Citizens Advice response to the Ofgem RIIO-ED2 Draft Determinations Consultation - Finance Questions

Citizens Advice
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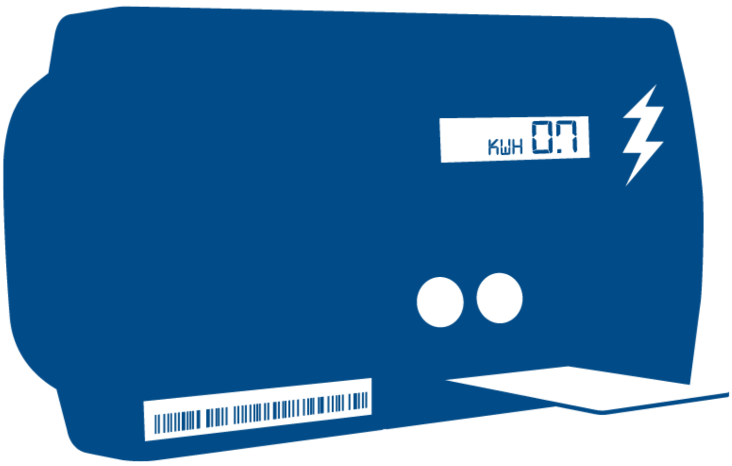

Executive summary

We believe that the cost of capital is too high because:

- Outperformance has not been addressed
- The approach to the Capital Asset Pricing Model (CAPM) favours the network companies
- The stronger protections and lower risk in ED2 are not reflected
- There is a consistently generous approach to detailed decisions

These points are supported by Ofgem's cross-checks. We estimate that, if the evidence of the cross-checks is not acted upon and changes made, consumers could pay over £1.5 billion[1] more than needed across ED2. This would increase when additional expenditure is included through the ED2 uncertainty mechanisms.

So, Ofgem should:

- Review approach to CAPM elements
- Remove generosity in detailed decisions
- Present Return on Regulated Equity (RoRE) ranges on a probability weighted basis. This should be used to provide a more plausible range for financeability checks

Outperformance has not been addressed

Whilst the Competition and Markets Authority (CMA) rejected the proposed solution for systemic outperformance for RIIO-2 GD&T[2], it supported the Gas and Electricity Markets Authority's (Ofgem's) position that operational outperformance in RIIO-1 was an important risk area for consumers in RIIO-2 GD&T[3]. The CMA also found that the return on equity was not too low[4] and

[1] Comparing nominal revenues with MAR cross-check inferred cost of equity (using most recent transaction, NGGT, 3.2%)
[2] CMA (2021) Final determination: Volume 2B: Joined Grounds continued: Outperformance wedge, Ongoing efficiency, Licence modification process §6.182
[3] Ibid §6.178
[4] CMA (2021) Final determination: Volume 2A: Joined Grounds: Cost of equity §5.1064

acknowledged the asymmetry of information between the regulator and regulated entities[5].

However, ED2 Draft Determinations do not consider the risk of outperformance and how it will be addressed. We do not believe it is sufficient, or consistent with the CMA ruling, to simply remain "*open to proposals*" in this area[6]. Given price control consultations tend to be dominated by the network companies, Ofgem should not be relying upon third-party representations to deal with outperformance. We also believe that if Ofgem had not introduced the wedge they would have considered a different approach to setting the cost of equity. This is to be expected because the rejection of the performance wedge as a method of dealing with expected outperformance does not change the expectation of outperformance. Ofgem relies upon consistency with the approach taken for GD&T on a number of occasions[7]. However, to remove a key aspect of the GD&T proposals (i.e. the performance wedge) and remain consistent with all other elements clearly will result in an overall settlement that is inconsistent and more generous than Ofgem's intentions with GD&T.

The approach to CAPM favours the network companies

ED2 represents a key opportunity to interrogate the assumptions inherent in assessing cost of capital. As such, we expected that due attention should be provided to the question of whether equity was too high following the arguments we presented to Ofgem and the CMA. For example, we have consistently argued that Total Market Returns (TMR) should not be based on just average returns on UK equities but instead on more diversified portfolios.

These sorts of metric choices demonstrate the subjectivity of the current approach to setting cost of equity. Further, we believe that the resource asymmetry between the network companies and other stakeholders means that the approach to CAPM is likely to be biased upwards. This leads Step 1 generally to consider observed evidence that allows higher required returns by using subjective choice of observations, often about less secure or less suited alternatives, such as proposals to use AAA bonds, different consumer indexes or a distortion of what the Risk-Free Rate (RFR) is supposed to represent. This contrasts starkly with the limited engagement with the alternative approaches we have raised.

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[5] CMA (2021) Final determination: Volume 2B: Joined Grounds continued: Outperformance wedge, Ongoing efficiency, Licence modification process §6.179
[6] Ofgem (2022) RIIO-ED2 Draft Determinations – Finance Annex, p26
[7] For example, regarding the use of cross-checks. See answer to FQ10.

