

Response to Ofgem's consultation on the methodology for assessing the equity market return in RIIO

Note prepared for Energy Networks Association (ENW; NPG; SPN; SSE; UKPN)

10 January 2014

1 Introduction

This note sets out Oxera's response, on behalf of Energy Networks Association (ENA),¹ to Ofgem's consultation on the methodology for assessing the equity market return for the purpose of setting RIIO price controls.²

The outcome of the consultation will affect the ongoing electricity distribution price review (RIIO-ED1) and future RIIO reviews. This consultation was prompted by the provisional findings of the Competition Commission (CC) issued in November 2013 in respect of the Northern Ireland Electricity (NIE) price control appeal.³

We discuss the background to the consultation, and in section 2 set out our conclusions on the broader policy implications of the possible change in methodology. In section 3 we then specifically consider Ofgem's consultation questions.

2 Background and summary

Ofgem has judged that the CC, in the NIE provisional findings, adopted a different methodology for assessing the equity market return relative to past CC inquiries and, indeed, relative to other regulators' practice, by giving greater weight to contemporary market evidence. This has raised the question for Ofgem of whether the CC decision merits a revision of the RIIO methodology for assessing the equity market return, which is rooted in a long-term view of financeability and financial parameters. The consultation is intended to help Ofgem assess the relative merits of changing the methodology to align more closely with the CC.

Given that the Competition and Markets Authority (CMA)—the successor to the CC—is the appeal body for any RIIO price control decision, it is understandable why Ofgem is consulting on the issue. However, we do not consider this to be the right time for Ofgem to change its methodology, nor do we consider the CC's

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¹ This includes all electricity DNOs with the exception of Western Power Distribution (WPD).

² Ofgem (2013), 'Consultation on our methodology for assessing the equity market return for the purpose of setting RIIO price controls', 6 December.

³ Competition Commission (2013), 'A reference under Article 15 of the Electricity (Northern Ireland) Order 1992', 8 November.

estimate for the equity market return necessarily to be the right estimate in the context of RIIO.

Oxera considers predictability and stability of the regulatory framework to be by far the most important considerations for a regulator in reaching a decision on this issue, and that it would be inappropriate for Ofgem to change the methodology or to reinterpret the evidence, for the following reasons.

- Changing the methodology at this stage in the price review process risks undermining the benefits that a stable and predictable regulatory environment delivers to consumers.
- Directly reading across one part of the CC decision would be inappropriate, as the CC decision applies to a company subject to a different regulatory regime and timeframe from the GB energy networks.
- As the CC decision is provisional, little weight can be placed on it at this stage.
- There have been no developments in the capital markets since the publication of Ofgem's RIIO-ED1 strategy decision that would support the implied reduction in the WACC from changing the methodology.
- The change in methodology will lead to downward pressure on credit ratings as a result of both an increase in regulatory risk and lower cash flows.
- In the context of RIIO-ED1, given the significant overlap with RIIO-T1 and GD1, the change in methodology could have negative implications for investment and consumption choices across the energy industry.

The remainder of this section expands these reasons.

2.1.1 Changing the methodology at this stage in the price review process risks undermining the benefits that a stable and predictable regulatory environment delivers to consumers

Slides presented by Ofgem in the cost of equity workshop held on 7 January indicate that changing the methodology for estimating the equity market return could lead to a reduction of up to £2 in the average annual household bill in RIIO-ED1. This reduction compares to an average household electricity bill in 2013 of £510.⁴ The long-term cost of such a change is much harder to quantify, but the impact on financial and/or operational risk would not need to be large to outweigh the short-term benefit to customers.

A key principle of the RIIO philosophy is to shift companies' focus from the regulator to the consumer through greater clarity around key price control parameters (including the allowed return) early on in the process, longer price control periods, and opportunities for early price control settlements (fast-tracking).⁵

The RIIO principles have been extensively consulted on with a wide range of stakeholders over a period of more than three years, providing various stakeholders, including consumers, with sufficient time to assess the implications

⁴ DECC (2013), 'Average annual domestic electricity bills by home and non-home supplier', 19 December.

⁵ The RIIO model is intended to provide 'clear ex ante rules and principles for various components of financeability', which should include improving transparency of the regime. See, for example, Ofgem (2010), 'Handbook for implementing the RIIO model', October, chapter 12, p. 104.

of the new framework. Stakeholders have endorsed the current principles, including those for setting the financial parameters.

