FAO Ms Lesley Moore
Director of Regulatory
Appeals
Competition and
Markets Authority
25 Cabot Square
London
E14 4QZ

Tuesday, 22 April 2025

Dear Ms Moore,

Ofwat Price Redeterminations – Future of Energy Networks ("FEN") submission

I am writing on behalf of FEN in response to the CMA's invitation on 25 March 2025 for third-party submissions relevant to the issues raised by five licensed water companies in their Statements of Case for a redetermination of Ofwat's price control determination for the period from 1 April 2025 to 31 March 2030 ("**PR24**").

To support the CMA's aim to proceed efficiently, this submission confines its focus to specific issues relating to the cost of equity, consumer interest and ongoing efficiency in Totex. These are issues on which FEN is well placed to comment, and which have wider relevance for other UK regulated sectors such as gas.

<u>Background on Future Energy Networks (FEN)</u>

FEN is a company within the Institution of Gas Engineers and Managers ("**IGEM**"), which is the global professional engineering institution for the gas industry. Our current membership consists of the owner and operator of the GB gas transmission network, National Gas Transmission ("**NGT**") and the four GB gas distribution companies ("**GDNs**"), i.e. Cadent Gas Limited, Wales & West Utilities Limited, Scotia Gas Networks Limited ("**SGN**") and Northern Gas Networks Limited, collectively referred to as the "**FEN members**" or "**we**" in this submission. FEN was established in 2024, and its members noted here have left the Energy Networks Association ("**ENA**") in 2024.

These companies have a combined total of c.22 million directly connected customers, 287,000km of pipeline, nominal RAV at 31 March 2024 of £32.9bn and new investment spend planned for their upcoming RIIO-3 price control of c.£16bn. We therefore have a common interest in attracting and maintaining investment in critical UK infrastructure, promoting growth and wish to support the CMA in its deliberations on these important issues.

<u>Relevance of this submission by FEN</u>

The PR24 redeterminations (rather than appeals) will be the first opportunity that the CMA has had to undertake a clean-sheet "de novo" review of regulated industry price controls since its PR19 determination in early 2021. As such, the CMA's decisions may have implications beyond the water companies and the water sector.

The CMA will be aware that Ofgem is due to publish its Draft Determination in June 2025 for the next regulatory price control period "RIIO-3" that will run from 1 April 2026 to 31 March 2031. Ofgem's Final Determination is expected by December 2025. The FEN members submitted their Business Plans to Ofgem on 11 December 2024.

We note that each of the five water companies whose PR24 price control is now subject to redetermination by the CMA has raised issues relevant to the appropriate methodology and evidence for setting the cost of equity and ongoing efficiency in Totex. These are matters that the FEN members have also had to consider in their Business Plans, and while the CMA's determination on these issues is water industry-specific, and so may not directly translate to the gas context, they are undoubtedly relevant to similar issues being considered by Ofgem for RIIO-3. We, therefore, think the CMA will find it helpful to appraise itself of the evidence and estimates that are being actively considered in the context of RIIO-3.

We consider that there is a common interest between FEN members and water sector companies due to (i) the decisional practice created by methodological approaches that the CMA takes, (ii) investor expectations, and (iii) the investability framework that is to be established in the current price controls. At the same time, there are important sector-specific differences including in relation to the evolution of current and forward-looking risks, which need to be taken into account in the regulatory decisions. Even though the evidence cited in this submission primarily focuses on non-water sector-specific evidence, it highlights issues that are of common interest and informative for the CMA's PR24 assessment. We do not seek to be exhaustive in relation to all relevant sector-specific considerations from FEN's perspective (e.g. we do not comment on beta estimation for gas).

Cost of equity

On cost of equity, our key messages for the CMA are briefly summarised as follows:

1. **Investability.** Ahead of the PR24 and RIIO-3 price controls, Ofwat and Ofgem have sought to understand how the regulated utilities would be able to retain equity, as well as attract new equity - something that Ofgem has formalised under the concept of investability. A key imperative in the CMA's forthcoming decisions should be to ensure that the flow of equity capital will not be impeded into the water industry, and into the UK's regulated sectors more generally.

