BEFORE THE COMPETITION AND MARKETS AUTHORITY

IN THE MATTER OF APPEALS UNDER SECTION 11C OF THE ELECTRICITY ACT 1989 AND SECTION 23B OF THE GAS ACT 1986

B E T W E E N:

1. CADENT GAS LIMITED
2. NATIONAL GRID ELECTRICITY TRANSMISSION PLC
3. NATIONAL GRID GAS PLC
4. NORTHERN GAS NETWORKS LIMITED
5. SOUTHERN GAS NETWORKS PLC AND SCOTLAND GAS NETWORKS PLC
6. SCOTTISH HYDRO ELECTRIC TRANSMISSION PLC
7. SP TRANSMISSION PLC
8. WALES & WEST UTILITIES LIMITED

Appellant

-and-

THE GAS AND ELECTRICTY MARKETS AUTHORITY

Respondent

RESPONDENT'S SUBMISSIONS ON PR19 FINAL REPORT (FINANCE)

A. Introduction and Summary

1. These are the submissions of the Gas and Electricity Markets Authority ("**GEMA**"), filed in accordance with the Competition and Markets Authority's ("**CMA's**") procedural letter of 15 April 2021, in relation to the CMA's Final Report in the PR19 water price control ("**PR19 FR**") [Exhibit SW3.01].

2. These submissions address the Appellants' submissions on finance issues:

   (1) Allowed return on equity, including:

      a. Risk-free rate ("**RFR**");

b. Total Market Return ("**TMR**");

c. Equity beta;

d. Cross-checks;

e. Aiming up;

(2) Expected outperformance; and

(3) Allowed return on debt.

3. GEMA will file separate submissions on totex modelling and the efficiency challenge.

B. <u>The overall relevance of the CMA's Final Determinations at PR19</u>

4. GEMA's position is that there are important differences between the exercise it undertook in setting the RIIO-2 price control and that undertaken by the CMA in the PR19 water price control re-determinations. In its response to the CMA's Provisional Findings at PR19,[1] GEMA made the following points:

(1) There were material differences between the CMA's statutory role in water sector references, which require the CMA to carry out a de novo assessment, and its statutory role in energy price control appeals, which require it to act as an appellate body and to determine whether GEMA's decision was wrong on one of the specified statutory grounds (§§3-4).

(2) *"There are important differences between the water and the energy sectors"* (§7).

(3) *"Differences in outcome in the regulatory process may result not only from differences in the industries in question but also by reason of the fact that different regulatory judgments may be made in relation to similar issues"* (§7).

[1] GEMA letter to CMA, 29 October 2020 (Akshay Kaul to Kip Meek) [SW3.02]

5. GEMA maintains that it cannot follow from the fact that the CMA has taken a different approach in its PR19 FR to the approach GEMA has taken at RIIO-2 that GEMA's approach is wrong on any of the specified statutory grounds. Not only are there material differences between the energy sector and the water sector, but regulatory judgments can legitimately differ in relation to similar issues. Accordingly, there can be no automatic "read across" from the PR19 FR to the correct approach in the different context of RIIO-2.

6. GEMA nevertheless addresses briefly below the CMA's approach on certain issues at PR19 which, in GEMA's submission, is not inconsistent with GEMA's approach. It may therefore provide an indication that GEMA has not exceeded the bounds of its regulatory discretion or erred on one of the specified statutory grounds.

C. Allowed return on equity

7. Setting the allowed return on equity is a complex judgment involving multiple steps. GEMA and the CMA took different views as to the various parameters in RIIO-2 and PR19 FR, as set out in the third witness statement of Mr Wilde ("**Wilde 3**"), §§5-10 and explained below. Differences of view in different contexts do not mean that GEMA's view was unreasonable or can be interfered with on appeal.