Under RIIO, effective stakeholder engagement is a central part of preparing well-justified business plans. The DNOs have already consulted on their plans, which are based on the existing methodology. While some stakeholders might not fully agree with the DNO financial proposals, the plans and their acceptability need to be viewed as a package. Were the financial assumptions of the business plans to be changed at this stage, companies would need to consider any implications for the packages of outputs and costs that they have consulted on.

Ofgem's consultation also suggests that the allowed real return for RPI-indexed assets should be adjusted down as a result of the ONS consultation into measurement issues associated with the RPI statistic.⁶ However, this was not raised as a formal consultation question.

The conclusions of the ONS study were published in January 2013, ahead of the RIIO-ED1 Strategy Decision in March 2013.⁷ It is not clear that these conclusions constitute new evidence not already considered during the price review process.

2.1.2 Directly reading across one part of the CC decision would be inappropriate, as the CC decision applies to a company subject to a different regulatory regime and timeframe from the GB energy networks

The CC has published a decision in which it has examined the evidence and exercised judgement over the full range of parameters that define the NIE price control (RP5). In terms of the WACC, the CC has expressed a view on what the evidence suggests is an appropriate asset beta. The CC has also estimated an allowance for the cost of debt for NIE based on a different methodology to the debt index used in the business plans of the GB DNOs.

The CC's assessment of an appropriate allowance for the return on the equity market has therefore been in a different context to that of RIIO-ED1. The other parameters in the WACC calculation have been estimated to have different values to those in the GB DNO business plans. The CC has also estimated a cost of equity and a WACC that reflects—at least implicitly—the CC's view of NIE's risk conditional on the methodology for setting the allowed return. In contrast, the RIIO-ED1 business plans contain cost of equity assumptions consistent with the companies' assessments of the risk profile created by the cost of debt index. As a significant proportion of the cost of debt allowance proposed for NIE consists of NIE's actual cost of debt, whereas the GB DNOs will receive an allowance based on a benchmark cost of debt, this aspect of the WACC methodology appears to make RIIO-ED1 higher risk than RP5.

A further important area where the RP5 and RIIO-ED1 price controls differ is that Ofgem and the CC are estimating the cost of capital over different time horizons. The CC is effectively forecasting it over the next 3.5 years, whereas Ofgem is doing so for the next nine years (an eight-year price control period starting 15 months from now). If there is any tendency for required returns to revert towards the long-term average, the CC's assessment that required returns are currently lower than long-term realised returns is less likely to hold, on average, over the RIIO-ED1 period than over the remainder of the RP5 period.

⁶ Ofgem (2013), op. cit., Appendix 2, para. 2.11.

⁷ Ofgem (2013), 'Strategy decision for the RIIO-ED1 electricity distribution price control—financial issues', 4 March.

2.1.3 As the CC decision is provisional, little weight can be placed on it at this stage

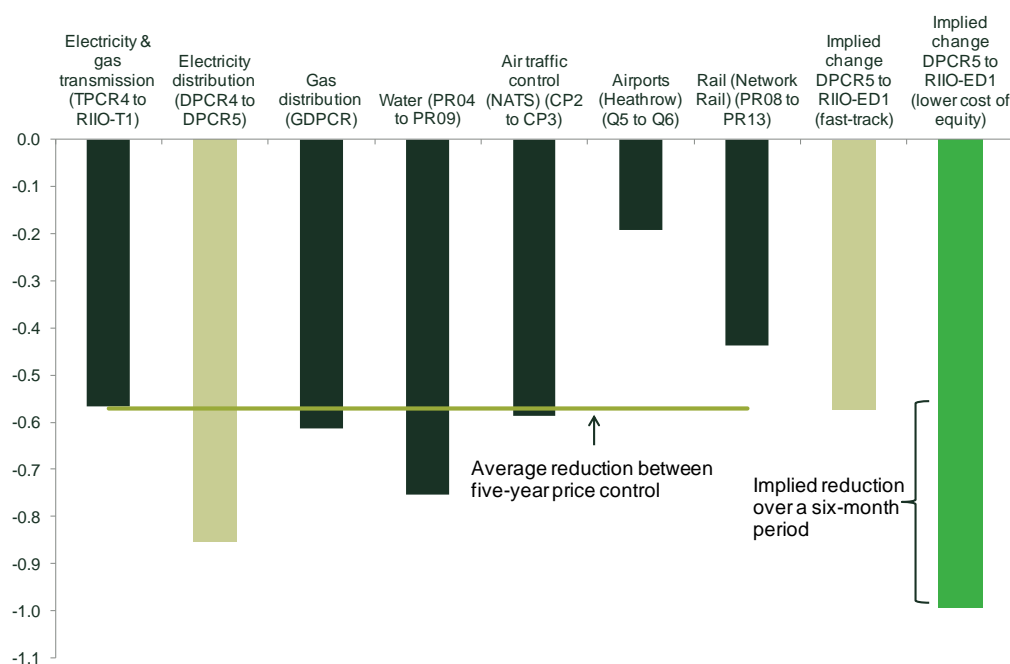
The CC decision for the NIE price control is provisional and subject to further deliberation ahead of the 29 April 2014 deadline for the final report. As the conclusions are subject to change, little weight can be placed on the provisional report as an item of evidence in and of itself.

