

**BEFORE THE COMPETITION AND MARKETS AUTHORITY
AN APPEAL UNDER SECTION 11C OF THE ELECTRICITY ACT 1989**

BETWEEN

Scottish Hydro Electric Transmission plc

(trading as SSEN Transmission)

(Appellant)

and

Gas and Electricity Markets Authority

(Respondent)

APPELLANT'S PR19 SUBMISSION

23 April 2021



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Defined terms and abbreviations

Abbreviations and capitalised terms used but not defined in this Reply have the meaning given in the Appellant’s Notice of Appeal filed with the CMA on 3 March 2021.

Section 1: The CMA's PR19 Final Determination fully supports SSEN Transmission's Notice of Appeal

Introduction

- 1.1 This submission (the ***PR19 Submission***) is made on behalf of Scottish Hydro Electric Transmission plc, trading as Scottish and Southern Electricity Networks Transmission (***SSEN Transmission*** or ***the Appellant***), following the publication of the CMA's PR19 Final Determination.
- 1.2 When the Appellant's Notice of Appeal was submitted on 3 March 2021, the CMA's PR19 Provisional Findings dated 29 September 2020 and January 2021 Working Papers were both publicly available and were referred to in the Notice of Appeal and supporting expert witness statements. However, at that date, the CMA had not yet made, or published, a final determination in respect of the issues raised in the Notice of Appeal. The CMA's PR19 Final Determination, dated 17 March 2021, was published in full on 9 April 2021.¹
- 1.3 Relevant portions of the CMA's PR19 Provisional Findings were referred to in the Notice of Appeal as support for Ground 1 (Cost of Equity) and Ground 2 (Outperformance Adjustment), in particular as evidence supporting the conclusion that GEMA had made multiple errors in its estimation of the WACC. The Notice of Appeal submitted that the CMA's PR19 Provisional Findings, which were available to GEMA prior to the RIIO-2 Final Determinations dated 8 December 2020, contained statements of relevant principles applicable to GEMA's decision on Cost of Equity which were disregarded in GEMA's decision. The CMA's PR19 Final Determination confirms the Appellant's position in the Notice of Appeal that GEMA's Cost of Equity estimate was wrong.
- 1.4 This Submission, which is accompanied by an annex prepared by SSEN Transmission's expert economists (**Annex 1**), sets out:
 - (a) in Section A, the confirmations and updates arising from the CMA's PR19 Final Determination relevant to the references made to the CMA's PR19 Provisional Findings or the January 2021 Working Papers in the Appellant's Notice of Appeal, which confirm SSEN Transmission's submissions in the Notice of Appeal; and
 - (b) in Section B, the new supporting statements and evidence in the CMA's PR19 Final Determination which are relevant to, and supportive of, the Appellant's Notice of Appeal which were not available in the CMA's PR19 Provisional Findings.
- 1.5 Overall, the CMA's PR19 Final Determination demonstrates that GEMA's decision on Cost of Equity is untenable in the light of the CMA's findings, which have increased the extent to which GEMA's Cost of Equity estimate diverges from the figure that it should have arrived at. In the light of the CMA's PR19 Final Determination, the Appellant maintains each of its Grounds of Appeal and claims for relief in the Notice of Appeal.

A. The CMA's PR19 Final Determination confirms the Appellant's position on the errors made by GEMA

¹ The PR19 Final Determination is annexed to this submission as **Annex 2**.

- 1.6 As explained in Annex 1 Table A, the CMA’s PR19 Final Determination confirms the Appellant’s position in the Notice of Appeal on the errors made by GEMA in setting the cost of equity and has supplemented the CMA’s PR19 Provisional Findings with additional commentary and findings which are supportive of the Appellant’s position. In summary, these points include:
- (a) *RFR*: The CMA has expressly confirmed SSEN Transmission’s submission that the appropriate RFR is likely to sit above the ILG yield and that evidence relating to AAA-rated corporate bonds is relevant evidence for setting the RFR for regulated utilities.² As submitted in the Notice of Appeal,³ the CMA’s PR19 Final Determination confirms that GEMA was wrong to rely solely on ILG evidence and to disregard evidence from corporate bonds in setting the RFR.
 - (b) *TMR (inflation)*: The CMA has expressly confirmed that evidence relating to the RPI measure of inflation is relevant and should be taken into account when setting the TMR.⁴ Furthermore, the CMA has provided further detail in its PR19 Final Determination which confirms the Appellant’s submission that GEMA was incorrect to seek to justify its decision to exclude RPI evidence on the basis of the CMA NATS redetermination, which was taken in unusual circumstances following the emergence of the pandemic and related to a business with very different characteristics to electricity networks. Consistent with the Appellant’s position in the Notice of Appeal,⁵ the CMA’s PR19 Final Determination contains express new wording reinforcing the submission that GEMA was incorrect to seek to support its decision in reliance on the NATS determination: “*the particular circumstances of the NATS/CAA appeal meant that evidence submitted received no further consideration following the publication of the provisional findings. As a result, conclusions reached in the provisional findings should not be considered as the definitive view of the CMA at the time.*”⁶
 - (c) *Beta*: The Appellant submitted in Ground 1C of its Notice of Appeal that GEMA wrongly relied on water companies to estimate the beta of electricity companies. The difference in the risk profiles that exists between energy and water was supported by the CMA in its January 2021 Working Papers where it recognised that “[t]he risks associated with water are different to energy, and there is no direct comparator to the cost of ‘blackouts’”.⁷ The CMA has maintained this position by repeating this statement in its PR19 Final Determination.⁸
 - (d) *Aiming up*: The Appellant submitted in Ground 1D of its Notice of Appeal that GEMA was wrong to disregard the widely accepted regulatory principle that economic regulators should “aim up” in setting the cost of equity in order to avoid the risks of underinvestment and ensure consumers’ interests (both present and future) are protected;⁹ the need to aim up was supported by the CMA’s PR19