D. Risk-free rate

(i) The CMA's approach at PR19

8. In PR19 FR, the CMA estimated an RFR of -1.34%. In doing so, it considered the following factors relevant to the RIIO-2 appeal:

    a. The CMA acknowledged that the RFR is a hypothetical number, and that regulators should *"look to use a proxy metric, or range of metrics, which as closely as possible match the required characteristics of the RFR"* (§9.90). When considering the suitability of Index Linked Gilts ("**ILGs**") as a proxy, the CMA identified four relevant factors: (i) regulatory precedent; (ii) ILGs' match to the key requirements of an RFR; (iii) evidence of distortion as a result of negative rates; and (iv) consistency with the assumptions in CAPM (§9.95).

b. Assessing ILGs against these criteria, the CMA held that *"ILGs closely match part of our key requirement of the RFR, that the bonds are risk free"* but they *"do not completely meet our requirement of the RFR as applied in the CAPM, that all market participants can borrow at the same rate"* (§9.103-4). The CMA also considered that AAA bonds provided a *"suitable upper bound"* for estimating the RFR, though it noted that it was *"likely to be a) an imperfect proxy for and b) slightly above the 'true' level of the RFR"* (§9.151). The CMA recognised that in relying on both ILGs and AAA bonds, it was *"deviating"* from long-term regulatory precedent, and more recent approaches based on the UKRN Report (§9.161) [Exhibit F1/18].

c. The CMA did not consider the use of nominal bonds as being *"likely to improve our estimate"* (§9.183), nor was it *"sufficiently clear"* to it that SONIA swaps rates provided a suitable input or cross-check for the long-term RFR estimate (§9.197).

d. The CMA chose a 6-month averaging period. It considered this would provide *"a suitable balance of ensuring the use of up-to-date data while avoiding the issues of short-term mark volatility"* (§9.208).

(ii) Relevance of PR19 Final Determinations to GEMA's approach at RIIO-2

9. It is striking that the CMA's RFR estimate (-1.34%) is only 0.24% higher than GEMA's estimate (-1.58%). Insofar as there are differences between the CMA's approach and GEMA's, these are because of (a) different considerations that apply to GEMA's decision in RIIO-2 and (b) how much weight to accord particular evidence, which is an exercise of regulatory judgment with which the CMA should be slow to interfere in an appeal under the GA 1986 and EA 1989 rather than a redetermination (see Section B above).

10. GEMA was not wrong to solely rely on ILGs as a proxy for the RFR[2]. As GEMA has explained in witness evidence, i) GEMA considered ILGs were the best proxy based on the principle of seeking a proxy that required the fewest discretionary adjustments for risks (see the second witness statement of Ms Jessica Friend, "**Friend 2**", §51), ii) cross checks reinforced GEMA's position that the use of ILGs was reasonable and unbiased

[2] Contrary to the suggestion of several of the Appellants: SHE-T §1.6; NGN §10; SGN §10; Cadent §27; SPT §4-16; NGET & NGG §2.11-17.

(Friend 2, §§64-85), iii) academic theory supports the use of one risk free rate rather than a distinction between borrowing and lending rates (Friend 2, §§38-41) and iv) an important reason for relying on ILGs alone was to make indexation simpler (Friend 2 §§44, 62). This last consideration did not apply in PR19 (Friend 2 §46). Further, given in its PR19 FR the CMA itself recognised that relying on both ILGs and AAA corporate bonds "deviated" from regulatory precedent, the CMA should be slow to interfere with GEMA's exercise of its discretion in this regard. GEMA has set out its concerns about the number of distortions in AAA corporate bonds that would require adjustment, for which there was no accepted methodology or precedent (Friend 2 §45). The CMA acknowledged some of these concerns in its PR19 FR (§9.151). This difference is one of weight, and GEMA submits that it was reasonable and within the scope of its discretion for it to conclude that such data integrity concerns justified its reliance on ILGs alone.

11. As regards alternative inputs, GEMA's approach to nominal bonds (Friend 2 §44) is supported by the CMA in PR19 FR. The CMA did not suggest that the SONIA swap rate was an incorrect proxy for the RFR but did not have sufficient clarity about its use. GEMA has explained why it considered SONIA swap rates a potential alternative proxy to cross-check the RFR (Friend 2 §42, §67-77). In any event, GEMA used this as a sense-check on using ILGs as a proxy for the RFR (Friend 2 §74). To the extent that the CMA's approach in PR19 discounts any use of SONIA swap rates, this discloses no material error in GEMA's decision in RIIO-2.