In preparing the provisional determination the CC has drawn on the same evidence base that has been available to Ofgem throughout the RIIO-ED1 review. Translating the CC's conclusions into the assessment of RIIO-ED1 business plans would therefore suggest that Ofgem has changed its interpretation of the evidence base at a very late stage in the price review.

2.1.4 There have been no developments in the capital markets since the publication of Ofgem's RIIO-ED1 strategy decision that would support the implied reduction in the WACC from changing the methodology

The change in the methodology would imply an extra reduction in the allowed WACC of 40bp compared with the fast-tracking draft determination (see Figure 2.1). The overall reduction in the WACC relative to DPCR5, if the CC methodology were adopted directly, would exceed 100bp. This compares with average reductions of 60bp in energy and other sectors in recent price control decisions. This material reduction does not appear to be justified, especially in light of recent capital market evidence.

Figure 2.1 Changes in allowed vanilla WACC in recent determinations (%)

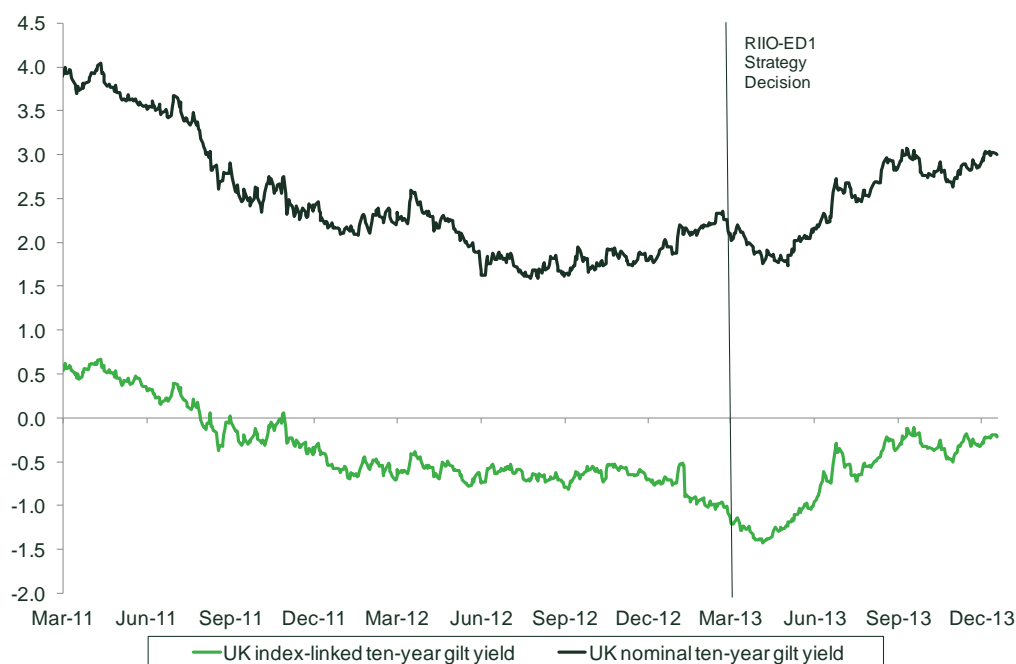


Note: The implied changes from DPCR5 to RIIO-ED1 shown by the two right-hand bars represent the reduction in the allowed WACC for the first year of RIIO-ED1 only.

Source: Various regulatory determinations; and Ofgem (2013), op. cit., Table 1.