   - For the regulated utilities to be investable, shareholders need to have sufficient confidence that equity that is retained or injected into the business will be remunerated in accordance with the risks that it faces. This should entail consideration of the full spectrum of current and forward-looking risks facing the relevant regulated companies and the broader sector (e.g. level of investment required, regulatory changes, public and political scrutiny, macroeconomic conditions, climate change / net zero considerations, risk drivers in the Final Determination).

   - Financial resilience and investability are interdependent concepts. Knowing that a regulated utility is able to attract and retain investment enables its financial resilience. Neither financial nor operational resilience can be assured through licence obligations alone, as capital will enter and stay only where the regulated utility is investable - i.e. where it earns sufficient risk-adjusted returns.

   - There is an interdependence of perceived investability between sectors, and it is reasonable to assume that frameworks and decisions applied to one sector will inform investor expectations across assets and over time. Such interdependence of investors' expectations across sectors, and over time, has been acknowledged and given weight by the CMA in past decisions.[1] In that regard, it is important to note that investability is relevant for all regulated sectors, not only at periods of time when sectors have a growing Regulatory Asset Value ("**RAV**").[2] Indeed, decisions for sectors with

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[1] See, for example, the discussion on regulatory certainty and cost of capital (section 8) in the Competition Commission decision for Phoenix Natural Gas; Competition Commission (2012), '*A reference under Article 15 of the Gas (Northern Ireland) Order 1996,*
Phoenix Natural Gas Limited price determination', 28 November, available at: https://assets.publishing.service.gov.uk/media/551948b8e5274a142b000186/phoenix_natural_gas_limited_price_determination.pdf, accessed on 14 April 2025.

[2] RAV in the energy sector is equivalent to Regulatory Capital Value in the water sector.

RAVs that are growing more slowly or declining will tend to send a signal about the future treatment of investors in assets that are at the growth stage today.

- It is therefore important to ensure that regulated utilities present a competitive investment proposition - i.e. that risk-adjusted returns are sufficient - so that equity is maintained once it has been attracted. If sectors are seen to be unattractive, asset values will decline, pushing up cost of capital paid by consumers.

2. **Dividends.** In previous reviews, it has sometimes been suggested that a company will be able to finance its activities, including with equity, as long as the regulator sets an allowed return in line with the cost of capital. We are firmly of the view that this is a necessary but not a sufficient condition, and that it is important that regulators also pay attention to the cash payments that investors expect, to retain and attract equity. The GDNs commissioned Oxera to assess how dividend payments would be expected to evolve over the RIIO-GD3 price control, and what the implications would be for Ofgem's regulatory decisions. That report was completed on 3 December 2024 and contains the following key points that we would like to highlight to the CMA for consideration in PR24.[3]

   - Oxera explained that financeability concerns should not be addressed by adjusting the dividend yield downwards, as it sends a negative signal to investors (who have particular preferences for specific cash investment yields). Instead, Oxera noted that as long as financial resilience requirements are met, dividend policies should not be constrained in a way that would fail to meet investors' expectations with regards to dividend payments.

   - Oxera's analysis of empirical data found that the average dividend yield of European gas networks has increased from 5.4% in 2018 to 7.4% in 2023. In work carried out for Water UK in August 2024, Oxera found that European utility sector dividend yields were invariant to levels of equity capital raised, i.e. utility sector firms do not in practice reduce dividends to fund investment.[4] FEN members regard this as an important cross-sector finding for both energy and water utilities.

3. **CAPM parameters.** When the FEN members (noted above) were members of the ENA, Oxera was commissioned by the ENA to report on CAPM parameters for RIIO-3. That report was completed on 8 November 2024 and had a cut-off date (for the market evidence presented) of 31 July 2024.[5] The report contains some important analysis that may be useful for the CMA's consideration of these issues.

   - Total Market Return ("**TMR**")

     - Oxera's analysis of the historical evidence and current market conditions points towards a TMR range of **7.0%-7.5% (CPIH, real)**.

     - This range takes into account the long-term historical benchmark for UK stock returns of 7.0% as well as market conditions prevailing when the report was finalised. Oxera also concluded that at the time the report was finalised, evidence suggested that investors would require higher market returns than the central estimate for the "through the cycle" TMR, and Oxera could not exclude the possibility that values higher than 7.5% could be required to meet investors' expectations in

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[3] This report was commissioned by FEN GDN members. Oxera report to GDNs, 3 December 2024, *Gas distribution networks' dividends in RIIO-GD3* (link included in Annex).