12. GEMA's averaging period was reasonable. The CMA's approach seeks to balance the twin concerns of using up-to-date data whilst also avoiding short-term distortions. A range of reasonable approaches may seek to achieve the same. To the extent that GEMA's approach in RIIO-2 differs, two points bear emphasis: (a) GEMA used a 1 month averaging period but will sample it 5 times (Wilde 3 §13), and (b) GEMA's RFR will be indexed and so will update for movements over the course of the price control. GEMA submits that these differences pursue the same aim as the CMA but by a different route. That falls within the scope of GEMA's regulatory discretion.

E. Total Market Return

(i) The CMA's approach at PR19

13. In the PR19 FR, the CMA estimated a TMR range of 5.6% to 6.5% RPI real. However, it observed that there is *"no universally accepted method for deriving the TMR"* and that the academic literature is *"large"* (§9.268).

    a. The CMA considered each of the three main approaches to TMR (historic ex-post, historic ex-ante and forward-looking approaches)[3]. The historic ex-post evidence produced a TMR range of between 5.6% to 6.5% (RPI real), the historic ex-ante evidence a range of between 5.2% and 5.7% (RPI real), and the forward-looking evidence a range of between 3.5% to 6.0%. The CMA concluded that *"it is appropriate to place most weight on the historic TMR estimates"* (§9.390) and expressed *"reservations"* about the *"robustness"* of forward-looking approaches, on which it placed *"limited weight"* (§9.394).

    b. As to the inflation series for deflating historic returns, for the period prior to 1947, the CMA used the CED dataset (§9.294) and from 1947 onwards it used both the RPI and the CPI (actual and backcast) inflation series, concluding that *"both these data series have relevant strengths and weaknesses"* (§3.295-6).

    c. As to averaging historic returns, the CMA found Wright and Mason's submission provided a *"useful framework"* (§9.325). The CMA considered that the *"theoretically correct measure of a return to use in deriving the cost of capital is the arithmetic mean. However, we agree with Wright and Mason that there is no particular reason to focus on estimates of the arithmetic mean of annual returns"*, noting the possibility that where returns are *"serially correlated and investors have a holding period of more than a year, the arithmetic mean return for a single year will be an upwards biased estimator of returns"* (§9.329). The CMA considered two approaches to estimating the arithmetic mean: (a) estimating arithmetic returns over a longer holding period using the DMS (Dimson Marsh Staunton) data set; and (b) using geometric returns and making an adjustment (§9.331). The CMA chose to place weight on (a) rather than (b) due to concerns over the reliability of modelling uplifts (§9.338).

    d. The CMA recognised the *"theoretical arguments for looking at international comparisons…but we note that it is difficult to draw strong conclusions from this*

[3] See Figure 9-9 of PR19 FR.

evidence". Further, it considered that "*US dollar returns on the UK market could be considered as a cross-check on the CPI/RPI debate*" though it noted that this relies on the "*strong assumption*" of purchasing power parity holding (§9.392).

(ii) Relevance of PR19 Final Determinations to GEMA's approach at RIIO-2

14. GEMA submits that there are marked similarities between its overall approach and that of the CMA in its PR19 FR. Where there are differences, these fall within the scope of GEMA's regulatory discretion for the reasons already set out in GEMA's main submissions on finance issues (the "**Main Submissions**") and witness evidence.

    a. GEMA placed most weight on long-run outturn data, i.e. historic approaches, rather than forward-looking approaches derived from Dividend Discount Model and Investment managers' forecasts (see the first witness statement of Mr PJ McCloskey "**McCloskey 1**" §315-316). This echoes the CMA's cautious approach in relation to forward-looking approaches set out above.