Capital market evidence since March 2013 shows that interest rates have been rising since spring 2013 (see Figure 2.2) and, based on implied forward rates, are expected to continue doing so (see Appendix 1).

Figure 2.2 Recent movements in gilt yields (%)

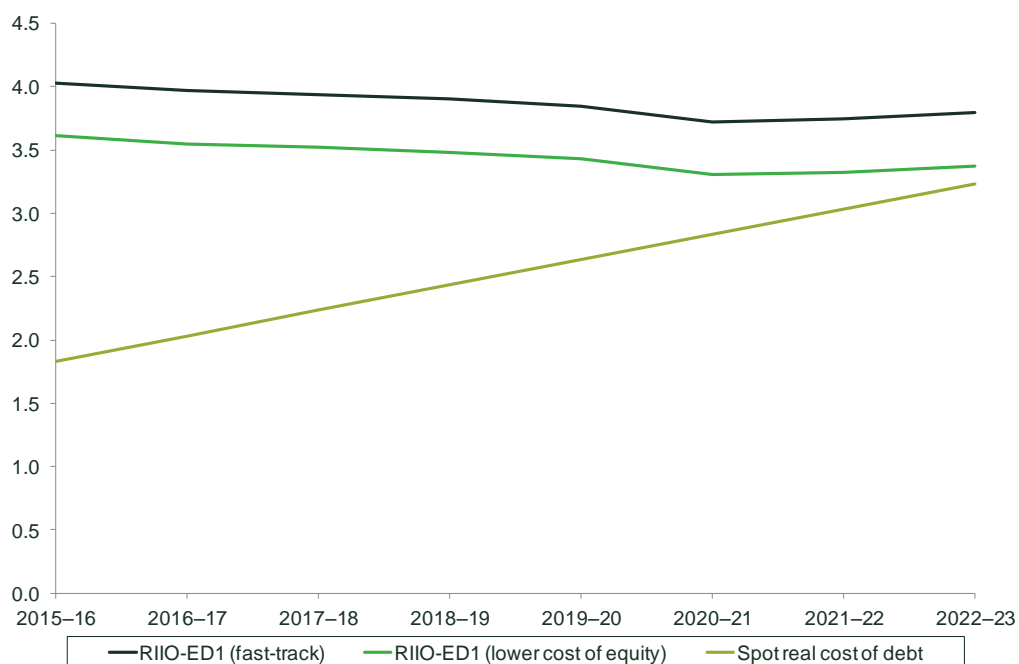


Source: Bank of England, and Oxera analysis.

Additionally, under the fast-tracking draft determination (which is based on the parameter ranges proposed in the March 2013 strategy decision), for the first year of RIIO-ED1 (2015–16) the vanilla WACC is likely to be slightly lower than 4.1%,⁸ and is likely to decline further over the eight-year price control period given the design of the debt index. For example, if interest rates increase by 20bp annually, the allowed WACC will still decline, and will average 3.9% over RIIO-ED1 (see Figure 2.3).

If the CC methodology is adopted and the CC estimates are translated into RIIO-ED1 in the way currently proposed by Ofgem, the vanilla WACC will be slightly below 3.7% in the first year of RIIO-ED1, and declining until 2021 (see Figure 2.3).

⁸ The value of the debt index up to 31 October 2013 is 2.72%. The value of the index that would be used to set the cost of debt allowance for 2015–16 will be based on the ten-year trailing average up until 31 October 2014. This value is likely to be lower than 2.72% given current levels of debt yields.

Figure 2.3 Forecast of vanilla WACC over RIIO-ED1 (%)

Note: The trajectory of vanilla WACC over the price control period is estimated assuming that corporate debt costs rise annually by 20bp. The trajectories are shown for illustration purposes only. The spot real cost of debt represents the annual average of the deflated iBoxx indices used by Ofgem to set the cost of debt allowance.

Source: Oxera.

2.1.5 The change in methodology will lead to downward pressure on credit ratings as a result of both an increase in regulatory risk and lower cash flows

The change in methodology at a late stage in the price review process could have long-lasting negative implications for investors' perceptions of regulatory risk, and subsequently for the financing costs of the regulated networks. In future, this could negate the positive impact of lower bills for today's consumers⁹ from the change in methodology.

