



Making a positive difference  
for energy consumers

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Date: 31 December 2019

Dear Judith,

### **NATS En-route Limited (NERL) RP3 Price Control Determination**

On 6 December 2019, the CMA invited representations from third parties on areas which will help inform the Group's decision in the NATS En-route Limited (NERL) RP3 Price Determination. The CMA noted that some third parties had contacted them about issues where there might be a potential read-across to other cases. We write in response to that invitation.

As you may be aware, RIIO-2, our energy price controls, are due to come into effect on 1<sup>st</sup> April 2021 for transmission (electricity and gas) networks and gas distribution networks, and on 1<sup>st</sup> April 2023 for electricity distribution networks.

The CMA's decision in this case may have read-across for RIIO-2 as the Total Market Return (TMR) is not unique to the RP3 price control. We considered TMR arguments in detail within the RIIO-2 consultations and decisions, including in March 2018<sup>1</sup> and July 2018<sup>2</sup> (framework stage), and in December 2018<sup>3</sup> and May 2019<sup>4</sup> (sector-specific stage).

<sup>1</sup> See [pages 86 and 87 of the March 2018 consultation](#).

<sup>2</sup> See [pages 55 and 56 of the July 2018 decision](#).

<sup>3</sup> See [pages 24-31 and appendices 2 and 3 of the December 2018 consultation](#).

<sup>4</sup> See [pages 31-42 and appendix 2 of the May 2019 decision](#).

In July 2020, we anticipate we will consult on draft determinations for RIIO-2, before making final determinations around November 2020 – at both stages we expect to update our view on TMR, reflecting upon our final comment from May 2019 that the range we presented of 6.25% to 6.75% (CPIH real), “... is conservative in light of the range of available evidence.”<sup>5</sup>

NERL estimate, we understand, a difference of £212m<sup>6</sup> between its view and the CAA’s decision for all aspects of its case, but on TMR alone, should the CMA be persuaded by the NERA/NERL arguments, the potential impact of the CMA’s view could be far greater for energy consumers. For example, a TMR assumption of 7.5% CPIH real, 100bps greater than our current working assumption, bringing it into line with NERA’s estimate on behalf of NERL, would cost energy consumers approximately an extra £1.3bn over 5 years.<sup>7</sup>

### **Our analysis to date for RIIO-2**

In order to assist the CMA in its consideration and analysis in this case, we refer to our existing work in this area, as referenced in footnotes 1-4 above, particularly given that the submissions by NERA/NERL are similar (or largely identical) to those we have already considered during the RIIO-2 consultation process. See, in particular, appendix 2 of the May 2019 decision.<sup>8</sup> For example, we note that NERL focus on RPI measurement, however, any use of RPI should be considered carefully, given that, as the CMA will recognise, RPI has lost its official status and credibility. The NERA/NERL arguments also appear to imply that inflation measures are consistent over time – in the May 2019 decision, we provide strong evidence to show that this is not the case.<sup>9</sup>

Further, NERL focus on comparing the CAA’s decision with previous price controls. Our view is that contemporaneous information from the investment community should also be taken into account. In our RIIO-2 Sector Specific Methodology Decision in May 2019, we collated the best available evidence and compared this with our working assumptions, as set out below.

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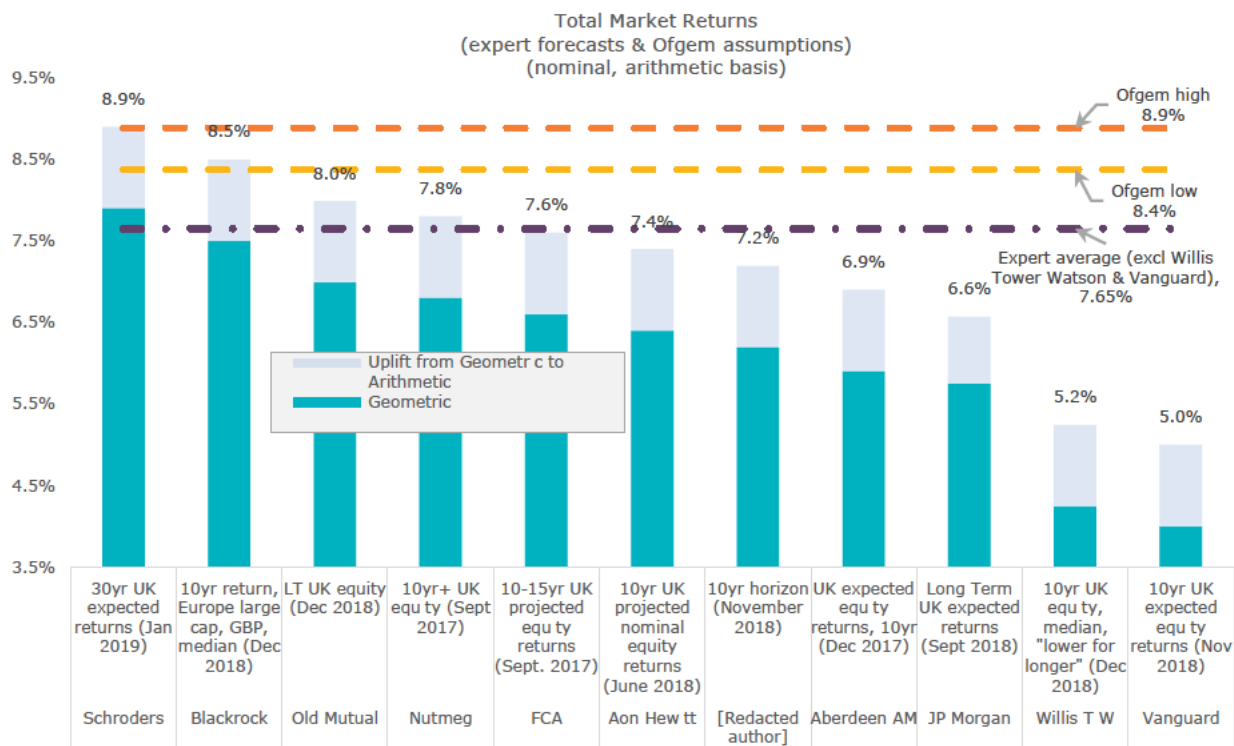
<sup>5</sup> *Ibid* at paragraph 3.104.