The lower risk and greater protections in ED2 is not reflected

A larger scale of investment is expected to be required in ED2 relative to other RIIO-2 controls. This will lead to significant, and necessary, growth of the regulated asset base. The incentive structure is also more high-powered in ED2, reflected in a wider RoRE range and higher efficiency sharing factors. This will simply enable the DNOs to outperform the cost of equity to a greater extent. There is uncertainty over the degree of outperformance, but not over the expectation of outperformance[8]. Network companies will seek arrangements that reward beating targets on the expectation they will be able to do so.

So, we disagree with investment opportunity and incentive opportunity within ED2 being used as arguments for increased systematic risk of a company that justifies a higher cost of capital. This would mean consumers funding rewards and also paying an additional cost to do so.

Ofgem has created numerous mechanisms that enable companies to make all investments, and notably uncertain investments, in a way that protects against risk. It is not credible that mechanisms such as the Return Adjustment Mechanism (RAM), volume drivers, re-openers, pass-through mechanisms and indexations do not reduce systematic or non-diversifiable risk to which a company is exposed. However, the impact on the price control risk is not currently reflected when setting the equity beta in the cost of equity calculation.

Generosity in detailed decisions

There appears to be a systematic approach to be generous to the network companies when judgement is required within the detailed decisions relating to cost of equity (in addition to the inherent bias within the subjective choices required within the CAPM approach):

Table 1

Finance examples	Draft Determination - Ofgem commentary
Halo effect	'The size of that halo effect is slightly larger than assessed for the GD&T sectors (7bps using a weighted average, 11bps using an unweighted average). …we continue to consider that the iBoxx GBP Utilities 10yr+ index is appropriate as the basis for the allowed cost of debt, and **do not propose an explicit**

[8] All network companies are expected to outperform under RIIO-ED1 https://www.ofgem.gov.uk/publications/riio-1-electricity-distribution-annual-report-2020-21

	adjustment for any halo effect.'
Infrequent issuer premium of 6bps	'We note that use of a 15bps premium on new debt, as per the NGN proposals at RIIO-GD&T2, would lead to a **3bps infrequent issuer premium** for RIIO-ED2, given the proportion of new debt expected to be raised in RIIO-ED2'
Cost of borrowing additional 25bps	'The 25bps additional cost of borrowing estimate is equivalent to the allowance provided in the RIIO-GD&T2 Final Determinations. We note this is **higher than the 10bps** included in the Competition and Market Authority's (CMA) PR19 Final Decision on its redetermination for four water companies.'
Cost of carry 10bps	'The point estimate we propose to adopt is from the **upper bound** of a plausible range (2-10bps)."
Cost of raising new equity 5%	'We said in the RIIO-2 GD&T Final Determinations that 5% was likely to be a **high estimate** of the cost of raising new equity.'
Revenue forecasting penalty mechanism	"Given that the average change even in year five is only 3.17%, a 6% threshold ought to be **more than sufficient**"

A similarly generous approach can be observed in the approach to setting incentive scheme parameters:

Table 2

Incentive examples	**Draft Determination - Ofgem commentary**	**Citizens Advice Notes**
Customer Satisfaction Survey (CSS)	'just under half (6/14) DNO licence regions would be **eligible for a small reward** if existing service levels are maintained'	With a high probability of improvement in the last 2 years of ED1, this target setting approach is likely to reward most DNO licence regions companies for simply maintaining performance levels in ED2.
Complaints Metric	'...improvements made by most DNOs in this area were weighted towards the last two or three years of RIIO-ED1 and we think that	This is inconsistent with other areas, by taking a six year average (rather than four). By seeking to include more data from before improvements were made,

	only using the last four years of data will not provide an accurate average of performance across RIIO-ED1 and, accordingly, would **skew the RIIO ED2 target**.'	targets will be less representative of (and easier than) current improved performance levels.
Time to connect	'...setting the **maximum reward** too high could make it unachievable. At +50% no DNO is already achieving the target in any category (although **some are close**) ensuring that there is still an incentive to improve performance.'	Based on the most recent 4-year average performance, around half of the DNO licence regions would be expected to be (or very close to) earning rewards for simply maintaining that level of performance (with some close to the maximum reward). With a high probability of improvement in the last 2 years of ED1, this target setting approach is likely to reward most DNO licence regions companies for simply maintaining performance levels in ED2.
Major connections	'We are proposing to use these figures to collate a target score by deriving the **mean average** of all DNO targets'	The target proposed by Ofgem is below (easier) than the targets proposed by 5 (out of 6) DNO groups - representing 13/14 DNO licence regions.
Vulnerability and LCT services customer satisfaction - setting target survey score at 9/10	'All DNOs who included this information are currently performing **above 9/10** in RIIO-ED1 and are **targeting between 9.3 and 9.5/10** for RIIO-ED2.'	Ofgem proposes that these targets 'relate to the satisfaction of a similar, and often overlapping group of customers' as well as 'anticipating high levels of customer satisfaction'. Setting the target at 9 acknowledges a high probability of rewards.
Interruptions Incentive Scheme	'The modelling shows that all but lower quartile DNOs would have **less challenging targets at the start of RIIO-ED2 compared to the current CML methodology'**	The targets proposed by Ofgem include improvement factors (1.5%) for trailing companies which are half the size as in ED1 despite only 2 scores out of 84 in ED1 having been worse than the targets set by Ofgem.