² CMA Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final Report, 17 March (*CMA Final Report*), 9.241, 9.264.

³ Notice of Appeal, Ground 1A.

⁴ CMA Final Report, para 9.295-96.

⁵ Notice of Appeal, para 4.39.

⁶ Footnote, 2252, also see para 9.60 et seq.

⁷ CMA, PR19 January 2021 Working Papers – Point Estimate, **NOA / PH-1 / Tab 49 / Para 47**.

⁸ CMA Final Report, para 9.1274.

⁹ Notice of Appeal, para 4.92.

Provisional Findings and the January 2021 Working Papers.¹⁰ In the CMA's PR19 Final Determination, the CMA has maintained its view on aiming up set out in its January 2021 Working Papers and has decided that its statutory duties required it to aim up by 25bps above the mid-point in the CMA's cost of equity range in order to:

- (i) promote investment, and specifically to address the risk of an exit of capital from the sector;
- (ii) address asymmetry of risk in the package of ODIs;
- (iii) allow for the scale of parameter uncertainty in estimating the Cost of Equity (i.e. uncertainty in the values of the parameters used to estimate the Cost of Equity, which are subject to theoretical debate and statistical uncertainty) particularly in the context of a material reduction in the Cost of Equity;¹¹ and
- (iv) take into account relevant cross-checks, including financeability, by using credit ratios to assess whether the Cost of Equity is of a level that is broadly consistent with the high-quality credit ratings required by the regulator.¹²

These factors all reinforce the Appellant's submission in the Notice of Appeal that GEMA's decision not to aim up was wrong, especially given the significant reduction in Cost of Equity since RIIO-T1,¹³ the need to properly take into account the significant investment necessary in the RIIO-T2 period to meet Net Zero objectives and energy-specific risk factors which characterise the sector as more risky than the water industry.¹⁴ Furthermore, in relation to the portion of its 25bp aiming up which the CMA assigns to account for asymmetry in expected returns, we note that energy also has asymmetry in expected returns and should also be subjected to aiming up.¹⁵ The CMA also maintained its favourable references to the New Zealand Commerce Commission (NZCC)'s approach to aiming up – and the NZCC's policy of setting regulatory price controls in energy based on the 67th percentile of the WACC range. The CMA acknowledged that sector-specific factors in energy are relevant to determining the level of aiming up required such that a greater degree of aiming up is appropriate in the electricity sector than in water.¹⁶ Specifically, the CMA notes that energy is subject to blackouts, which is a sector-specific risk.¹⁷

- (e) *Incentive-based regulation:* Ground 2 of the Notice of Appeal submits that GEMA's decision to apply a novel expected outperformance adjustment was wrong as it is contrary to the principles underlying incentive-based regulation in its design and likely to lead to perverse outcomes. The CMA indicated its agreement with the Appellant on the importance of incentive-based regulation in

¹⁰ Notice of Appeal, para 4.83.

¹¹ CMA Final Report, para 9.1281.

¹² CMA Final Report, paras 86 and 9.1399.

¹³ Notice of Appeal, para 1.43: GEMA's decision results in a reduction of 357 bps in the CoE compared to RIIO-T1.

¹⁴ Notice of Appeal, para 4.55-4.58.

¹⁵ Oxera (2020) 'The cost of equity for RIIO-2', 4 September, **NOA / PH-1 / Tab 28 / Pages 51-53**.

¹⁶ CMA Final Report, para 9.1231-9.1235.