First, the transparency and predictability of the regulatory framework directly affect the assessment of creditworthiness by credit rating agencies. For example, Moody's methodology attaches a weight of 15% to stability and predictability of the regulatory regime.¹⁰ Similarly, Standard & Poor's considers 'a utility company's regulatory framework to be the most important factor in determining its competitive position and therefore its credit risk'.¹¹

Currently, credit rating agencies view the regulatory regime for GB energy networks as providing a stable environment that supports credit ratings. This has benefited consumers as companies have been able to raise finance at reasonable cost. However, the methodology change considered by Ofgem would be likely to have an adverse influence on the assessment of the regulatory framework.

⁹ Estimated as £2 per household per year in slides presented by Ofgem at the workshop on 7 January.

¹⁰ Moody's (2009), 'Rating Methodology, Regulated Electric and Gas Networks', August, p. 11.

¹¹ Standard & Poor's (2013), 'Why U.K. Utilities' Regulatory Frameworks Merit A "Strong" Regulatory Advantage Assessment', 11 December, p. 2.

Therefore, from the consumer's perspective, the long-term benefits of maintaining positive perceptions of stability, transparency and independence of the regulatory regime should not be underestimated.

Second, in the context of RIIO-ED1, the change being considered to the cost of equity methodology, combined with the introduction of debt indexation, would put significant pressure on cash flows. This could make it more difficult for the networks to raise debt and could increase their financing costs. For example, Moody's has recently noted that the potential reduction in cash flows if Ofgem were to change the methodology is likely to be credit-negative for the sector.¹²

Ofgem's own analysis suggests that, to offset the negative impact on cash flows, companies would have to defer dividends or inject equity equivalent to one year's-worth of new debt.¹³ Such action would be non-trivial and the long-term implications on investor perceptions of the sector are unknown.

2.1.6 In the context of RIIO-ED1, given the significant overlap with RIIO-T1 and GD1, the change in methodology could have negative implications for investment and consumption choices across the energy industry

Investment incentives would be distorted, in that returns would be lower in electricity distribution than in gas distribution or transmission. Consumption would be distorted as electricity prices would be lowered relative to gas prices. Changing the methodology could lead to a misallocation of resources between sectors.

Fundamentally, it seems inappropriate to have different financial assumptions underpinning price controls that were consulted on consecutively, and which will exist in parallel over the six-year period of 2015–21.

3 Consultation questions

Ofgem's consultation document invites views on specific questions. This section sets out Oxera's response to these questions.

3.1 A direct translation of the CC's estimates to DNO cost of equity allowances

Do you agree with our direct translation of the CC's equity market return estimate to DNO cost of equity allowances?

Ofgem infers that a direct translation of the CC decision to RIIO-ED1 would imply a cost of equity for the DNOs of 5.5% at 65% gearing (see Table 3.1), compared with the 6.7% currently proposed by the DNOs that are candidates for fast-tracking.

¹² Moody's (2013), 'Ofgem consultation on the RIIO-ED1 cost of equity is credit negative', 22 November.

¹³ Ofgem (2013), 'Consultation on our methodology for assessing the equity market return for the purpose of setting RIIO price controls', 6 December, Appendix 1, para. 1.24.

Table 3.1 Ofgem's translation of the CC estimate

	Ofgem's existing methodology		CC's methodology	
	DNO fast-track proposals	Reference point for testing business plans	CC's NIE provisional determination	DNO equivalent
Gearing (%)	65	65	50	65
Risk-free rate (real, %)	2.00	1.60	1.25	1.25
Equity risk premium (%)	5.25	5.25	4.75	4.75
Equity market return (%)	7.25	6.85	6.00	6.00
Asset beta ¹	0.38	0.38	0.42	0.38
Debt beta	0.10	0.10	0.10	0.10
Equity beta	0.90	0.90	0.75	0.90
Cost of equity (real, %)	6.70	6.30	4.80	5.50

Note: ¹ Ofgem shows an illustrative asset beta for the DNOs that is consistent with the CC's debt beta assumption.

Source: Ofgem (2013), op. cit., Table 1.

The translation in Table 3.1 is based on the assumption that if Ofgem were to change the methodology, it would use the CC's provisional point estimate for the total equity market return of 6.0% and would leave all other parameters (i.e. the asset beta, treatment of cost of debt, and gearing) unchanged from the current values used in the fast-track draft determination.