	'Quality of Service (QoS) data the DNOs report to us shows that **the cost to achieve reductions in CIs and CMLs has been far lower than the rewards that they have earned over RIIO-ED1** and, although we recognise additional improvements may become more expensive to deliver, **we have not seen any evidence that this is currently the case.'**	If the incentive rate methodology is unchanged then DNOs will still be rewarded at a value that significantly outweighs the cost but this will be coupled with far less ambitious targets than ED1. Earning rewards will therefore be easier and unnecessarily high.

This is supported by Ofgem's cross-checks

Ofgem recognises that its cross-checks indicate that the cost of equity is too high [9]. Given that this is to be expected given the inherent bias and generosity built into how cost of equity is calculated, Ofgem is required to act upon the cross-checks.

The real-world evidence related to the Market Asset Ratios revealed by recent acquisition activity is particularly compelling. We estimate that consumers could pay over £1.5 billion[10] more than necessary based on what these cross-checks reveal.

Review approach to CAPM elements

Ofgem should examine the robustness of the Step 1[11] findings against the stated theoretical aims and intended outcomes of the CAPM model. For example, Ofgem should fully consider known issues with upward bias in TMR evidence sources, including the limitations of UK equities raised by Citizens Advice in multiple consultation responses (and the CMA supporting this argument)[12].

We have long argued that Ofgem is correct in favouring a '*forward looking*' view on betas[13]. We are pleased that Ofgem acknowledges, specifically on MARs data

[9] Ibid §3.83 '*In our view, cross-checks support values in the lower half of the CAPM range'*
[10] Comparing nominal revenues with MAR cross-check inferred cost of equity (using most recent transaction, NGGT, 3.2%)
[11] Step 1 - The Capital Asset Pricing Model evidence
[12] See response to FQ4
[13] Ofgem (2019) RIIO-2 Sector Specific Methodology Decision – Finance, §3.106.

that "*we want to know the latest information on forward looking costs even if this differs materially from historical information*"[14].

However, despite Ofgem's apparent willingness to consider and reflect evidence inclusively, the CAPM calculation approach has meant it has not reflected this in its cost of capital decision. Ofgem should make an explicit consideration of Step 1 evidence corrections of outturn performance as a predictor of future performance.

Remove generosity in detailed decisions

In any case, Ofgem should address the generosity provided within all the detailed decisions listed above. Given the evidence of cross-checks and the inherent bias in the approach to setting cost of capital, there is no justification, when there is a range of possible values, for selecting values above the middle of any ranges or allowing estimates known, or suspected, to be generous.

Probability weighted basis RoRE ranges

Ofgem is right to highlight *'that there is a difference between possible outcomes and probable outcomes*' when looking at RoRE ranges[15]. Ofgem needs to go further than this and produce probability-weighted RoRE ranges. The current range includes many elements that are not credible. For example, the maximum rewards and penalties for incentives schemes are included which are simply part of the scheme design and not representative of any expectation of performance. Also, efficiency incentives are assumed to be +/-10% where 10% overspends would be unprecedented. This is all in addition to the generous decisions outlined above (in Table 2) which also need to be reflected in RoRE analysis until addressed.

This, in turn, leads to an implausible downside performance scenario of up to 200bps. It also creates a false impression of the price control package that is generally unhelpful. Ofgem should present RoRE ranges based on P10 or P90 outcomes (i.e. '1-in-10' scenarios), using historical incentive performance data.

[14] Ofgem (2022) RIIO-ED2 Draft Determinations – Finance Annex p45
[15] *Ibid* p56

Finance questions

Consultation question on allowed return on debt

FQ1. Do you agree with our approach to estimating efficient debt costs and setting allowances for debt costs?

Halo effect

We think Ofgem should approach the halo effect in a more balanced manner. The evidence threshold Ofgem sets that "*we cannot be certain that a positive halo effect will continue for new debt*" is unrealistic and not applied elsewhere[16]. We think that it is sensible to make downward adjustments to reflect the balance of evidence Ofgem provides. As Ofgem suggests that the slightly higher perceived higher halo effect observed on more recent issuances was due to the COVID-19 pandemic, it would follow that ongoing international volatility and uncertainty led by the Russian occupation of Ukraine and the impacts on gas costs are likely to enhance this trend of 'flight to safety'.

We do not think that because the average rating of the constituents of the GBP Utilities 10yr+ index constituents broadly may have fallen over time, this reduces its suitability. Given numerous returns protections for regulatory asset bases which provide significant safety over those average ratings within the index means that only highly similar companies are an evidence to cross-check any observed trend.

Additional cost of borrowing estimate

We also do not see a good reason why the additional cost of borrowing estimate should be 25bps while the PR19 Final Decision on its redetermination for four water companies was 10bps. Given the use of water as a close comparator on other metrics, this appears inconsistent.

