3rd Floor North
200 Aldersgate Street
London EC1A 4HD
Tel: 03000 231 231

citizensadvice.org.uk

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Judith Ross
NATS/CAA regulatory appeal
Competition and Markets Authority
The Cabot
25 Cabot Square
London E14 4QZ

Dear Judith,

NATS En-route Limited (NERL) Price Determination Provisional Findings

This response is completely non-confidential and may be published on your website.

Citizens Advice has statutory responsibilities for representing the interests of energy consumers in Great Britain (GB). We responded to the NATS En-route Limited (NERL) appeal because we consider that the decisions that the CMA make will set a relevant precedent for other sectors (such as water, telecoms and energy in particular, where we are the statutory advocate). Regulators in the UK have a history of referring to and learning from determinations in other price controls[1] (i.e. they are not entirely distinct decision making processes). As such, Ofgem will look to the outcome of this appeal to inform its own determination for the RIIO-2 price controls, as will other economic regulators which will directly impact outcomes for consumers of other essential services in GB.

We welcomed the CMA's provisional findings on the NERL appeal and we are pleased to be invited to comment. We have comments on the CMA's provisional findings relating to

[1] Indeed, the CAA clearly state (Document: CAP 1857, RP3 reference CAA document 002, p29) that in setting the WACC for RP3 they referred to recent consultations and determinations from other UK regulators, including Ofwat, Ofcom and Ofgem, as well as the cost of equity study by Professor Wright et al. for the UK Regulators Network (UKRN).

two specific aspects of the cost of capital that we focussed on in our submission to the appeal: the total market return (TMR) and the relative risk profile (equity beta).

In addition to the comments made in our submission the CMA has given their views on two further issues around gearing ratios relating to the equity beta and the risk free rate. We also offer some high level views on the impact of COVID-19 on the CMA's decision.

Total Market Return (TMR)

In our submission to the NERL appeal we gave views on two areas of TMR:

1. Long term historical returns data

We are encouraged by the CMA's views in this area and note that these are aligned with other GB regulators including Ofwat, Ofgem and the UKRN report on Cost of Capital. Two aspects in particular are changes that favour consumers. Firstly, the move to measure inflation in CPI-H rather than in RPI. This is much more reflective of the real costs that consumers and businesses face.   Secondly, we are encouraged by the focus on 10 year holding TMR periods that better reflect equity investors' historic intentions. Although overall we have reservations about the use of longer term historic data, we recognize that CMA's position does benefit consumers more than a more granular 1 year average view.

2. Forward looking forecast data

In our submission to the NERL appeal we observed that when assessing the CAA's final determination for the period 2020 to 2024, we thought the CMA to consider supplementing 10-year and 20-year trailing average outturn TMR data up to 2019 with a simulation of expected returns for years 2020-2024. Providing the CMA were mindful of any risks (including forecast errors) that this approach might introduce, this could be a useful way of combining outturn TMR data with various expectations of TMR for the next four years.

The CMA has set out its case for why it does not consider forward looking data to be as robust as historical data. However, it still remains that by using long term historic data, and not using forecasts, the CMA is effectively weighting market conditions in 1922 to a much greater extent than the views of equity investors making real decisions in today's markets. Given the significant impact shifts in the cost for consumer that can result from small changes in calculations of the cost of equity we would prefer regulators use the most relevant evidence possible to consider how they can include simulations of expected returns in future decisions.

Risk profile and beta

The CMA has argued that NERL is a business that is not a reasonable comparator to energy or water companies for estimating the equity beta - and that it would be better to compare NERL to other air travel sector businesses. Whilst we agree these are different types of company we stress our view that these regulated public utilities, including NERL, are in general lower risk businesses than the market average and it is in consumers' interests to adopt the lower end of beta estimates given the historic overestimation of cost of equity in previous price controls by GB regulators.

Levels of gearing and beta

We support the CMA's view to calculate the equity beta using a gearing ratio of 30% or lower, rather than de-gearing and regearing from the nominal rate. Our view is that this will result in betas closer to those which are directly observable in the market.

Risk Free Rate (RFR)

We support the CMA's view to use index linked gilt (ILG) rates to estimate RFR rather than nominal rates including a risk premium. We share the view that investors are already protected from interest risk and so do not need additional protection associated by deflated nominal gilt yields.

Impact of COVID-19

The long term impacts of COVID-19 are not clear, as we are currently still in the first few weeks of lockdown. Short term impacts are putting economic stress on all the economy, however recovery from the crisis may impact equity markets and interest rates. We have already seen that regulated monopolies such as utilities are seen as safe havens for investors in the current climate. This support arguments Citizens Advice have been making for some time that these businesses are less risky that regulators have consistently estimated over previous price controls, and it is in consumers' interests to redress this balance in future price controls. We look to GB regulators, including the CMA in its decision here, to ensure consumers are protected both from the short and long term effects of this crisis. We think this could be done by recognising the low risk nature of regulated monopolies to a greater extent when estimating equity betas, and/or (although we have reservations for using very long term data for calculating TMR) by using available economic precedents (such as the recovery from the 1918 Spanish Flu pandemic) to indicate how markets may respond, although we would caution using this data with significant caveats given the structural changes that have occurred since this time in global markets and in GB.

We hope that you find this response helpful and clear. Please contact me if you wish to discuss anything in this submission in more detail.

Yours sincerely

Stew Horne
Head of Energy Networks & Systems
Citizens Advice