Ofgem's consultation concerns the broader policy issue of how much weight to give to contemporary evidence in assessing the equity market return. It therefore does not follow that, if Ofgem does decide to change its methodology, the regulator should necessarily adopt the point estimate used by the CC. There are a number of considerations that might influence how Ofgem decides to apply the 'new' methodology to its assessment of the appropriate equity market return, as follows.

- Interpreting current market evidence remains challenging in the current market environment. If more weight is given to contemporary evidence, there is still considerable uncertainty about what the right range for the equity market return is, particularly in the context of RIIO with eight-year price controls.
 - Capital markets continue to be heavily influenced by macroeconomic policy, which has created an unusual source of uncertainty and volatility.
 - Interest rates have been rising since Ofgem published the RIIO-ED1 strategy decision in March 2013, and, given the low absolute levels of government bond yields and evidence from implied forward rates, they are likely to continue rising in the future (see Appendix 1).
- Even if the CC range for the equity market return were adopted, it is not evident that choosing the midpoint of this range is appropriate.
 - In previous CC decisions, the CC used point estimates at or near the top end of the range, on the basis of capital market volatility and the costs of

underinvestment.¹⁴ Both these arguments remain relevant in the context of RIIO.

- The CC took a different approach to Ofgem for parameters of the WACC other than the equity market return. If the CC were to review a RIIO–ED1 determination then all parameters would be reassessed, as the scope of the review would not be limited to the equity market return.
- The CC estimated a higher cost of debt and asset beta, and a lower gearing for NIE, compared with the DNO business plans. The CC also set the cost of debt based on a fixed allowance rather than the indexation method adopted in DNO business plans.

3.1.1 Interpretation of the impact of the recent ONS RPI consultation

Additionally, in deciding how the CC decision is read across to the RIIO price controls, it is important to understand the CC's view on any possible distortions in the statistics used to calculate the equity market return.

The Office for National Statistics (ONS) recently reviewed the methodology used to calculate the Retail Price Index (RPI).¹⁵ The consultation highlighted that, owing to a change in the formula used to calculate the RPI in 2010, the RPI statistic might be subject to an upward bias, which would explain the widening of the gap between the RPI and the Consumer Price Index (CPI) since 2010. However, the ONS decided to leave the current RPI methodology unchanged following the consultation.

Ofgem notes that, on the day of the announcement of the ONS decision (10 January 2013), index-linked gilt yields dropped by 0.4%. It uses this evidence to suggest that investors' required return from investing in RPI-linked assets has decreased by 0.4%, and therefore that it would be appropriate to reduce the real risk-free rate from 2.0% to 1.6%.

This direct translation of one-day movement in gilt yields into the risk-free rate is not appropriate for several reasons. First, Ofgem does not use spot rates to estimate the risk-free rate. Like most regulators, Ofgem uses a range of evidence as well as judgement; taking one day's-worth of data to affect this judgement in such a material way does not seem proportionate. Second, on any given day, gilt yield movements will reflect a range of events. Attributing the entire change in yields to one event is difficult. Third, gilt yields would have reflected investor expectations of the possible outcomes of the ONS consultation prior to the event itself—it would be inappropriate to assume that the movement in yields on the day captured solely the effect of the announcement, given the full range of outcomes that were possible for the holders of RPI-linked gilts, such as changing the index-linking to CPI.

Furthermore, the CC seems to interpret the outcome of the ONS consultation in a different way to Ofgem. In the NIE decision, the CC suggests that the upward bias in the RPI statistic could mean that index-linked gilt yields might be biased downwards, and uses it as part of the justification for adopting a risk-free rate range for NIE that is higher than spot rates.¹⁶ This highlights another methodological point of difference between the CC and Ofgem that is relevant to

¹⁴ Competition Commission (2007), 'BAA Ltd—A report on the economic regulation of the London airports companies (Heathrow Airport Ltd and Gatwick Airport Ltd)', Appendix F, Table 13; Competition Commission (2010), 'Bristol Water plc—Determination on a reference under section 12(3)(a) of the Water Industry Act 1991', August, Appendix N, Table 12.

¹⁵ Office for National Statistics (2013), 'National Statistician's consultation on options for improving the Retail Prices Index', 8 October.

¹⁶ Competition Commission (2013), *op. cit.*, pp. 13–36.

the cost of equity and the WACC assessment. If Ofgem reads across the CC decision on some methodological issues but not others, this could be considered selective.

In summary, the process of choosing the appropriate point estimate for each WACC parameter depends on the judgement of the individual regulator within a wider context of regulatory objectives. Even if Ofgem decides to change the methodology, careful consideration of the appropriate range and point estimates within the range would still be required.