We question the reliance on self reported transaction and liquidity cost reporting to set this allowance and do not have clarity that the elements of the adjustment are independent and so whether each factor is justified. Any claim that the PR19 approach was different in the round on the attribution of cost clearly implies a degree of overlap in these funding grounds.

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[16] *Ibid* p12

Cost of Carry

We do not think Ofgem has taken a proportionate position on setting the cost of carry at the top of a plausible range (10bps in a range of 2-10) based on how this calculation is carried out at different levels of a company's structure.

It is up to companies to decide about efficient structure. Yet setting this cost in this way means that it does not give a clear incentive to structure efficiently as it guarantees adequate compensation for any structure. It also reduces the incentive to mitigate the risk of lower end of year balances than at other points during the year.

We think that choosing at the very top end of the range over-rewards some companies and does not encourage this cost impact of company structure to be passed on to the companies. This is suboptimal from a consumer perspective.

Infrequent issuer premium

We think that the 26bps premium on the cost of new debt based on the notional licensees not issuing debt equal to the £150 million yearly threshold does not likely reflect a credible additional cost that companies face. The ability for a company to decide on an efficient structure should, where possible, be left to companies. It is then up to companies how to structure their financing within acceptable parameters. Low issuance in a segment of large corporate structures such as those that provided the premium such as National Grid (WPD) or Berkshire Hathaway (NPg) in ED2 means that additional costs of low issuance can be well-mitigated. It is not credible that the prevalent ownership structures of ED2 companies cannot mitigate this periodic fluctuation of investment at this scale.

It is odd that the opportunity to grow RAV and to not grow RAV debt are both considered by Ofgem in ED2 Draft Determinations to be risks for which network companies should be compensated. This is not credible.

We also note that evidence that Ofgem refers to from RIIO2-GD&T, that NGN proposed a lower cost of new debt, at 15bps. Even if an infrequent issuer premium is allowed, this supports that the level should be reviewed and reduced.

Derivatives

We agree that derivatives are not a necessary feature for the notionally efficient operator.

Step 1 - Consultation question on risk-free rate and equity indexation

FQ2. Do you have any views on the model to implement equity indexation that is published alongside this document, (the 'WACC Allowance Model - RIIO-ED2 30th April 2022 update Alternative Wedge')?

No response provided.

FQ3. In light of the upcoming change to the definition of RPI in 2030, should the RPICPIH inflation wedge be based on: a) a single year (as shown in the WACC allowance model when: cell D2 is "year 5 forecast" and cell B5 is "01/04/2022"); or b) should it be based on 20 years of inflation forecasts (as shown in the WACC allowance model when: cell D2 is "20 year geometric" and cell B5 is "01/04/2031")?

We favour the use of forecast evidence to inform the setting of CAPM parameters to better inform likely anticipated future costs and performance. This means that the inflation wedge should be based on 20 years of inflation forecasts, which provides due weight to additional supporting data as to why generalised past performance will not be accurately representative of future costs.

Step 1 - Consultation questions on TMR

FQ4. Is there evidence that suggests we should change our approach to TMR for RIIO-ED2?

We think that Ofgem should be considering evidence that we have previously presented on setting a more accurate TMR.

We have previously argued that TMR should not be based on just average returns on UK equities but instead on more diversified portfolios:

> "*The TMR should not just be based on the average returns on UK equities, but ideally on the average returns on a wider and more diversified portfolio of investments, namely, including bonds, property, infrastructure, private equity, and other such assets that are all readily available to the typical investors in UK energy and water network companies. Such a portfolio is necessarily more diversified than UK listed equities alone, therefore a much better fit for the*

CAPM's requirement that the 'market portfolio' should represent the most diversified (and readily available) portfolio of investments to relevant investors. Such a portfolio is also likely to exhibit lower average returns than equities alone, owing to the inherently geared nature on average of equities. […]

Correspondingly, estimation of water company betas with respect to UK equities alone is likely to result in overestimation of the relevant non-diversifiable risk. This is because the risk associated equities – assumed by the UKRN report as having a beta of 1 – itself represents a diversifiable risk, especially from the perspective of highly sophisticated global investors. Hence, water company betas estimated with respect to UK equities should represent at most an upper bound estimate."[17]

We continue to view that TMR should reflect the totality of opportunities available to the investors and that the use of UK quoted equities gives the wrong answer. We suggest that Ofgem look at National Accounting Data as a proxy for total market return as an alternative to the quoted equity market, the use of which biases the estimates of TMR upwards.

The CMA decision on RIIO-2 appeals accepts the rationale for this argument which supports the suitability of it to be looked at in more detail.

"*We agree with Citizens Advice's argument that, theoretically, the TMR should reflect the return on all assets in the economy, and that there is some evidence suggesting that total returns across all asset classes are lower than those on equities alone, and potentially materially lower. … such an approach may find that the evidence supports a lower TMR than is estimated under the current standard approach of using equity returns.*"[18]

We would like to see modelling on the implications of this approach to be actively considered.

