks and therefore on how leveraged they are. Networks have put forward the argument that if they are forced to reduce their levels of debt that this would actually increase their cost of capital. We would like to see you fully test such arguments in your final decision.

From a timing perspective, we would find it useful to understand more detail on how the timescales for Ofgem's decisions on this matter and those of the CC in relation to NIE interact. Our understanding is that the CC has until April 2014 to affirm or alter its provisional finding for NIE, but that you anticipate making a final decision on whether to fast-track WPD in February 2014. This would appear to deprive you of the opportunity to take into account any information that may come from the CC's final decision, whether new evidence in reaffirmation of the provisional decision, or its rationale for coming to a different decision. This may also interact with the appeals timetable for any party who may be considering appealing the price control decision. Such an appeal would need to be lodged within 20 working days of the Authority's decision. This may leave an appellant in the uncomfortable position of having to file an appeal immediately in advance of a CC determination that is directly relevant to that appeal, but without sight of where it is has landed. We would encourage you to work with the CC to try and mitigate this risk as best you can.

Yours,



**Richard Hall**  
Director of Strategic Infrastructure