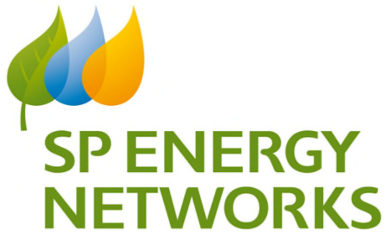

Network Planning & Regulation
Date
26th October 2020
Contact / Extension
Scott Mathieson
0141 614 1581

Sarah Fox
PR19 Regulatory Redeterminations
Competition and Markets Authority
The Cabot 25 Cabot Square
London E14 4QZ

Dear Ms Fox,

Ofwat Price Determinations – PR19

SP Energy Networks (SPEN), welcome the opportunity to respond to the CMA's Provisional Findings into the redetermination of the 2020-25 price controls for Anglian Water, Bristol Water, Northumbrian Water and Yorkshire Water. SPEN comprises two distribution licensees, SP Distribution plc and SP Manweb plc, and a transmission licensee, SP Transmission plc. These licensees own and operate the electricity distribution and transmission networks in the Central Belt and South of Scotland (SP Distribution & SP Transmission), as well as the distribution network in Merseyside and North Wales (SP Manweb).

SPEN is part of the Iberdrola Group, one of the largest utility companies in the world and a leader in promoting the UN Sustainable Development Goals. Iberdrola is a global investor, engaging in activities in many countries, including Spain, the UK, the US, Brazil, Mexico, and others. Iberdrola is supporting these countries' decarbonisation ambitions and their transition to becoming carbon neutral economies. In order to achieve this and to facilitate the transition to Net Zero and the Green Recovery, Iberdrola plans to invest at record levels in the coming years, carrying out €10 billion (£9.8 billion) worth of investments in 2020, up from an annual average of €5-6 billion in previous years. These investments will also make a direct contribution to economic activity in the UK. In December 2019, we submitted our RIIO-T2 Transmission Price Control Business Plan to Ofgem for 2021-2026. Within our submission, we have allowed for a 6.5% (CPIH, real) return on equity in line with our investors' expectations.

In regard to the cost of capital, the CMA's provisional findings represent a cogent approach and recognise what is ultimately fair and reasonable to current and future customers. The CMA's principle of "aiming up" in relation to the cost of capital is of significance in order to secure a rate of return that is reasonable and promotes adequate investment in the regulated sectors, which, in turn, will directly benefit both existing and future customers. It is important to be clear that the principle of aiming up is *not* to deliberately over-remunerate the relevant companies, but to maximise the overall welfare of consumers, an objective that is not controversial. In the absence of certainty around the required rate of return, the allowed return needs to match (or exceed) the expected required return for investment to be viable. However, due to the high level of uncertainty in estimating the allowed return, in particular the cost of equity, there is no guarantee that the midpoint of a reasonably judged range would turn out to be the right level to satisfy the expected required return for investment.

As the CMA explains, setting the cost of capital too low would have an adverse effect on the sector's longer-term attractiveness to investors and ultimately result in an exit of capital from the sector.[1] This, in turn, would create material consumer detriment from underinvestment, for example leading to the worsening of the operational performance of assets and constraining innovation that could lead to the adoption of new and efficient technologies, services and business practices. Iberdrola's investors assess the available rates of returns globally, therefore, it is inevitable that countries which offer the fairest rates of return and the most regulatory certainty, will be favoured. This is a clear example of capital allocation and is the reality that we, and other utilities face. The CMA correctly recognises that investor capital is not unlimited.

Ensuring and promoting investment in the UK regulated sectors has also become increasingly crucial in the current climate due to the scale of investment required to support the country's decarbonisation ambitions, as well as being a vital policy measure in the context of the post COVID-19 economic green recovery package.

A failure to aim up risks reducing the attractiveness of potential projects to investors, beyond those deemed as core, which might otherwise unlock significant customer and wider societal benefits. Investors do not have infinite balance sheet capacity to invest, and faced with a limited set of viable projects, can only be expected to choose to pursue those projects which offer the best return – which may be outside the UK.

The short-term benefit to consumers from the reduction in the level of bills from a lower allowed return on capital is more than offset by the significant welfare loss from underinvestment and the medium- to long-term deterioration in investor confidence in the sector.

Given the adverse consequences to overall societal welfare arising from a failure to invest, aiming up is the correct regulatory response to the uncertainty inherent in estimating the cost of equity and the asymmetry of the consequences arising from setting the allowed return too high or too low. The purpose therefore of aiming up is not to systematically over-remunerate the relevant regulated business (or its shareholders), but to minimise the expected losses to society from underestimating the regulated business's true cost of capital, given the asymmetric risks associated with failure to invest. It is important to appreciate that this is a real issue which could lead to underinvestment in GB's essential regulated sectors rather than a theoretical debate.

We also agree with the CMA's provisional position in taking potential asymmetries in the broader price control settlement as well as company financeability into account in its consideration of whether to aim up on the cost of capital. The CMA correctly recognise that a package of penalty-only and asymmetric ODIs, (with which we disagree with in principle), exposes companies and their investors to asymmetric risk, which could drive the expected return for an investor below the required cost of capital.

The CMA also recognises that the use of a performance wedge within the cost of debt

[1] CMA (September 2020), 'Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations - Provisional findings', para 9.667

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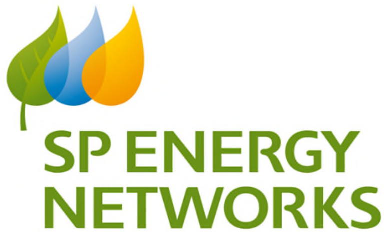
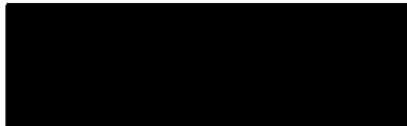
SP Distribution plc, Registered Office: SP House, 320 St Vincent Street, Glasgow, G2 5AD Registered in Scotland No. 189125 Vat No. GB 659 3720 08



risks encouraging companies to shorten the tenor of their debt, which may not be in the best interests of customers over the long-term. As a general point we believe that the premise of arbitrary adjustments must be avoided. We agree with the CMA that such a performance wedge may create perverse incentives.

Overall therefore SPEN supports the CMA's provisional findings in relation to the principle of "aiming up" on the cost of capital. This is even more crucial than ever to ensure UK regulated companies can support the achievement of Net Zero and facilitate a Green Recovery. It is therefore essential, that in setting the cost of capital, regulators place significant weight on the risks of underinvestment that can arise from setting it too low as has been recognised by the CMA.

Yours sincerely,



Scott Mathieson
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