FQ5. Can stakeholders confirm their view on the trade-off between: the objectivity of using outturn averages (even though the results may be materially higher or lower in future price controls than current TMR expectations); versus the benefits of putting more weight on current expectations (noting the evidence from cross-checks and the associated risk of subjectivity)?

[17] Citizens Advice (20 Ofgem consultation on RIIO-2 Draft Determinations Finance Section p27
[18] CMA (2021) Final determination: Volume 2A: Joined Grounds: Cost of equity §5.200

While outturn averages may be objective, the choice and interpretation of these averages is subjective. The current process of setting TMR involves a series of choices that involve a high degree of judgement. Further, due to the resource asymmetry between the networks companies and other parties involved in the price control, it is reasonable to assume an inherent bias upwards within the current process as the companies are better placed to influence.

We would like Ofgem to use current expectations to help reflect the way in which network companies diverge from conventional cyclical equity comparators. For example, we encourage Ofgem to utilise a broader range of equities to establish TMR so as to take a more accurate approach to setting TMR. We do not see this as less objective.

We encourage Ofgem to pursue objectively chosen evidence that will support the accuracy of a forward looking estimate, rather than relying on raw outturns of past performance. We do not believe that a static approach to outturn evidence gives the objectivity and precision it may appear to. We think there is further evidence to utilise, in the weighting of evidence or scope to improve on evidence differing circumstances and price control designs as a predictor of future total market returns.

FQ6. Do stakeholders agree with our proposal to apply the same TMR for RIIO-ED2 (a mid-point of 6.5% CPIH) as we did for RIIO-GD&T2?

We do not agree that Ofgem has taken the correct approach to developing a mid-point view on TMR due to not explicitly utilising the best available evidence or factoring in key issues with the data it has used as set out in FQ4 and FQ5.

FQ7. Do you believe that DNOs have a higher or lower level of systematic risk than the GD&T companies during their respective RIIO-2 periods?

We believe the level of systematic risk is lower than reflected in ED2 Draft Determinations both in absolute terms and relative to the GD&T companies. This is for a number of reasons outlined below.

Weighting of shock periods

Ofgem's approach does not differentiate between evidence of outturn betas from volatile and stable market periods. Volatile periods represent a valuable econometric indicator of counter-cyclical behaviours. However, these will be highly diluted by long run betas defined by large periods of market stability. As stated by Economic Insights "*shock periods are likely to be the data that best helps to establish the value of beta, since there is likely to be a larger movement of the explanatory variable (market return)*".[19] We encourage Ofgem to consider upweighting of shock periods when determining beta.

Reflect ED2 risk reduction mechanisms in cost of equity calculation

We view the ED2 price control design lowering the systematic risk for network companies. ED2 presents less systematic risk to past price controls due to the incredibly secure level of return as established by numerous factors such as: the apparent confidence in baseline allowances due to all companies passing the BPI; the format of the RAM; and the number of re-openers to address potential changes to financeability. Within the price control period there is also a likely increase of information asymmetry due to the continuous nature and scale of reassessments which means that the volume of cost assessments will increase in ED2. It then follows that outperformance is more likely.

For RIIO-2 Ofgem notes that "*Overall, the RIIO-2 price control exhibits lower systematic risk than previous controls, with lower sharing factors and a narrower RoRE range* [...than] *RIIO-1* [...providing] *greater certainty for investors than previous controls* [...including Ofgem's decision to index the WACC (debt and equity allowances)] *to protect both consumers and networks from forecast error*"[20]

This aligns with the view from CEPA for Ofgem:

"*The analysis indicates that RIIO2 represents more limited risk across the cost and performance incentives than previous price controls in the energy sector.*"[21]

The case for this systematic risk reduction is clear in ED2 and now includes:

- Equity indexation
- Reconciliation and adjustment mechanisms that protect investors from changing wage rates, new cost of debt, business rates, abstraction charges, tax rates, and demand volume
- Allowances for special cost factor claims
- Volume drivers - that help protect companies from risk of forecast uncertainties

[19] Economic Insight (2021) Methodological issues in estimating the equity beta for Australian network energy businesses p57
[20] Ofgem (2020) Consultation - RIIO-2 Draft Determinations - Core Document, Ofgem, July 2020, §6.11 and §2.15-2.16.
[21] CEPA (2020) RIIO-2: Beta estimation issues, Final report for Ofgem

- Reopeners - that allow for additional financing to further address forecast uncertainty
- Return Adjustment Mechanism - providing companies added confidence that return on equity will reach a minimum level
- Caps and collars to financially material and/or highly uncertain performance commitments

Further protections are built into the detailed design of the price control, including:

- For severe weather 1-in-20 costs, Ofgem will assume the relevant pass-through costs are efficient
- Units costs for the LRE volume driver will be reviewed mid-period limiting company exposure
- Allowances for worst served customers will not be clawed back if funding is not used for the purpose for which it was intended

Short term beta

We have also previously outlined that the assessment of company risk is increasingly distorted by referring to short term betas that are based on the automated trading of grouped companies such as the FTSE[22].