<sup>6</sup> NERL’s Statement of Case, [page 18](#).

<sup>7</sup> An increase from 6.5% CPI/CPIH real to 7.5% CPI/CPIH real would, given an equity beta assumption of 0.75, have a knock-on impact on the allowed return to equity of approximately 75bps. We estimate that each 10bps return on equity is worth £172m over the course of the 5-year energy price controls, and therefore the arguments by NERA/NERL potentially imply an increase in costs for energy consumers of approximately  $7.5 * £172m = £1.3bn$ .

<sup>8</sup> [Beginning on page 130 of the May 2019 decision](#).

<sup>9</sup> See [Figure 4 on page 36 of the May 2019 decision](#).



Similar to the CAA, we also take into account outturn averages, and overall, given these various sources of evidence, we arrived at a TMR of 6.5% (CPI/CPIH real) as a working assumption for RIIO-2. For further information and analysis, we refer you to our December 2018 consultation<sup>10</sup> and May 2019 decision.<sup>11</sup>

### Ongoing evidence emerging

This working assumption (6.5% CPI/CPIH real), whilst in line with the CAA's view, should not, however, be considered our final position for RIIO-2. We will, during 2020, consider this further and it is possible that we could set a TMR lower than our current working assumption of 6.5%.

In line with our approach to cross-checking TMR estimates (with, for example, dollar-based returns, Dividend Growth Model estimates and professional forecasts), we remain open-minded to new evidence, particularly that which helps us consider the difference between outturn averages and forward-looking estimates. In our view, it is crucial to consider both outturn averages and forward-looking estimates when considering the various arguments and sources of evidence. To assist the CMA, we refer to recent evidence<sup>12</sup>, which we are

<sup>10</sup> December 2018, RIIO-2 Sector Specific Methodology consultation, finance annex page 24 onwards: [https://www.ofgem.gov.uk/system/files/docs/2018/12/riio-2\\_finance\\_annex.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/12/riio-2_finance_annex.pdf)

<sup>11</sup> May 2019, RIIO-2 Sector Specific Methodology decision, finance annex page 31 onwards:

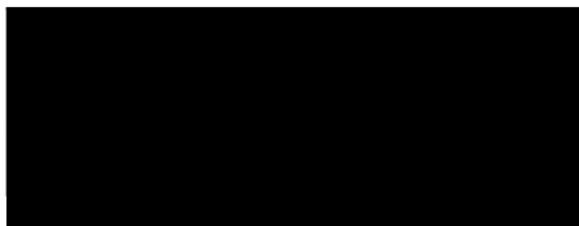
[https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2\\_sector\\_specific\\_methodology\\_decision\\_-\\_finance.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_finance.pdf)

<sup>12</sup> See SSRN, "Are Stock Returns Predictable? Rewarding Patient Investors & Powerful Binding Equilibriums" [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3507393](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3507393)

currently reviewing alongside its associated studies, in the expectation that it will aid the CMA's consideration of the matters put to it during this determination; this evidence may indicate that the CAA's decision in respect of TMR could, in fact, be too high.

We hope the above information is useful to the Group in its determination of this case. If we can be of any further assistance then please do not hesitate to contact me.

Yours sincerely,



Simon Wilde

**Senior Financial Advisor**