[4] Oxera report, *Investability at PR24*, 27 August 2024.

[5] Oxera report to ENA, 8 November 2024, *RIIO-3 cost of equity — CAPM parameters* (link included in Annex).

current market conditions. This is a topical consideration given that there is competition for capital investments in utilities on a global basis, in the context of climate change and the net zero transition, and in light of further recent increases in global government bond yields.

- Oxera noted that it is highly likely that the recent increase in gilt yields will not have been entirely offset by a reduction in the equity risk premium and therefore will have led to upward revisions to investors' expectations of market returns. It also noted that when a similar level of gilt yields was last seen, the TMR allowance set by Ofgem was above 8.0% in CPIH real terms.

- The relationship between gilt yields and TMR has also been analysed by Frontier Economics with its TMR cross-checks also supportive of a TMR range of 7.0% to 7.5% with a point estimate towards the top end of the range.

- Risk-Free Rate ("**RFR**"). Oxera noted that the existence of the convenience premium is well-documented in academic literature. Moreover, regulators including the CMA, the Civil Aviation Authority and the Utility Regulator (NI), have adjusted government bond yields for the convenience premium.

4. **Market cross-checks to inform cost of equity**. When FEN members were part of the ENA, the ENA commissioned Frontier Economics to prepare a report on cost of equity cross-check evidence.[6] This report found that Ofgem's CAPM-based cost of equity estimation was too low in light of market-based cross-checks that included hybrid bonds, listed infrastructure fund implied IRRs, market-to-asset ratios and profitability benchmarking. This reinforces the importance of using a broad range of evidence, appropriately weighed, to assess the adequacy of returns in order to ensure investability.

Also, in its analysis of the cost of equity of GDNs for RIIO-GD3, Oxera applied another cross-check, the ARP-DRP (Asset Risk Premium minus Debt Risk Premium) framework using gas-specific debt market evidence. Based on market evidence on the GDNs' longer-term debt costs, Oxera estimated a lower bound for the cost of equity estimate that could only be consistent with Ofgem's CAPM estimates if these parameters for the TMR and beta were selected at levels above its central point estimates. Given similarities in CAPM estimation approaches between Ofgem and Ofwat, we would recommend that the CMA takes into account the evidence from the above cross-checks in its redetermination of the appropriate ranges and point estimates of the allowed cost of equity in PR24.

<u>Consumer interests</u>

As the CMA is aware, Ofwat is required to appropriately weigh its primary and secondary statutory duties when setting the PR24 price control, including the new growth duty and environmental duty that apply to all sectoral regulators. FEN considers it important that, with the CMA stepping into Ofwat's shoes, the CMA should ensure that equal weight is placed on its primary duties (including the consumer duty, the financeability duty and resilience duty) and appropriate weight on its secondary statutory duties and growth duty. These issues are interrelated, and ensuring investability and financeability for regulated companies in PR24 and other price controls is crucial for protecting the long-term resilience of the sector and thereby protecting consumer interests over all timeframes.

[6] Frontier Economics report to ENA, 22 November 2024, *Updated Cost Of Equity Cross-Check Evidence* (link included in Annex).

Ofgem has highlighted the vital importance of a regulatory framework that attracts the necessary investment.[7] In the context of increased competition for capital globally, the capital required may not be deployed in UK regulated utilities.

Even in periods where no new capacity is required, consumers and investors should be aligned in delivering a high quality of service with well-maintained and efficient utilities. This is in line with the growth duty of regulators, which puts emphasis on the fact that 'sustainable, resilient and inclusive' infrastructure is paramount to economic growth.[8] In this context, the regulatory objectives of ensuring investability (in the context of overall debt and equity financeability) and meeting consumer interests can be considered aligned, rather than in opposition or tension with one another.

Regardless of any existing or potential differences between sectors, it is reasonable to assume that frameworks and decisions developed for one price control will inform investor expectations across sectors - all the more so as there is a common pool of capital and cross-ownership in UK utilities. Any perception that there are risks to investability in a given sector may spill over across time and sectors, with, ultimately, detrimental consequences for consumer interests.

As a result, ensuring investability is in consumers' interests, even acknowledging that to support raising and maintaining capital in regulated utilities, an appropriate cost of capital may have implications for consumer bills. Any contrary framing of affordability as being antithetical to investability misses this key point.

