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[redacted]

26 October 2020

Dear Ms Fox

**Ofwat Price Redeterminations – Provisional Findings**

Thank you for the opportunity to comment on the CMA's Provisional Findings (**PFs**) in relation to the above redeterminations.

This is a single combined response on behalf of National Grid (**NG**) – which covers National Grid Electricity Transmission plc (**NGET**) and National Grid Gas plc (**NGGT**), who together manage a regulated asset value of nearly £20bn.

As you know, the CMA's redeterminations in this matter will set a precedent to which sector regulators will refer when reaching their own decisions, including Ofgem in the imminent RIIO-2 price controls. They will therefore have cross-sectoral importance in the UK.

Mindful of the CMA's administrative timetable, NG has focused its comments on high-level principles with respect to the estimate of the cost of capital, as this is also an issue of significant focus in the ongoing RIIO-2 process. These comments are detailed in the attached Appendix, but can be summarised briefly here as follows:

- We consider that the CMA's PFs set a better balance between water companies' ability to finance investment to help ensure climate change resilience and reducing customer bills relative to PR14.
- We welcome the CMA's further reinforcement that Ofwat's primary statutory duties of financing water companies and protecting the interests of consumers are each of equal importance and intended to complement one another.
- We consider that the CMA's updated WACC range and decision to 'aim up' better reflect the range of evidence, however further adjustments are required in order to fully reflect market evidence.

In drafting these comments, NG has sought not to duplicate detailed evidence that has been submitted on NG's behalf as part of the Energy Networks' Association (**ENA**) response to the CMA.  Rather, we include cross-references to that evidence where relevant.

I confirm that this submission, including the accompanying Appendix, does not contain any confidential information, and that we are content for it to be published in full on the CMA's case page.

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We should be grateful if you could acknowledge receipt of this submission.

Yours sincerely,

[redacted]

Chris Bennett,

Director of UK Regulation

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## Appendix

## Ofwat Price Redeterminations:
## National Grid's Response to CMA's Provisional Findings

**1 We consider that the CMA's Provisional Findings set a better balance between water companies' ability to finance investment to help ensure climate change resilience and reducing customer bills relative to PR14.**

1.1 Efficiently funding infrastructure investments will be critical over the PR19 period given the twin challenges of meeting the UK's climate change goals and rebuilding the economic damage from the COVID-19 pandemic.

1.2 The Committee on Climate Change progress report in June 2020 makes clear that *"'action taken in this Parliament will define the pathway towards Net Zero and climate change resilience."*[1]. It also links Net Zero investment with the UK's ability *"to rebuild from the COVID-19 pandemic and its economic damage".* It is therefore essential to ensure the UK can manage and mitigate the impacts of climate change and that water networks are appropriately funded to play their part.

1.3 We note that the PR19 price control is expected to fund just under £50bn of total investment. A similar, but potentially greater, level of investment will also be required in the energy sector during the RIIO-2 period to maintain resilience and put the UK on a pathway to deliver Net Zero ambitions. This is a significant level of investment that will require private sector backing over the next five years and across the lifetime of the assets. To ensure efficient delivery and lowest cost to consumers over the medium to long term, regulated companies must be able to attract and retain investors to fund the infrastructure.

1.4 Regulatory stability and an appropriate return are important facets of maintaining investor confidence in the sector. That is not to say regulatory frameworks and return have to remain the same across multiple price controls; but any changes need to be appropriately justified and their impacts assessed.

1.5 In its Provisional Findings (**PFs**), the CMA has, in our opinion, improved regulatory stability and set a more appropriate return for the water sector. This will in turn improve investor confidence in that sector.

1.6 We were concerned by the introduction of the Gearing Outperformance Sharing Mechanism in the PR19 framework. We considered that it reached through the regulatory ringfence and was unnecessary. Its removal in the CMA's PFs is therefore welcomed.

1.7 We also agree with the CMA that the PR19 weighted average cost of capital (**WACC**) determined by Ofwat was too low and consider that by increasing the WACC from 2.96% to 3.5% the CMA has better represented the available market evidence.