    b. GEMA recognised there is no perfect data series for deflating historic returns (McCloskey 1 §328). Similarly, the CMA observed strengths and weaknesses in both RPI and CPI. The question of whether to use both RPI and CPI as the CMA did in PR19, or to rely on CPI rather than RPI as GEMA did in RIIO-2, depends on how much weight is accorded to the data series' respective strengths and weaknesses. GEMA reasonably considered that CPI is the more consistent measure of inflation, particularly having considered other approaches and methods of deriving a real expectation (McCloskey 1 §328).

    c. GEMA estimated the arithmetic mean of returns by the second of the two possible methods the CMA identified in PR19 FR. The CMA did not discount the use of geometric returns and an uplift, but preferred the first method because of its concerns about the uplift based on the PwC study [Exhibit PJ1_064] as set out above. As GEMA has explained, its implied uplift (1.3% to 1.5%) was not based on PwC's study (which suggested a much lower number, see Exhibit PJ1_064, Figure 10) and is in any event consistent with the KPMG report [Exhibit PJ1_058, Table 4] relied on by some of the Appellants (McCloskey 1 §340). Therefore, the concern

expressed by the CMA in PR19 FR does not read across to RIIO-2, and SGN's suggestion that it does is without merit (§22). GEMA's averaging estimation method discloses no error.

d. GEMA expressed a similar view to the CMA regarding the utility of measuring international returns for select countries (McCloskey 1 §357). As to the US dollar TMR cross-check, the CMA did not discount this possibility. To the extent that it observed this relied upon purchasing power parity holding, GEMA refers to its view that this remains a useful proxy for avoiding RPI issues unique to the UK (McCloskey 1 §355) and in any event, the cross-check did not lead to any material impact on the TMR decision in RIIO-2.

15. Moreover, several factors point to the PR19 TMR range as being at the top end of investors' expectations (contrary to the Appellants' views[4]). First, the CMA itself recognised as much in its PR19 Provisional Findings (§9.221) [Exhibit SW3.03], and this applies with (at least) equal force to its PR19 FR. Secondly, the report of Mason & Wright dated 7 May 2021 (the "**Mason & Wright Report**") [Exhibit SHW1_001] highlights the risk of higher TMR estimates in light of the weight placed on ex-post measures of TMR rather than the Equity Risk Premium ("**ERP**") (Wilde 3 §20; Mason & Wright Report, §4.30-4.45). Thirdly, the most recent DMS dataset supports lower ex-post TMR measures by between 0.1 and 0.2% (Wilde 3 §22). Although this data was not available to GEMA when it took its RIIO-2 decision, GEMA submits that the CMA is entitled to, and should, take this most recent data into account in determining this appeal, pursuant to s.11(3) of the EA 1989 and s.23D(3) of the GA 1986. Taken together, these three factors all support the conclusion that the PR19 FR TMR range is at the higher end and generously favours the Appellants; to the extent that GEMA's TMR range in RIIO-2 is (slightly) lower than this, it is not unreasonable or outside the scope of GEMA's regulatory discretion.

F. Equity Beta

(i) The CMA's approach at PR19

[4] See e.g. NGET & NGG at §1.6.

16. In the PR19 FR, the CMA estimated the unlevered beta for the notional efficient water company at 0.29, being the mid-point of a range 0.28 to 0.30: see §9.494 and Table 9-17. This estimate was based on the observed betas for Severn Trent and United Utilities across a range of periods and frequencies: §9.479.

(ii) Relevance of PR19 Final Determinations to GEMA's approach at RIIO-2

17. The majority of the Appellants observe that (i) the CMA did not rely on observed betas for National Grid to inform its estimate of the unlevered beta of the efficient water company and (ii) the CMA's estimate of unlevered beta for the efficient water company was lower than GEMA's estimate of the unlevered beta for the efficient energy company in the RIIO-2 Final Determinations ("**FD**"). The Appellants seek to infer therefrom that:

    a. the CMA has implicitly concluded that observed water company betas cannot be used as proxies for the efficient energy company; and/or

    b. systemic risk in the energy sector is necessarily higher than systemic risk in the water sector.

