

Sarah Fox
PR19 Regulatory Redeterminations
Competition and Markets Authority
The Cabot
25 Cabot Square
London E14 4QZ
(by email: waterdetermination2020@cma.gov.uk)

11 May 2020

Dear Ms Fox,

Ofwat Price Determinations – 2019 price review

- 1.1 Thank you for the opportunity to submit evidence in respect of the above redeterminations.
2. **ENA's interest as a third party**
 - 2.1 Energy Networks Association (**ENA**) is the voice of the networks, representing the 'wires and pipes' transmission and distribution network operators for gas and electricity in the UK and Ireland. Our members control and maintain the critical national infrastructure that delivers these vital services into homes and businesses.¹ ENA's overriding goals are to promote the UK and Ireland energy networks, ensuring our networks are the safest, most reliable, most efficient and sustainable in the world. The combined regulated asset value of our members totals £66 billion.
 - 2.2 ENA has a clear interest as a third party in the CMA's water sector price redeterminations. This is because the CMA's determinations are likely to have implications beyond the water companies and the water sector, and for the energy sector in particular.
 - 2.3 ENA's members are currently engaged in Ofgem's RIIO-2 price control processes. The price controls for gas and electricity transmission (RIIO-T2) and for gas distribution (RIIO-GD2) are due to commence in April 2021, while that for electricity distribution (RIIO-ED2) is due to commence in April 2023. Ofgem is expected to publish its final view on the price control allowances for RIIO-T2 and RIIO-GD2 by the end of 2020. A number of aspects of the CMA's determinations in the present process may well affect the approach of Ofgem, with subsequent scope for appeals to the CMA.
 - 2.4 An illustrative example of this is the cost of capital. While there are differences amongst the various regulated sectors and each regulatory decision must take

¹ This submission is on behalf of the following ENA members: Cadent, Electricity North West, National Grid, Northern Gas Networks, Northern Powergrid, Scottish & Southern Electricity Networks, SGN, SP Energy Networks, Wales & West Utilities, Western Power Distribution and UK Power Networks. More information on the ENA is available here: <http://www.energynetworks.org/>.

account of those, regulators have in the past placed weight on the findings of other sectoral regulators and the CMA when considering the cost of capital. It is reasonable to expect that economic regulators may be influenced by the approach taken by the CMA on cost of capital in determining the present references. The CMA's determinations in these references will also have an influence on investors' views of the "investability" of the UK regulated infrastructure industries.

2.5 Indeed, together with Ofwat, Ofgem and a number of other regulators (the CAA, ORR, Ofcom and NIAUR) have signed up to the UK Regulators Network (the **UKRN**) Cost of Capital Principles,² which require that the signatory regulators seek to adopt a consistent approach, voluntarily committing to learn from each other's approaches and explaining if they take a different approach to another UKRN member.

2.6 Participating UKRN members have committed to ongoing collaborative working on the cost of capital with, among other things, a Cost of Capital Working Group and support for comparisons of regulatory approaches within decision documents.³ In the UKRN's Cost of Capital Annual Update Report (September 2019), it stated:⁴

The UKRN's cost of capital network will continue to work closely together, bringing together experts from across our member regulators, ensuring that our work in this area is aligned where possible and sharing knowledge and best practice. We shall also be exploring how we can more effectively share resources, including through shared training programmes and exploring the potential for cross-regulator secondments.

2.7 The impact of such collaborative working can clearly be seen in the Ofwat's Final Determinations, which draw on and make reference to regulatory decisions by other UKRN members (including Ofgem, Ofcom and the CAA⁵).

2.8 Ofwat's Final Determinations also make reference to the 2018 UKRN Cost of Capital Study,⁶ which was jointly commissioned by the CAA, Ofgem, Ofcom and NIAUR (and representatives from other UKRN members, notably including Ofwat, were involved in its governance).⁷

² Available here: <https://www.ukrn.org.uk/wp-content/uploads/2018/11/2016MarCoC-Principles.pdf>.

³ See summary of the UKRN Cost of Capital Principles. Available here: <https://www.ukrn.org.uk/wp-content/uploads/2018/11/2016MarCoC-CollaborativeWorking.pdf>.