¹⁷ CMA Final Report, para 9.1274.

the January 2021 Working Papers, finding that company outperformance can be desirable (and therefore does not need to be adjusted for) in the context of a ‘repeated game’ (i.e. periodic price reviews). As noted in the Notice of Appeal,¹⁸ the CMA stated in January that “[i]ncentives are part of normal regulation and operational outperformance is a desirable outcome. If companies are able to outperform, this delivers benefits to customers both from the actual improvements and from Ofwat being able to use the evidence in its comparisons in future periods”. The CMA’s confirmation of this principle in its PR19 Final Determination¹⁹ supports the Appellant’s position in Ground 2 of its Notice of Appeal that GEMA’s decision to impose the expected outperformance adjustment was wrong in principle.

1.7 As explained in Annex 1 Table A, there is only one significant change made by the CMA between its PR19 Provisional Findings and its PR19 Final Determination which results in amendments to the Appellant’s Notice of Appeal evidence. This point is as follows:

- (a) *Debt beta*: GEMA considered the debt beta range of 0-0.15 from the PR19 Provisional Findings²⁰ in selecting its debt beta point estimate of 0.075. There has been a change to the CMA’s debt beta range between its PR19 Provisional Findings and its PR19 Final Determination as the range has now been updated from 0-0.15 to 0.05-0.10.²¹ However, the midpoint of 0.075 has remained the same. Although the Appellant supports the reduction in the top end of the range²² and also the CMA’s continued recognition of the uncertainty surrounding the decomposition approach (which was used by GEMA in calculating its debt beta),²³ the Appellant maintains its position in the Notice of Appeal that a debt beta no higher than 0.05 should be used on the basis that the three generally accepted methods for estimating a debt beta result in an estimate below 0.05, as well as academic evidence supporting a debt beta below 0.05.

1.8 Therefore, overall, the CMA’s PR19 Final Determination has confirmed the CMA’s PR19 Provisional Findings references in the Notice of Appeal (requiring only minimal clarifications) and also included additional commentary supporting the Appellant’s case.

B. Additional findings in the CMA’s PR19 Final Determination which support the Appellant’s position in its Notice of Appeal

1.9 As explained in Annex 1 Table B, the CMA made certain amendments to its PR19 Final Determination which were not included in its PR19 Provisional Findings which are relevant to, and supportive of, SEN Transmission’s grounds of appeal. These include the following:

- (a) *TMR (averaging)*: The Appellant submitted in Ground 1B of its Notice of Appeal that GEMA has incorrectly relied on the geometric average plus a subjective

¹⁸ Notice of Appeal, para 5.21.

¹⁹ CMA Final Report, para 9.1334.

²⁰ Competition and Markets Authority, ‘Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations - Provisional Findings’, September 2020 (*CMA Provisional Findings*), NOA-1/Tab 55/Para 9.315 and Table 9-17.

²¹ CMA Provisional Findings, NOA/Tab 55/Table 9-16 and CMA FD, Table 9-18.

²² The upper bound has been reduced due to a recognition “that different inputs to the decomposition approaches, particularly in terms of the risk-free rate and the probability of default, can produce widely varying figures (as highlighted by Oxera’s submission), and that the current observed debt premia appear to have increased” – see CMA FD, para 9.528.

²³ CMA Final Report, para 9.517-9.530.

uplift rather than the directly observed arithmetic average when calculating historical equity returns (thereby inherently producing a downwardly biased estimate of TMR).²⁴ The CMA's PR19 Final Determination supports SSEN Transmission's submission in this respect and has adopted the arithmetic average to estimate the TMR owing to its "*simplicity and transparency*" and the narrower range of values produced by this approach.²⁵

- (b) *Cross-checks:* the Appellant outlined in Ground 1E of its Notice of Appeal that GEMA purported to undertake a cross-checking process, on the basis of which it has reduced the midpoint of the Cost of Equity produced by its CAPM analysis from 4.55% to 4.40% despite the fact that many of the cross-checks that it relied on were flawed, including MAR data, Modigliani-Miller theorem, discount rates of infrastructure funds, OFTO returns and investment manager forecasts.²⁶ Instead, the Appellant suggests that other cross-checks would be more reliable, including the ARP-DRP cross-check and, for TMR, the Dividend Discount Model (*DDM*). The CMA's PR19 Final Determination has included some new commentary on a number of these cross-checks including:
 - (i) *Investment management forecasts:* The CMA has included new commentary in its PR19 Final Determination on investment manager (i.e. broker) forecasts which they warn should be interpreted with caution. The CMA notes that the forecasts focus on only two companies, and that the estimates may be specifically tailored to particular investors or house views rather than representing the cost of capital of the sector. The CMA also states that there might be circularity in these estimates if analysts assume the Cost of Equity to be close to that set by the regulator.²⁷ The Appellant welcomes the CMA's conclusion which accords with its position in the Notice of Appeal that investor manager forecasts (which GEMA relied upon in respect of five companies) are unreliable for use as a cross-check to the Cost of Equity decision and that it was an error for GEMA to rely on them in its analysis.²⁸
 - (ii) *ARP-DRP:* The CMA has included new commentary in its PR19 Final Determination on the ARP-DRP cross-check. The Appellant agrees with the CMA's comments that the ARP-DRP is conceptually sensible and underpinned by a logical principle that, for a regulated business with capped returns, the Cost of Equity used in the WACC should be assumed to remain sufficiently above the current Cost of Debt.²⁹