    (See NGET & NGG, §2.20 & 2.39; NGN, §13; SGN, §25; SHE-T, §1.6(b).)

18. Neither of these inferences is warranted.

19. As to §17.a above, the CMA's PR19 FR does not discuss the potential use of observed UK energy company betas to estimate the beta of the notional efficient water company or explain in terms why it has chosen not to rely on these. The CMA's observation that water companies do not face the equivalent "blackout" risks to energy companies (PR19 FR, §9.1274) is made in a section of the PR19 FR dealing with "*selecting the point estimate of the cost of capital*"; not the section concerned with beta. GEMA notes, however, that the CMA expressly preferred to rely on observed betas from "pure play" water companies where available: see PR19 FR, §9.461. Neither of the two listed UK companies with a substantial energy business – National Grid and SSE – are "pure play" as both carry on more or less significant unregulated, or non-UK, business. In the circumstances, the CMA's decision not to rely on observed betas for National Grid and/or SSE to inform its beta estimate for the notional efficient water company does not imply that "pure play" energy companies

provide poor proxies for "pure play" water company betas or vice versa; the decision is equally consistent with the CMA's preference for relying on observed "pure play" betas where available. Thus, contrary to the Appellants' contention, the PR19 FR does not suggest that the observed betas of the two "pure play" water companies cannot be relied upon to estimate the notional equity beta of the efficient "pure play" energy company. In any event, as explained in GEMA's Main Submissions, §158, GEMA's RIIO-2 decision placed greater weight on the observed (long term) betas of National Grid than on the observed betas for the water companies. As to §17.b above, no such inference can safely be drawn from GEMA's and the CMA's separate and independent estimates of the unlevered betas for the notional efficient energy and water companies, respectively. Indeed, as explained in Wilde 3, §26-32, there are good reasons to believe that water companies may face greater risks under PR19 than energy companies will face under RIIO-2 given (i) the wider ranges for Returns on Regulatory Equity ("**RoRE**") under PR19 and (ii) higher pension deficit risk sharing under PR19.

20. Some Appellants also observe that the CMA took a different approach from GEMA in relation to (i) the use of data from the Covid-19 period (Cadent, §39(a); NGN, §14; SGN, §2.5) (ii) the weight placed on GARCH estimates (Cadent, §39(b)) and (iii) the weight given to larger (long term) data samples (SPT, §§28 & 29). GEMA has explained its judgment on these points in the FD, its Main Submissions (§§166-171) and Wilde 3 (§32). That judgment is entirely reasonable. The fact that the CMA may have come to different judgments when considering the PR19 settlements *de novo*, is no basis for interfering with GEMA's conclusions on RIIO-2.

G. Cross-checks

(i) The CMA's approach at PR19

21. In its PR19 FR, the CMA considered three cross-checks on the level of the WACC and their implications for the point estimate on the cost of capital (§9.1345): MAR data, broker estimates and financeability.

    a. As regards MARs, the CMA remained *"cautious"* in using this data *"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 (for example, 10 to 20bps on WACC)"*

(§9.1358). The CMA did not give the MAR analysis *"significant weight in coming to a final view on the point estimate"* but this was because the evidence relies on the market view of only two companies and therefore it expressed concerns as to the sufficiency of the evidence (§9.1362).

b. As to its broker forecasts cross-check, the CMA considered that *"caution is warranted"* given such forecasts focus only on two companies (§9.1365). However, it noted that, *"as with the MAR data above, while this data cannot conclusively show that either Ofwat or the CMA's cost of capital allowance has been set too high, the data from the broker estimates certainly does not indicate that market participants believe that the allowance has been set materially too low"* (§9.1366).

c. The CMA concluded that *"financeability should be a valuable cross-check when picking an appropriate point estimate from a calculated cost of capital range"* (§9.1383).