1.8 We were also concerned by Ofwat's use of pay as you go ratios to accelerate revenue to meet financeability ratios. We agree with the CMA that *"The WACC is the main driver of expected financial ratios. There is a legitimate concern that, if the WACC is set too*

[1] Committee on Climate Change, 'Reducing UK emissions: Progress Report to Parliament', 25 June 2020 (available at https://www.theccc.org.uk/publication/reducing-uk-emissions-2020-progress-report-to-parliament/).

*low, notionally geared companies would not be able to retain strong investment grade credit ratings.".*[2]

1.9 In increasing the WACC relative to Ofwat's Final Determinations (**FDs**), the CMA has improved the ability of water companies to attract and retain investment whilst also reducing the customer bill relative to PR14. The WACC increases will mean customer bills in PR19 will be higher than in Ofwat's FDs, but the improved predictability and stability of the CMA's proposals will benefit consumers through lower future bills. We note that there remains a 1.5% reduction in the cost of equity between PR14 and PR19 which contributes to a customer bill reduction of over 9%.

## 2 We welcome the CMA's further reinforcement that Ofwat's primary statutory duties of financing water companies and protecting the interests of consumers are each of equal importance and intended to complement one another.

2.1 Over the last few years, we think there has been undue regulatory focus on the short-term costs to current consumers at the expense of efficiently funding networks over the longer term. Whilst costs to consumers are obviously important, they must be considered over the life of the (necessarily long term) assets. We are pleased to note that the CMA's PFs reaffirm that Ofwat's primary statutory duties - including financing water companies and protecting the interests of consumers – are each of equal importance and intended to complement one another[3].

2.2 We agree that there have been economic and market movements that should be reflected in the next regulatory settlements. For example, interest rates have dropped which need to be reflected in lower risk-free rates. However, we are concerned that, recently, regulators tend always to see a conflict between investor and consumer interests, rather than that those two stakeholders can and do have complementary interests if price controls are appropriately calibrated and incentivised.

2.3 It is important to current and future consumers' interests that long-term investor confidence in the sector is maintained. This is in line with Ofwat's primary statutory duty to protect the interests of consumers and will result in lower costs.

2.4 It is also true that consumers are concerned about more than just short-term costs. As part of our own business planning process for RIIO-2, we undertook extensive engagement with consumers and found that maintaining the reliability and resilience of our networks was their top priority.

2.5 In September 2020, we subsequently tested whether COVID-19 had changed consumers' priorities and found that views have remained the same. In fact, 76% of consumers favoured more investment over cutting spending when we commissioned independent experts to ask a representative sample of 4,018 consumers in August 2020. This remained the case for consumers in weaker financial positions and those who had been more economically impacted by COVID-19.

2.6 We therefore agree with the CMA that Ofwat's primary statutory duties should not be applied in isolation, and that is a question of "balancing" duties of equal importance[4].

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[3] CMA PR19 Provisional Findings, September 2020, at paragraph 2.67.
[4] Ibid., at paragraphs 2-67-2.68.

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## 3 We consider that the CMA's updated WACC range and decision to 'aim up' better reflect the range of evidence, however further adjustments are required in order to fully reflect market evidence.

3.1 We agree with the CMA's decision to 'aim up' within its cost of equity range, and consider that the use of a broader range of evidence has improved its estimation of the cost of capital.

3.2 However, in our view, adjustments are required to fully reflect the market evidence. For example, we consider that:

(a) the CMA has given too little weight to highly credible evidence that the Total Market Return (**TMR**) could be above its 6.20% to 7.21% range; and

(b) the CMA has also applied too great a weight to evidence from unadjusted government bond yields in setting the lower bound of its -1.40% to -0.81% risk-free rate (**RFR**) range.

Beta estimation

3.3 We note that the CMA has included 2-year, 5-year and 10-year beta estimates using daily, weekly and monthly sampling methodologies and a range of averaging periods (spot betas as well as averaging periods of 1, 2 and 5 years) in its review of beta estimates.

3.4 We agree that this approach is likely to lead to a more robust beta estimate than Ofwat's focus on a narrower evidence base.

3.5 We also agree with the CMA's approach to identifying and excluding outliers which has the effect of placing less weight on older beta estimates that include the impact of the global financial crises.