3.2 Implications for risk

Can you provide evidence on the impact of giving greater weight to contemporary market evidence on perceived systematic and regulatory risk?

Relying more on contemporary market evidence will introduce more volatility into the cost of equity assessment. This approach would also be likely to increase pro-cyclicality and hence exposure to systematic risk. This is because the allowed return on equity—and, by implication, the average returns achieved by companies—will vary more with short-term movements in the equity market. The standard measure of systematic risk exposure at the company level is the equity beta. However, extracting robust conclusions about the systematic risk impact of different regulatory methodologies for setting the equity market return is difficult to impossible. This is because of the statistical uncertainty around the beta estimates combined with the multiple drivers of beta estimates, of which regulatory methodology is just one. The challenge applies when trying to either prove or disprove any relationship.

A case in point is BT, which has a higher asset beta than traditional network utilities and a regulator (Ofcom) that takes a more forward-looking approach to the cost of capital than any other regulator. However, although this is consistent with the theoretical prediction that giving greater weight to contemporary market evidence increases systematic risk exposure, it does not prove a causal relationship.

Considering impacts on regulatory risk, a change in methodology could have some impact on regulatory risk perceptions as the cost of equity allowances might become 'less predictable'. However, establishing a direct link between regulatory risk and the methodology itself is difficult. Rather than the methodology itself, it is the unexpected changes in the methodology at a late stage of the price review process that are likely to increase regulatory risk.

3.3 Financing issues

Do you think changing our methodology for the equity market return would impact on interest costs for DNOs? If so, how would this need to be accommodated in our approach to the financial package or the regulatory package more widely?

The methodology change will lead to a material squeeze on cash flows (at least in the context of RIIO-ED1), particularly when combined with the introduction of the debt index. This is likely to put downward pressure on credit ratings and have negative implications for companies' ability to manage short-term cash-flow

fluctuations. For example, Ofgem estimates that DNOs would need to reduce gearing by about 10% to sustain credit metrics.¹⁷

Taking a stylised example, a reduction in the allowed WACC from 4.1% to 3.7%, which could result from the change in methodology, would reduce the adjusted interest coverage ratio (AICR), all else being equal, from 1.7 to 1.5 (see Table 3.2).

Table 3.2 Stylised example of the impact on ratios

	RIIO-ED1 (fast-track)	RIIO-ED1 (lower cost of equity)	
Assumptions			
Allowed pre-tax cost of debt, real (%)	2.7	2.7	a
Allowed post-tax cost of equity, real (%)	6.7	5.5	
Notional gearing (%)	65	65	b
Allowed vanilla WACC (%)	4.1	3.7	
Allowed pre-tax WACC (%)	4.7	4.2	c
Inflation (%)	3.0	3.0	d
RAV (£m)	1,000	1,000	e
Proportion of debt that is index-linked (%)	50	50	f
Calculations			
Pre-tax return (£m)	47	42	c*e
Interest cost (£m)	28	28	$[a*f+(a+d)*(1-f)]*e*b$
AICR	1.7	1.5	

Note: Assumptions on inflation and the proportion of index-linked debt are illustrative only and do not necessarily represent the assumptions that will underpin the RIIO-ED1 price control.

Source: Oxera.

The pressure on ratios will also be exacerbated by the declining WACC allowance over the price control period due to the debt index, especially since, in practice, companies' debt costs are unlikely to decrease in line with the allowed cost of debt.¹⁸

Current credit rating assessments are also supported by the relatively favourable view of the GB regulatory framework. The change in methodology could lead to perceptions of higher regulatory risk. When combined with the negative direct impact on cash flows, deterioration in credit quality and an increase in financing costs would certainly seem plausible.

Ofgem's own analysis suggests that, to offset the negative impact on cash flows, companies would have to defer dividends or inject equity equivalent to one year's-worth of new debt.¹⁹ Such action would be non-trivial and the long-term implications on investor perceptions of the sector are unknown.

¹⁷ Ofgem (2013), 'Consultation on our methodology for assessing the equity market return for the purpose of setting RIIO price controls', 6 December, Appendix 1, para. 1.24.

¹⁸ Oxera (2012), 'RIIO-ED1 consultation on strategy—financial issues', 16 November.