The Financial Conduct Authority (FCA)'s Asset Management Market Study compared the performance of passive and active investing. It found:

- No correlation between prices and charges
- Increasing and accelerating prevalence of passive index funds
- Short-term movements in price driven by passive fund behaviour rather than fundamentals.

This suggests that measuring returns from short-term share price movements will not provide an accurate measure of risk. The CMA did not make comment on the substance of Citizens Advice proposals as they stated Ofgem placed

[22] Citizens Advice (2020) Ofgem consultation response on RIIO-2 Draft Determinations Finance Section p8

weight on long term betas. Where Ofgem places weight on short term betas then this evidence should be reflected.

FQ8. What are your views on the relative risk comparison shown in Table 10?

Currently Ofgem are factoring into its decision the likely characteristics of risk in the demands of the price control in reasons there may be higher risk:

- RoRE range is higher
- Higher Totex incentive rates
- Scale of investment

We accept a larger scale of investment is expected to be required in ED2 relative to other RIIO-2 controls. We do not accept that this increases risk. Rather, this will lead to significant, and necessary, growth of the regulated asset base. The incentive structure is also more high-powered in ED2, reflected in a wider RoRE range and higher efficiency sharing factors. This will simply enable the DNOs to outperform the cost of equity to a greater extent. There is uncertainty over the *degree* of outperformance, but not over the *expectation* of outperformance.

Network companies will seek arrangements that reward beating targets on the expectation they will be able to do so.

So, we disagree with increased investment opportunity and increased incentive opportunity within ED2 being used as arguments for increased systematic risk of a company that justifies a higher cost of capital. This would mean consumers funding rewards and also paying an additional cost to do so.

Due to the scale of the investment and the uncertainty over timing of investment in ED2, Ofgem have created numerous mechanisms that enable companies to make all investments and notably uncertain investments in a way that protects against risk. It is not credible that mechanisms such as the RAM, volume drivers, re-openers, pass-through mechanisms and indexations do not reduce systematic or non-diversifiable risk to which a company is exposed. However, the impact on the price control risk is not currently reflected when setting the equity beta in the cost of equity calculation.

FQ9. Do you have any evidence that suggests the beta for GD&T companies has materially changed since RIIO-GD&T2 Final Determinations in December 2020?

During the global financial crisis the utility share prices outperformed the market, highlighting the economic value that regulatory asset bases for energy networks represent[23].

Ofgem should be looking at how companies respond to periods of significant strong or weak market performance to reflect the cyclicality of companies to get a better picture of systematic risk. We encourage Ofgem to look closer at how share prices, MAR, investor expectations all provide indicative evidence that safe havens for capital such as regulated assets benefit are at times inversely related to wider market performance.

The MAR evidence from a number of transactions also demonstrates the real picture of the value in these assets and frequency and premium of transactions is indicative of increased perceived value and therefore lower risk.

Step 2 - implied cost of equity consultation questions

FQ10. Do you agree with our interpretation of the cross-check evidence?

Ofgem recognises that its cross-checks indicate that the cost of equity is too high. Given that this is to be expected given the inherent bias and generosity built into how cost of equity is calculated, Ofgem is required to act upon the cross-checks.

Ofgem states:

> *"In our view, cross-checks support values in the lower half of the CAPM range. However, for consistency with our decision in the RIIO-GD&T2 Final Determinations and because no cross-check is perfect, we do not propose to modify the cost of equity to reflect step 2 evidence"*[24]

The cross-checks appear to have been used primarily to check if the cost of equity is too low with Ofgem claiming that *'our cross-checks give us confidence that the CAPM results are not too low'*[25]. We see no evidence to give confidence that the

[23] Citizens Advice (2021) Citizens Advice Application for Permission to Intervene in Energy Licence Modification Appeal §120-121
[24] Ofgem (2022) RIIO-ED2 Draft Determinations – Finance Annex, p50
[25] ibid §3.84

CAPM results are not too high. It is not a sufficient reason to ignore cross-check evidence because it is not *'perfect'.* It is unclear when a cross-check would ever be acted upon if that is the test. Also, to remove a key aspect of the GD&T proposals (i.e. the performance wedge) and remain consistent with all other elements clearly will result in an overall settlement that is inconsistent and more generous than Ofgem's intentions with GD&T.

FQ11. Do you agree with our updated MAR and OFTO cross-check techniques, in terms of drawing better inferences for RIIO-ED2?

We support this approach.

FQ12. Do you agree with the cross-checks we have used and are there other cross-checks we should consider?

We believe the 'unadjusted' numbers are generally of limited use as they are not directly comparable to the ED2 cost of equity. We believe the cross-check generated by applying an equity beta of 0.9 to the investment managers TMR is upwardly biased as an equity beta of 0.9 is implausible.

We think that MAR evidence represents a key indicator of generosity to companies. We want to see cross-checks that show due consideration to the evidence of estimated risk of outperformance. Currently we think that this is missing and Ofgem is putting too much store by the indicators of past performance in differently defined price controls.

FQ13. Do you consider we should put greater weight on cross-checks or reconsider our CAPM parameters in light of the adjusted cross-check results?

We think Ofgem should reconsider the CAPM parameters. As outlined in FQ4 and FQ7, we have identified various issues that need to be addressed.