However, the Appellant disagrees with the CMA that ARP-DRP should not be taken into account as a cross-check on the basis that the assumptions used are different to those of the CMA.³⁰ As discussed in para. A1.64-A.1.67 of Oxera's Cost of Equity Report, the ARP-DRP is an important and valuable framework which allows for market-based

²⁴ Notice of Appeal, Ground 1B.ii.

²⁵ CMA Final Report, para 9.328.

²⁶ Notice of Appeal, para 4.105-4.106.

²⁷ CMA Final Report, para 9.1363-9.1366.

²⁸ Notice of Appeal, Ground 1E.vi.

²⁹ CMA Final Report, para 9.1384-9.1386.

³⁰ CMA Final Report, para 9.1386.

benchmarking of Cost of Equity by introducing contemporaneous market evidence for the Cost of Debt and the RFR, and a mixture of contemporaneous market evidence and regulatory precedent on the asset beta and the TMR.

The CMA's concern that *'the [ARP] calculation provided is itself based on a particular set of assumptions for ARP, which are different to those used in the CMA's Approach'* is no different than any other financial model. For example, the CAPM, the most common cost of equity model in regulatory finance, requires a large number of theoretical and empirical assumptions. Further, the ARP-DRP framework has two distinct advantages over other cross-checks and approaches.

- (A) First, ARP-DRP framework allows for financeability assessment in a way that is neutral with respect to the treatment of inflation. This allows the underlying financeability of the regulatory package to be evaluated without the confounding influence of the switch from RPI to CPIH indexation.
- (B) Second, the ARP-DRP framework allows for more conservative benchmarking. While the ARP component of comparators embeds a form of regression bias (i.e. attenuation bias) that would have biased the regression coefficients of CAPM-based models (i.e. the equity beta and debt beta) towards zero, the DRP component, derived from traded yields of bonds, does not. As a result, the cost of capital estimates derived from the mid-point of the empirical distribution of market evidence would actually be below the mid-point, rendering the estimates more conservative.
- (iii) *MARs*: The Appellant outlined in Ground 1E of its Notice of Appeal that the MAR data for two listed water companies (Severn Trent and United Utilities) and two listed energy companies (National Grid and SSE) is unreliable because it is driven by a wide range of factors and is also subject to a significant degree of interpretation error.³¹ This position is corroborated by new commentary from the CMA in its PR19 Final Determination on the topic which states that *"[o]n balance, we remain cautious about using market prices to determine the point estimate for the cost of equity or overall cost of capital, particularly in determining the suitability of a relatively minor adjustment"* and *"[i]n the round, we do not consider any of the parties' MAR analysis to represent sufficient evidence to determine whether the CMA or Ofwat's cost of capital is more appropriate for the entire water sector, nor to arbitrate between an allowance that is at the midpoint or one that is 0.1% higher in WACC terms"*.³² The Appellant agrees with the CMA that MAR data should be treated with caution and maintains that it was an error for GEMA to rely on MAR data as a cross-check for the Cost of Equity.

Conclusion

³¹ Notice of Appeal, para 4.115-4.116.

³² CMA Final Report, 9.1358-9.1362.

- 1.10 In summary, as the Appellant sets out in its Notice of Appeal, the PR19 redetermination contains important and relevant evidence for the estimation of the Cost of Equity in RIIO-2 – there has been little relevant change to the CMA’s PR19 Final Determination since the CMA’s PR19 Provisional Findings and, where there has been, the changes largely go further in supporting the Appellant’s case in its Notice of Appeal (such as in relation to the approach to averaging for TMR). GEMA was wrong to ignore the PR19 redetermination at the time of its RIIO-2 Final Determinations and the confirmation of the CMA’s position in its PR19 Final Determination highlights the importance of this evidence to the appeals currently before the CMA.

Statement of Truth

The Appellant believes that the facts stated in this PR19 Submission are true.

Signature of Authorised Representative

Mazin Alkirwi

Name of Authorised Representative

23 April 2021

Date

for and on behalf of Scottish Hydro Electric Transmission plc