(ii) Relevance of PR19 Final Determinations to GEMA's approach at RIIO-2

22. GEMA submits that the CMA's approach in the PR19 FR provides support for GEMA's approach to cross-checks (contrary to NG's suggestion at §2.42) and three points are of specific relevance:

a. The CMA clearly envisages using cross-check data to determine the point estimate for the cost of capital. GEMA used its cross-check data more conservatively than this, relying on it only to alter the upper and lower ends of the range of equity. The CMA's approach in PR19 FR suggests that, where a regulator has a robust body of evidence (the sort of which was not available to the CMA in PR19, but which GEMA has compiled over 3 years in the course of preparing to set the price control for RIIO-2), it can reasonably rely on this cross-check evidence to make adjustments to the CAPM equity estimate. As GEMA has already submitted, its approach to its cross-check evidence has been conservative, and in fact it could be relied upon to support a lower cost of equity (McCloskey 1 §24).

b. The CMA's approach to MAR data is also instructive. Although observing a need for caution, nevertheless the CMA considered an adjustment of 10 to 20bps (on WACC) to be "relatively minor". GEMA, and several of the Appellants' advisers,

likewise considered MAR data to be helpful when used carefully (McCloskey 1 §47). Further, GEMA has submitted that there is sufficient evidence to support a lower point estimate on the basis of the significant MAR premium in the recent WPD sale. In GEMA's submission, this would be more than sufficient evidence for, at the very least, a "relatively minor" adjustment.

c. The CMA's approach to broker forecasts echoes that of GEMA in RIIO-2 (see McCloskey 1 §112-115).

H. Aiming up

(i) The CMA's approach at PR19

23. In its PR19 FR, the CMA selected a point estimate for the allowed return on equity 0.25% above the mid-point of the range derived from the application of the CAPM: see §9.1404. In taking this view, the CMA had regard to, inter alia, (i) regulatory precedent, (ii) parameter uncertainty in the CAPM, (iii) asymmetric risks in the price control settlement and (iv) financeability concerns. It recognised, however, that "*there is no single way to calculate a value… which correctly addresses all these concerns and the decision is a matter of judgement*": §9.1403.

(ii) Relevance of PR19 Final Determinations to GEMA's approach at RIIO-2

24. Each of the Appellants, with the exception of WWU, contends that one or more of the CMA's reasons for "aiming up" within the CAPM-implied range applies equally (or to a greater extent) in the RIIO-2 context, such that GEMA ought also to have selected a point estimate above the mid-point of the cost of equity range: Cadent, §§46-56; NGET & NGG, §§2.60-2.68; NGN, §§20-21; SGN, §28; SHE-T, §1.6(a); SPT, §30. However, the fact that the CMA took a different view on the point estimate in PR19 is no basis for interfering with GEMA's reasoned and reasonable *judgment* as to the appropriate point estimate in RIIO-2: see also Main Submissions, §§252-275.

25. Further and in any event, as explained in the Mason & Wright Report, §1.7.3 when GEMA's point estimate is considered in the round – in particular if having regard to

Expected Returns rather than Allowed Returns – it is consistent with a degree of "aiming up", albeit a lesser degree than in RIIO-1.

I. Expected outperformance

(i) The CMA's approach at PR19

26. There was no outperformance adjustment proposal put to the CMA in PR19. However, four appellants contend that the CMA's decision not to adopt Ofwat's Gearing Outperformance Sharing Mechanism ("**GOSM**") supports their case against the outperformance adjustment for RIIO-2 (NGET &NGG §3.4, Cadent §58-62, NGN §22-23; SHE-T §1.6(e)).

27. GOSM was designed such that companies with gearing higher than specified trigger points would have to "share" the presumed benefit of that gearing with consumers. The premise was that excessive gearing leads to higher returns to shareholders, increasing the risk of failure (which risk is ultimately borne by consumers – but with no corresponding benefit) (see §§9.1152-9.1154).

28. The CMA declined to include GOSM in its final redetermination. In its view, the underlying assumption—that there is a certain measurable level of outperformance resulting from higher gearing which is capable of being paid to consumers—did not hold good (§9.1211).