<u>Ongoing efficiency in Totex</u>

FEN note Ofwat's position to set Ongoing Efficiency ("**OE**") at a 1% level in the PR24 price control period is not consistent with the available evidence that shows a substantial slowdown in UK productivity growth, which has been near-zero for almost two decades, post the financial crisis. These broader economic trends have impacted all sectors, and it would be erroneous to consistently expect to significantly outperform the wider UK economy. As discussed within both an expert report by Economic Insight ("**EI**")[9] and a supplementary evidence report[10], the gas networks propose an OE of 0.5% based on benchmarking analysis.

Furthermore, the EI report avoids speculative or narrow technical assumptions which we believe help drive the 1% assumption used by Ofwat regarding future productivity growth. EI challenge the claims that underinvestment is not a driver of the productivity slowdown and challenge that there are likely to be significant technological developments over the coming years to reverse the significant slowdown in productivity growth post the financial crisis. They also emphasise the need to focus on the most recent data, which embodies the wider slowdown in productivity growth. This provides a more accurate prediction of productivity growth in the current economic climate, rather than utilising specific long-term data points which are not reflective of the environment of both today and the near future.

Noting that any decision the CMA reaches on OE for the water sector may have implications for the setting of future gas price controls, we think it is important that the CMA transparently sets out the robust evidence base it has used to arrive at its decision and specifically highlights where it has relied on sector-specific evidence to justify its redetermination. This is particularly important as variations in sector-specific investment needs and other factors could impact the potential for OE across different sectors.

<u>Evidence</u>

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[7] Ofgem (2024), *RIIO-3 Sector Specific Methodology Decision – Overview Document*, 18 July, pp. 5–6.

[8] Department for Business & Trade (2024), *Growth Duty: Statutory Guidance – Refresh*, 21 May, p. 14.

[9] Economic Insight (13 May 2024), *Ongoing Efficiency for Gas Networks at RIIO-3* (link included in Annex).

[10] Economic Insight (11 October 2024), *Further Evidence on OE for Gas Networks at RIIO-3 (Supplementary Report)* (link included in Annex).

As part of their RIIO-3 Business Plan submissions on 11 December 2024 to Ofgem, the FEN members submitted evidence on the above matters, with more details contained in the accompanying expert reports. These are itemised in the annex to this letter with links.

I trust this submission is helpful to the CMA. FEN would welcome an opportunity to discuss these important issues and evidence directly with the CMA and is otherwise ready to assist the CMA with any questions or to provide views and expert input on the above matters.

Kind regards,

[redacted]

James Earl

CEO, FEN

Annex of evidence

Title of report	**Link**
Oxera report to ENA, 8 November 2024, *RIIO-3 cost of equity—CAPM parameters*	https://www.wwutilities.co.uk/media/5966/58b-riio-3-cost-of-equity-capm-parameters-oxera-redacted.pdf
Frontier Economics report to ENA, 22 November 2024, *Updated Cost Of Equity Cross-Check Evidence*	https://www.northerngasnetworks.co.uk/wp-content/uploads/2024/12/Frontier_ENA_Cross-checks_221124.pdf
Oxera report to GDN's, 29 November 2024, *Cost of equity for RIIO-GD3*	https://www.northerngasnetworks.co.uk/wp-content/uploads/2024/12/Oxera_GDN_CoE_291124.pdf#:~:text=In%20this%20report%2C%20we%20analyse%20evidence%20on%20an,the%20existing%20evidence%20base%20with%20gas-specific%20sector%20data.
Oxera report to GDN's, 3 December 2024, *Gas distribution networks' dividends in RIIOGD3*	https://www.northerngasnetworks.co.uk/wp-content/uploads/2024/12/Oxera_GDN_Dividends_031224.pdf
Economic Insight report to ENA, 13 May 2024, *Ongoing Efficiency For Gas Networks AT RIIO-3*	https://www.economic-insight.com/wp-content/uploads/2024/12/Ongoing-efficiency-at-RIIO-3-11-10-24-STC.pdf
Economic Insight Supplementary Report, 11 October 2024, *Further Evidence on OE for Gas Networks at RIIO-3*	https://www.economic-insight.com/wp-content/uploads/2024/12/Further-evidence-on-OE-at-RIIO-3-11-10-24-STC.pdf