Network Planning & Regulation

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Sent by E-mail to
waterdetermination2020@cma.gov.uk

Your ref

Our Ref

Date
27/01/2021

Contact / Extension
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Scott Mathieson

Dear Ms Fox,

Ofwat Price Determinations – Response to 'Choosing a Point Estimate for the Cost of Capital - Working Paper'

SP Energy Networks (SPEN) welcomes the opportunity to respond to the CMA's consultation on its working paper on choosing a point estimate for the cost of capital as part of its redeterminations of the 2020-25 price controls for Anglian Water, Bristol Water, Northumbrian Water and Yorkshire Water (CMA's Cost of Capital Working Paper). 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 previously submitted a response, dated 26 October 2020, to the CMA in respect of these redeterminations following publication of the CMA's Provisional Findings on 29 September 2020 (SPEN's PF Response). We hope that the CMA will take into account SPEN's PF Response and this response on the CMA's Cost of Capital Working Paper when reaching its final decision.

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.

SPEN supports the CMA's continued view that it is important to "aim up" in relation to the mid-point of the cost of equity range. As the CMA recognises, the principle of aiming up on the allowed return has been supported by regulators in the past in order to secure rates of return, which promote and ensure adequate investment in the regulated sectors.

The CMA correctly acknowledge that retaining a consistent approach to setting the allowed return across regulatory decisions will help support a long-term investment environment in the regulated sectors (see paras 103(a) and 105 of the Cost of Capital Working Paper). This in turn will ensure continued investment in vital sectors and support a long-term low cost of capital, which will directly benefit both existing and future customers.

The CMA are also correct to acknowledge that there are long-term adverse risks from setting the cost of capital *too* low, with a risk of a withdrawal of capital over time. A lack of sufficient financial incentives or available finance would create material consumer detriment from future under-investment, with companies unwilling to commit resources to design and identify additional desirable capital projects, which might otherwise unlock significant customer and wider societal benefits. This deterrence to commit to investment exists not only in the short-term, but also over the long-term through companies' long-term investment planning proposals. The lack of incentives to invest would also serve to restrict companies' innovation ambitions, despite those ambitions potentially leading to the adoption of new and efficient technologies, services and business practices which would benefit existing and future customers.

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. Whilst we note the CMA's criticism of the international returns comparators provided by Ofgem and Ofwat as a cross-check for the allowed return (noting that the returns were not set on a like-for-like basis and higher returns comparators were excluded from the list), there needs to be acknowledgement of the regulatory returns made available elsewhere. 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.

Overall, we agree with the CMA's view that a low cost of capital over multiple periods risks leading to an exit of capital from the sector by long-term investors, which would lead to a gradual reduction in new investment, with limited growth in the asset base over time. This risk of a reduction in investment sits entirely at odds with the need to ensure a desirable level of investment in the UK regulated sectors at a time when significant investment is 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.

SPEN agrees with the CMA that there is substantial uncertainty over the true level of the required cost of capital. Given the inherent uncertainty in the parameters, aiming up is the correct regulatory response so as to minimise the adverse societal welfare consequences arising from setting the cost of capital too low. In the face of this uncertainty, the CMA have suggested an aiming up level of 25bps above the mid-point in its working paper – a downwards revision from the 50bps suggested in the PFs. Based on its Monte Carlo modelling, the CMA suggest that a 25bps uplift approximates to the 80th percentile in the cost of equity estimation.

However, evidence from other models which calibrate the appropriate level of aiming up supports an optimal allowed return above the 90th percentile, especially for sectors with low levels of elasticity of demand such as water and energy.[1] This suggests that the CMA should aim up to a higher level than it has suggested in its working paper. A higher level of aiming up is justified in order to secure the level of allowed return that will lead to the optimal level of investment in the sector. This is even more crucial given the expected level of investment required to adequately address the futures challenges from climate change and the transition to net zero.

We reiterate the position we set out in SPEN's PFs Response that the purpose of aiming up on the cost of capital 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.

[1] See: Oxera (April 2020), "Is aiming up on the WACC beneficial to consumers? Prepared for Heathrow Airport Limited" and Frontier Economics (March 2019), "Adjusting Baseline Returns for Anticipated Outperformance: An assessment of Ofgem's proposals", section 2.3.

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We also agree with the CMA's position of taking into consideration potential asymmetries in the broader price control settlement as well as company financeability when considering adjustments to the scale of aiming 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. Aiming up is therefore also justified in order to account for asymmetry in the price control package.

Yours sincerely,

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