29. Further, in the CMA's view, Ofwat was unable to present any analysis to identify the excess benefits to equity investors which were said to have derived from high gearing, or to quantify those benefits (§9.1212). The CMA concluded that Ofwat's approach was not supported by finance theory, was inconsistent with its own approach to estimating the cost of equity and WACC, and was inconsistent with standard regulatory practice in the UK (§9.1214). Overall, the measure was not supported by the evidence (§9.1215) and in the absence of evidence of benefits resulting from higher gearing, the measure would function as a tax (§9.1216). Importantly, it would not necessarily deter high gearing and may actually exacerbate the risks, "*because it would have the effect of taking cash away from the company at a time of financial stress*" (§9.1216).

30. The CMA held, at §9.1223:

> *"Our assessment found that there is weak evidence of a regulatory gap after considering the range of relevant regulatory tools. We acknowledge there is a risk that gearing can be too high. However, in this case, for the Disputing Companies and within the foreseeable future,* ***we have not been presented with evidence*** *demonstrating that either the risks or consequences of these companies experiencing financial failure are likely to be large. To the extent that there are risks of financial failure,* ***we also have doubts over the effectiveness of the proposed mechanism to improve financial resilience—it does not reduce or eliminate financial risks*** *(which in any event may not be exclusively caused by high levels of gearing)* ***and may even exacerbate them****. Further, the notion of sharing the benefits of higher gearing which underpins the mechanism's design is not supported by finance theory or practice. We are also concerned that a GOSM as proposed by Ofwat would represent a significant break from a well-established regulatory approach without offering enough evidence to justify doing so."* (emphasis added)

(ii) Relevance of PR19 Final Determinations to GEMA's approach at RIIO-2

31. GEMA submits that the CMA's reasoning with respect to GOSM is of little or no relevance for the outperformance adjustment to RIIO-2. As is clear from the above summary, the CMA's decision not to adopt GOSM was rooted in its careful analysis of the objectives of the measure, the absence of a robust evidence base, and its likely effects, which ran counter to the objective it was designed to serve (see particularly paragraph 30 above). That analysis has no application to GEMA's outperformance adjustment:

    a. Where the CMA found that GOSM lacked an adequate evidence base, GEMA has compiled an extensive dataset of 943 observations across price controls and sectors over time. That dataset is largely unchallenged by the Appellants (see the Main Submissions, §§295-296, 310-313).

    b. Where the CMA found that GOSM was not supported by finance theory, information asymmetry is widely recognised in the literature and the outperformance adjustment is rooted in theoretical analysis by UKRN (see the Main Submissions, §§288-289).

c. Where the CMA found that GOSM failed to address the root problem (high gearing), the outperformance adjustment appropriately counterbalances the systemic advantage of information asymmetry, and is set at a level (0.25% CPIH real), which is modest compared to historic evidence of outperformance (see the Main Submissions, §312).

d. Where the CMA found GOSM may have increased the risks of financial distress, GEMA's outperformance adjustment is supported by a licensee-specific ex-post 'true-up' to mitigate any risk to equity investors.

32. The contrast with GOSM is stark.

33. Despite these obvious differences, three Appellants contend that the CMA's decision not to adopt GOSM for PR19 lends support to their argument that an outperformance adjustment is unnecessary. They argue that RIIO-2 includes a range of other tools and policy alternatives to address outperformance (see Cadent §61; NGN §23(ii); NGET & NGG §§3.4, 3.6-7)). That argument is ill-founded for the reasons explained in GEMA's substantive submissions (see GEMA's Main Submissions, §§320-322).

34. GEMA further notes that, in the context of PR19, the CMA was considering the price control as a whole and was well placed to assess the necessity for GOSM in the round and in light of other elements of the package. In contrast, in the energy sector, the CMA is tasked with considering 'single issue' appeals. In this context, it is appropriate to afford a wider margin of appreciation to the regulator as to the necessity for particular measures (such as the outperformance adjustment) in the round.