In any case, Ofgem should address the generosity provided within all the detailed decisions listed above in Tables 1 and 2. Given the evidence of the cross-checks and the inherent bias in the approach to setting cost of capital, there is no justification, when there is a range of possible values, for selecting values above the middle of any ranges or allowing estimates known (or suspected) to be generous.

Step 3 - allowed return on equity consultation questions

FQ14. Do you agree that we should not adjust for expected outperformance when setting baseline allowed returns on equity?

As set out in the introduction the CMA decision requires something to be done on outperformance. The CMA recognised alternative action was outside their remit and this puts an explicit onus on Ofgem, We do not think that Ofgem has taken the correct approach by not explicitly recognising the significant scope for outperformance in ED2. We expect Ofgem to provide a view on the level of outperformance risk and how this will be mitigated.

FQ15. Do you believe there is new evidence which would support an adjustment downwards (eg expected outperformance) or upwards (eg aiming up) that we have not yet considered?

See response to FQ14

Inflation and WACC consultation questions

FQ16. Do you think we should adjust our approach to allowed returns (noting our approach to expected inflation for WACC and outturn inflation for RAV as described above) so that outturn inflation does not permit the notional company to generate real equity returns that are materially higher or lower than our cost of equity allowance? What would be the consequences to consumers and DNOs of doing so?

We believe that current forecast inflation rates, and the degree of uncertainty around them, are beyond what could reasonably have been expected when the approach to allowed returns was being designed. We believe that Ofgem should adjust its approach. If Ofgem fails to do so, and network companies are able to earn a return on equity significantly inflated, then the legitimacy of the regulatory approach overall is likely to be brought into question.

We have previously indicated that there may be some extreme circumstances where it would be appropriate to consider notional company financeability constraints at the time that they arose, and that we consider it appropriate and proportionate that potential remedies be considered in those circumstances at the time rather than incorporating ex ante 'fixes' to a problem that we do not expect to materialise. For example, in the event that notional company financeability constraints were to arise following a period of very low inflation, it would be open to Ofgem to consider in its discretion what tools, if any, might be appropriate to respond to that distress. However, there is no similar protection in extremis for consumers in the event of high inflation.

FQ17. If you believe we should make such an adjustment, what is the best method for making it?

We accept that the current treatment of inflation is a long-standing and well understood aspect of price controls. This means that the adjustment to the approach needs to be well-designed and proportionate to avoid affecting the overall stability of the regime.

The ED2 framework already includes a returns adjustment mechanism. This is designed to protect consumers and companies against returns that vary from expectations to an extent that is not legitimate, without affecting the operation of the price control in other circumstances. We believe a returns adjustment mechanism should also apply to real equity returns arising from inflation.

We believe this is a proportionate approach that should be introduced across all the RIIO-2 price controls.

FQ18. If you don't believe we should make such an adjustment, how should we ensure that the fairness of the price control is maintained to prevent ex post returns from deviating from ex ante expectations for both consumers and investors?

No response provided.

Consultation questions on financeability

FQ19. Do you agree with our approach to assessing financeability?

We agree with Ofgem's approach to financeability.

FQ20. Do you have any evidence that would enable us to improve our calibration of stress test scenarios?

Ofgem is right to highlight '*that there is a difference between possible outcomes and probable outcomes*' when looking at RoRE ranges[26]. Ofgem needs to go further than this and produce probability-weighted RoRE ranges. The current range includes many elements that are not credible. For example, the maximum rewards and penalties for incentives schemes are included which are simply part of the scheme design and not representative of any expectation of performance. Also, efficiency incentives are assumed to be +/-10% where 10% overspends would be unprecedented. This is in addition to the generous decisions outlined above.

This, in turn, leads to an implausible downside performance scenario of up to 200bps. It also creates a false impression of the price control package that is generally unhelpful. Ofgem should present RoRE ranges based on P10 or P90 outcomes (i.e. '1-in-10' scenarios), using historical incentive performance data.

FQ21. Do you agree with the requirement to provide the Financial Resilience Report within 60 days?

No response provided.

Consultation questions on corporation tax

FQ22. Do you agree with our proposals to make allocation and allowance rates variable values in the RIIO-ED2 PCFM?

No response provided.

FQ23. Do you agree with the proposed additional protections? In particular:

No response provided.

[26] Ofgem (2022) RIIO-ED2 Draft Determinations – Finance Annex §3.109

FQ24. Do you have any views on a materiality threshold for the tax reconciliation?

No response provided.

FQ25. Do you think that the "deadband" used in RIIO-ED1 is an appropriate threshold to use? If not, what would be a more appropriate alternative?

No response provided.

FQ26. Do you have any views on our proposals relating to the Tax Trigger and Tax Clawback mechanisms? In particular, do you have any views on a proposed “glide path” for the notional gearing levels used in the tax clawback calculation?

No response provided.

Consultation question on Return Adjustment Mechanisms

FQ27. Do you agree with our proposals for the RAM thresholds and adjustment rates? Consultation question on indexation of the regulatory asset value (RAV)

We support the proposals for RAM thresholds.