Estimation of embedded debt costs

3.6 We agree with the CMA's approach of using a benchmark index to set the cost of debt for the notional company. This approach minimises the impact of company specific issues by looking at a large pool of similar bonds.

3.7 The use of a benchmark index ensures that companies are responsible for any costs which arise from differences between their own borrowing profile and capital structure and the assumed typical profile and structure, and so protects consumers from the individual financing decisions that companies have taken. It also ensures customers do not pay more than necessary if the costs of debt that are typically observed in the financial markets fall during the price control period as they have during the PR14 period, whilst supporting the financeability of network companies if the cost of debt rises.

3.8 We also agree with the CMA that *"the use of shorter lookbacks could provide an inappropriate signal to companies that the regulator is encouraging them to shorten the tenor of their debt in order to reduce costs, potentially trading lower short-term costs for increased financing risk".*[5]

[5] CMA PR19 Provisional Findings, September 2020, paragraph 9.357.

TMR estimation

3.9 We consider that the CMA's real TMR range is artificially skewed downwards by the cumulative effect of errors in four aspects of the CMA's PFs:

(a) errors in deflating nominal TMR, including giving too much weight to the 1950-1996 CPI data series and ignoring the top half of the CED/RPI distribution;

(b) errors in averaging historical values, including misinterpreting the submission by Professor Shaefer;

(c) incorrectly dismissing the Bank of England's dividend discount model and survey evidence, both of which show that the range should be higher, whilst simultaneously placing weight on other (out of date) forward-looking evidence; and

(d) failing to consider evidence regarding historical TMR data sources being artificially reduced and biased downwards.

3.10 The cumulative effect of these errors is a real TMR range that is materially too low (that is, both the bottom and the top of the range are materially too low), resulting in a cost of equity that is too low.

3.11 The Energy Networks' Association (**ENA**) response to the CMA, submitted on behalf of NG and other energy networks, provides a detailed explanation of these errors.

RFR estimation

3.12 We consider that the CMA is correct to propose a substantial revision to Ofwat's RFR, as the latter is demonstrably too low. However, we think that the CMA makes two errors in its provisional determination of the RFR range:

(a) the incorrect use of unadjusted government bond yields for the bottom end of the range; and

(b) the unjustified decision not to apply a forward rate uplift to spot yields.

3.13 These errors artificially skew the CMA's RFR range downwards, and therefore incorrectly reduce the CMA's proposed cost of equity.

'Aiming up'

3.14 We welcome the CMA's decision to 'aim up' within its cost of equity range. We agree that a policy of 'aiming up' is in the best interests of consumers and *"[t]here are well-established arguments that underinvestment caused by a cost of capital being set too low damages the overall welfare of consumers (and potentially the wider economy) materially more than the welfare lost through bills that may be slightly too high."*.[6]

3.15 We also agree with the CMA that the ability to attract debt and equity investors is fundamentally aligned with consumer interests. Significant consumer harm comes from failure to invest if companies are unable to attract sufficient investment. Conversely, the

[6] CMA PR19 Provisional Findings, September 2020, paragraph 9.667.

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cost to water customers of the CMA's decision to 'aim up' is only 0.5% of the customer bill[7].

3.16 We further agree with the CMA that "*there may be benefits to consistency – including ensuring investor confidence in the sector*"[8] in 'aiming up' over multiple price controls and that a decision to 'aim straight' or 'aim down' could have long term consequences with regard to investor confidence in the sector.

3.17 It is possible to model the optimal level of 'aiming up' that is required to avoid consumer detriment. We have previously submitted evidence[9], though the ENA, setting out such approaches. These models support higher levels of 'aiming up' than the CMA adopted in its PFs, with 75% being the minimum that would be expected to take account of the need to promote investment, i.e. before any asymmetry in the price control or financeability concerns are taken into account in further uplifts. Detailed supporting arguments and evidence are provided in the ENA's submission to the CMA.

[7] CMA PR19 Provisional Findings, September 2020, paragraph 9.679.
[8] CMA PR19 Provisional Findings, September 2020, paragraph 9.668.
[9] See, e.g., section 4 of ENA's June 2020 submission to the CMA, and the report of Frontier Economics referred to therein, included as Annex 6 to ENA's submission.