¹⁹ Ofgem (2013), 'Consultation on our methodology for assessing the equity market return for the purpose of setting RIIO price controls', 6 December, Appendix 1, para. 1.24.

3.4 Investment incentives

How do you consider that the choice of methodology for determining the appropriate equity market return impacts on investment incentives? Is there any evidence that you can provide?

The main negative impact on investment incentives from changing the methodology is likely to be an increase in perceived regulatory risk. This could have long-lasting negative implications for the attractiveness of the sector to both debt and equity investors, in turn increasing financing costs. There is also likely to be a distortion of investment incentives between electricity and gas, and between distribution and transmission, as a result of the inconsistency that would be introduced between the RIIO price controls.

The choice of the methodology in itself, as long as it is well communicated in advance, is unlikely to be directly linked to investment incentives. However, given the long-lived nature of assets, consistency in methodology over different price control periods is important. If a change is to be made, it needs to be consulted on sufficiently in advance of companies preparing their business plans.

For example, as part of the RPI-X@20 review, Ofgem did make some changes to its approach to financeability, by moving to economic asset lives to calculate depreciation allowances. However, this material change was consulted on extensively, with stakeholders having multiple opportunities to contribute their views, several years before the start of the first RIIO price control.

3.5 Eight-year RIIO price control period

To what extent do you think the merits of the alternative approaches to the assessment of the equity market return are affected by the eight-year RIIO control period?

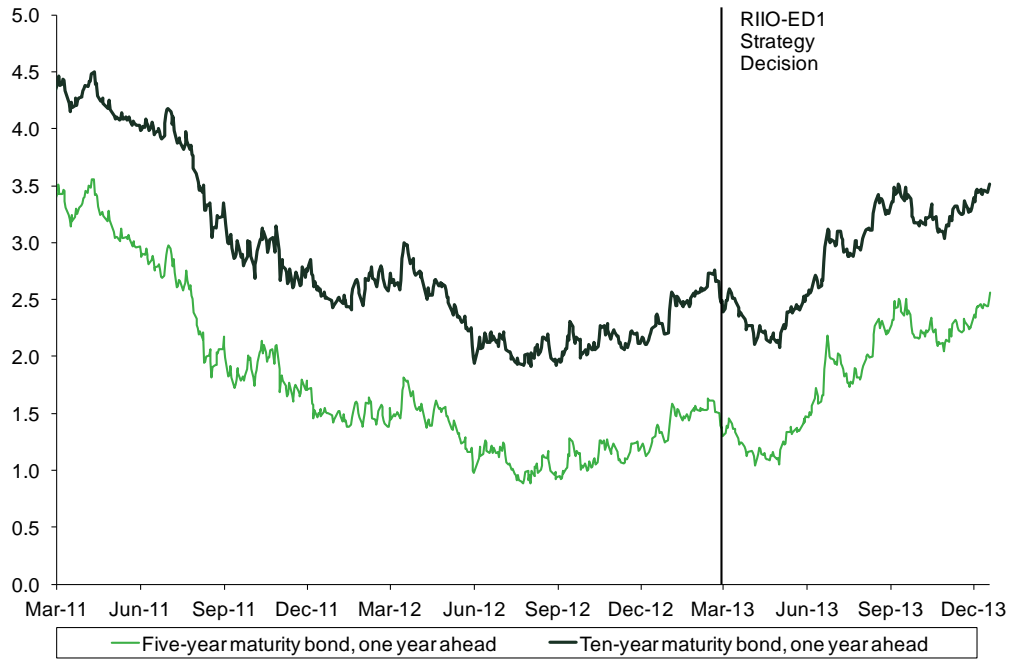
The CC's decision applies to a five-year period that started 1.5 years ago—the CC has the benefit of 1.5 years of outturn data and is therefore forecasting the cost of capital over a 3.5-year period only.

Ofgem's RIIO decisions will apply to an eight-year period. In the case of RIIO-ED1, this period will begin only 15 months from now. In future RIIO reviews, Ofgem is also likely to have to forecast the equity market return for an eight-year period starting around 12–24 months ahead.

If there is any tendency for required returns to revert towards the long-term average, the CC's provisional assessment, that required returns are currently lower than long-term realised returns, is less likely to hold, on average, over the RIIO-ED1 period than over the remainder of the RP5 period.

A1 Supporting evidence

Figure A1.1 Recent movements in forward rates (%)



Source: Bank of England, and Oxera analysis.