(iii) <u>Other arguments</u>

35. Three Appellants contend that the CMA's emphasis on the benefits of incentives and the desirability of outperformance supports their case that the outperformance adjustment was unnecessary and/or harmful (see Cadent §59, NGN §23(i), NGET & NGG §3.5). The relevant part of the CMA's reasoning which they invoke was not related to the GOSM. The CMA was considering the Disputing Companies' arguments that the package overall held asymmetric downside risk for licensees. That argument was not accepted by the CMA. However at §9.1334(a), the CMA said, *"Incentives 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."

36. Contrary to the Appellants' claims, GEMA's outperformance adjustment is consistent with the principles of incentive-based regulation and does not remove the possibility of operational outperformance. There remains a strong incentive to outperform well in excess of the 0.25% adjustment. In any event, GEMA's evidence and analysis indicated the probability of licensees finding themselves in the 0 - 0.25% range was just 7%: see the Main Submissions §342). To the extent that there is any effect on incentives within the 0-0.25% deadband, that effect is limited. There remain strong incentives to avoid underperformance given the cap on the ex post adjustment (see the Main Submissions, §351).

37. It is true that the CMA said, in the context of the Disputing Companies' arguments regarding asymmetric downside risk, that it was *"not persuaded that it is consistent for Ofwat to both set new and increasingly stretching targets for PCs in PR19 and also to assume that companies will outperform against those targets"* (§9.1334(b)). But the CMA also noted that GEMA had adopted a different approach to Ofwat in this context (§9.1334(c)). It made no findings about the likelihood of future outperformance based on GEMA's extensive historical dataset and the three analytical approaches GEMA considered (see the Main Submissions, §312).

38. Finally, Cadent (§60) invokes Moody's response to the GOSM as evidence of the importance of the predictability and stability of the regulatory regime (see PR19 FR at §10.75). But the Appellants' claim that the outperformance adjustment will negatively affect the predictability and stability of regulation is unfounded. Indeed Moody's has maintained its view that the stability and predictability of UK energy network regulation is on a par with other 'best in class' regimes (see the first witness statement of Mr Simon Wilde "**Wilde 1**", §186).

J. <u>Allowed return on debt</u>

(i) <u>The CMA's approach at PR19</u>

39. The CMA set an allowance for the cost of debt by reference to the structure of the notional company and market indices. It rejected the submission from Yorkshire Water (summarised at §9.633):

> *"We continue to disagree with Yorkshire's view that embedded debt costs at each company should be separately reimbursed, absent evidence of inefficiency. The water sector is broad enough to ensure that aggregate industry debt costs provide a good indication of the efficient costs associated with securing that water companies can finance the proper carrying out of their statutory functions. An individual allowance based on the costs incurred by each company would likely require the regulator to conduct forensic assessment of the efficiency of each debt instrument used, which would not be a suitable use of the regulator's time or resources. More importantly, such an approach would reduce incentives to ensure that companies drive best practice, ensure efficiency and do not take inappropriate risks in their treasury management practices."*

(ii) Relevance of PR19 Final Determinations to GEMA's approach at RIIO-2

40. The CMA's approach to allowed return on debt in PR19 is consistent with the well-established and long standing regulatory practice of setting debt allowances on a sector wide basis, as GEMA explained in its Main Submissions at (§§428-440) and in the first witness statement of Ms Friend (Friend 1 30-33). Similarly, the CMA's use of market indices cross-checked against data from the relevant sector is broadly consistent with the approach taken by GEMA for RIIO-2.

41. GEMA agrees with WWU that the approach taken by the CMA to PR19 cannot be automatically transposed to the energy context (see WWU §§3.4 - 3.17). But it does not follow that the CMA's approach is irrelevant. In relation to the allowed return on debt, it is telling that the approach the CMA adopted was consistent with longstanding regulatory practice, and that the approach now advanced by WWU (pass-through subject to an efficiency check) was advanced before, and rejected by, the CMA, albeit in a different context. While it is true that none of the Disputing Companies advanced their case by reference to discrimination, that in itself is telling. GEMA is not aware of any other case in which a licensee has successfully argued that a debt allowance set by reference to market indices, on a sector average basis and with reference to a notional company structure, has been held to be discriminatory. WWU's case on that ground is hopeless.

10 May 2021