FQ28. What are your views on the technical implementation of the switch to CPIH as set out in the attached PCFM? Consultation question on regulatory depreciation and economic asset lives

No response provided.

FQ29. Do you agree with our proposal to set depreciation policy on RAV additions in the RIIO-ED2 period to 45-years straight line, based on the average economic life of the assets?

No response provided.

Consultation question on capitalisation rates

FQ30. Do you agree with our proposal that we should set different capitalisation rates for ex ante allowances and re-openers and volume drivers?

We favour natural rates as it supports intergenerational fairness and an observable evidence basis for asset returns.

FQ31. Do you have any evidence that would enable us to improve our estimates of regulatory capitalisation rates?

No response provided.

Consultation question on RAV opening balances

FQ32. Do you have any views on the use of forecast RAV opening balances for the start of RIIO-ED2, which will be trued-up following RIIO-ED1 closeout?

No response provided.

Consultation question on transparency through RIIO-ED2 reporting

FQ33. Do you agree that additional corporate governance reporting described (including on executive director remuneration and dividend policies), will help to improve the legitimacy and transparency of a company's performance under the price control? If not, please outline your views in relation to the rationale provided for these additional requirements, including consumer protection.

We agree with the proposed additional corporate governance reporting, specifically the requirement for licensees to explain their approaches to dividends over the ED2 price control period.

Questions on consolidated reporting and calculation of allowed revenue

FQ34. What are your views on the proposed consolidation of the revenue RRP and PCFM, or applying a fully dynamic concept of allowed revenue?

The proposed consolidated reporting and approach to calculating allowed revenue increases transparency by ensuring all data is made public within one model. We believe this will simplify licence drafting and make the licence easier to read and use while providing consistency with the other regulated sectors.

Questions on licensee self-publication of allowed revenue

FQ35. What are your views on allowing licensees to self-publish the PCFM with their charging statements, rather than relying on an GEMA publication or direction to determine allowed revenue?

Assurance will be required to ensure the accuracy of PCFMs.

Questions on best vs reasonable endeavours in charge setting

FQ36. What are your views on having a best endeavours obligation for charge setting: "The licensee must, when setting Network Charges, use its best endeavours to ensure that Recovered Revenue equals Allowed Revenue"?

We support a best endeavours obligation for charge setting. As the proposed forecasting penalty mechanism still allows significant variation between forecasts and outturn, this needs to be adequately bolstered by an obligation.

Consultation questions on the appropriate time value of money

FQ37. What are your views on applying a single time value of money to all prior year adjustments, based on nominal WACC?

No response provided.

Question on forecasting

FQ38. What are your views on our proposed approach to using forecasts within RIIO-ED2?

We agree that reducing revenue volatility is useful and using forecasts should help to do this. We are concerned, however, that this could occur at the expense of predictability if DNO forecasts prove unreliable. We are not convinced that the revenue forecasting penalty mechanism is sufficiently tightly calibrated to manage this.

We believe that replacing incentive lags with forecasts will reduce predictability and are not convinced this is outweighed by the reduction in volatility.

Questions on forecasting penalty mechanism

FQ39. What are your views on the proposed charging penalty mechanism?

We support the charging penalty mechanism.

FQ40. What are your views on the proposed revenue forecasting penalty mechanism?

We believe that the 6% threshold is too generous as set out by Ofgem: "*Given that the average change even in year five is only 3.17%, a 6% threshold ought to be more than sufficient to cover routine forecast error. We also re-iterate that for exceptional events, we have proposed a waiver mechanism.*"[27]

Consultation question on incentive lags

FQ41. What are your views on removing lags from incentives?

We believe there are benefits in simplifying the licence algebra and making the entire revenue calculation consistent within the PCFM. However, we are concerned that this will make future costs harder for suppliers to forecast. This

[27] Ofgem (2022) RIIO-ED2 Draft Determinations – Finance Annex §10.162

is because suppliers now need to take a view on what forecast the DNO will choose, rather than having the certainty of lagged incentive value. This could lead to higher risk premia for consumers. We suggest Ofgem revisits the reasoning for introducing lagged incentives and review whether it still applies.

Consultation question on baselines for ODI incentive rates, caps, and collars

FQ42. What is your view on using RoRE as a general baseline for describing ODI caps, rather than base revenue?

We support this approach.

FQ43. What is your view on fixing the potential £m 20/21 value of incentives using one number for all years, based on a forecast of RIIO-ED2 at Final Determinations (an approach similar to RIIO-ED1)?

No response provided.

FQ44. What is your view on the method of calibrating incentive caps in RoRE terms, or the overall proposed incentive caps?

No response provided.

Consultation question on bad debts

FQ45. What are your views on our proposal to remove the Bad Debt terms from the pass-through licence condition? Consultation question on revenue profiling

We support this approach.

FQ46. Should GEMA allow proposals to re-allocate or re-profile revenue throughout the RIIO-ED2 period and what profiles could be considered in the customers' interest?

Proposals will need to considered on a case-by-case basis

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