⁴ UKRN, *Cost of Capital – Annual Update Report*, September 2019, paragraph 5.2. Available here: <https://www.ukrn.org.uk/wp-content/uploads/2019/09/2019-UKRN-Annual-Cost-of-Capital-Report-Final-1.pdf>.

⁵ See, for example, p. 19, 22, 30, 37, 53, and 55 of Ofwat's *PR19 Final Determinations: Allowed return on capital technical appendix*, at <https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Allowed-return-on-capital-technical-appendix.pdf>.

⁶ For example this is referred to throughout Ofwat's *PR19 Final Determinations: Allowed return on capital technical appendix*, at <https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Allowed-return-on-capital-technical-appendix.pdf>.

⁷ See Wright, Burns, Mason and Pickford, *Estimating the cost of capital for implementation of price controls by UK Regulators*, 2018 (**UKRN Cost of Capital Study**). Available at: <https://www.ukrn.org.uk/wp-content/uploads/2018/06/2018-CoE-Study.pdf>. This is referred to throughout Ofwat's *PR19 Final Determinations: Allowed return on capital technical appendix*, at <https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Allowed-return-on-capital-technical-appendix.pdf>.

2.9 It is therefore clear that the CMA redetermination on the cost of capital in the PR19 references is likely to have implications beyond the water sector and, specifically, for the energy sector in the forthcoming RIIO-2 price controls.

3. **Aspects of redetermination where ENA intends to make representations to CMA**

3.1 ENA considers it can uniquely assist the CMA in the present redeterminations by efficiently and effectively providing submissions in a number of targeted areas from the perspective of its electricity and gas transmission and distribution network operator members.

3.2 Our submissions will focus on material issues and areas where ENA can provide evidence that the CMA should consider prior to making its Final Determination. We expect that some of our members may additionally submit evidence to the CMA on aspects of the water price control redeterminations not covered by ENA's submission.

3.3 We are working with economic consultants to produce analysis of matters which should have a direct bearing on the CMA's redeterminations. Accordingly, our submissions will include substantial, newly-commissioned work that has not been shared with the CMA as part of any previous redetermination process.

3.4 We recognise your desire for early submissions in May to help shape the scoping of the CMA's work on these redeterminations.

3.5 To assist the CMA in the scoping of its analysis phase, we thought it would be helpful to share details of the areas where, and when, we expect to submit evidence to the CMA.

3.6 First, we expect to submit substantial new evidence on or about 22nd May on the subject matters below. The CMA may wish to consider some or all of this evidence at a hearing later in May. ENA and its consultants would be happy to participate and support that hearing.

- Gearing impact on WACC, and consequences for Risk Free Rate
- Equity and debt betas
- Use of Market Asset Ratios (MARS) as a cross check on cost of equity and WACC

3.7 Secondly, we intend to make a further submission on 4th June, potentially including additional evidence on the subjects noted in 3.6, and also potentially evidence on additional areas. We are in the process of evaluating the extent to which energy networks have relevant evidence that could aid the CMA's redetermination for water companies but, to aid the CMA's forward planning, our further submission may include comment on topics such as:

- Cost of Debt
 - (A) halo effect
 - (B) additional costs of CPI indexation
 - Cost of equity
 - (A) Risk Free Rate
 - (B) Total Market Returns
 - (C) Aiming up for cost of equity
 - Real Price Effect allowances
 - Financeability assessment and overall price control package
 - Gearing outperformance mechanism
- 3.8 We have not yet had opportunity to fully review Ofwat's Reply to the appellants' statements of case, or any other documents published after 4th May 2020. It is possible that we may add further subjects to our submission on 4th June once we have reviewed those further documents.
- 3.9 We note that other aspects of the water companies' submissions and Ofwat's PR19 Determinations highlight aspects of Ofwat's approach that are not consistent with regulatory best practice. Accordingly, ENA may wish to comment on such additional issues at an appropriate time during the redetermination process.
- 3.10 I confirm that this letter does not contain any confidential information, and that we are content for it to be published in full on the CMA's case page.
- 3.11 We should be grateful if you could acknowledge receipt of this letter.

Yours sincerely,



David Smith
Chief Executive