R11O-2 appeals: CMA Final Determination
differences between the CMA's decision in the PR19 redetermination in the water sector (published in March 2021) and the RIIO-2 appeal (published in November 2021), some of which could be explained by the difference in the CMA's role between the two appeals.

While the CMA extended its argumentation in several areas in response to parties' responses to the PDs, the CMA's decisions regarding the substantive, joined grounds of appeal remain unchanged since the PDs. The CMA maintains its provisional decision to:

- keep the cost of equity unchanged at Ofgem’s estimated level of 4.55% (CPIH, real) at 60% gearing;
- remove the outperformance wedge on the cost of equity;
- reduce Ofgem’s estimate of ongoing efficiency (OE) by 0.2% p.a.

In the rest of this article, we examine these areas of appeal in more detail.

### Cost of equity

All Appellants submitted that Ofgem has set the cost of equity too low. The Appellants argue that Ofgem has erred in its decisions on setting the risk-free rate (RFR), the total market return (TMR) and the beta, and selecting a point estimate. In its PD, the CMA concluded that Ofgem’s decision is within the margin of appreciation for interpreting the evidence. The CMA’s FD retains this provisional conclusion in its entirety.

Specifically, the CMA concludes the following:

- **Ofgem was not wrong to use UK gilts as the sole benchmark to estimate the RFR.** This decision differs from the outcome of the PR19 appeals, where the CMA used yields on both UK gilts and AAA rated credits. The CMA acknowledges that even the highest-rated market participants can borrow only at rates above UK gilt yields, and notes that there is evidence to support the notion of a ‘convenience yield’ in government-issued securities, which pushes the yields on government bonds below the required rate of return for a zero-beta asset. Nonetheless, the CMA that decided the theoretical imperfections of inflation-linked gilts are insufficient to support the Appellants’ case that Ofgem has erred.

- **Ofgem’s point estimate and range of TMR is not incorrect.** First, on the choice of averaging method, the CMA decided that the Appellants had not proved that RPI is more reliable than CPI to deflate historical returns. The CMA concludes that Ofgem has not made an error in relying solely on CPI. In contrast, the CMA put weight on both the CPI and RPI series in the PR19 appeal. Second, on the choice of averaging method, Ofgem was within its margin of appreciation to rely on the uplifted geometric average of historical returns. Again, this conclusion is at odds with the outcome of the PR19 appeals, where the CMA noted that “the most appropriate estimate to use is the arithmetic mean.”

- **Ofgem’s asset beta estimate based on a comparator set that includes water companies was not wrong.** This is despite the CMA’s acknowledgement that energy networks are likely to be riskier than water networks, and that, in its PR19 decision, the CMA placed weight only on companies operating in the sector of interest (i.e. water). Moreover, the CMA concludes that Ofgem was not wrong to view the COVID-19 pandemic as a systematic event that could be included in the data used for beta estimation.

- **Ofgem’s implementations and interpretations of the cross-checks are not incorrect.** While the CMA agrees with the Appellants that Ofgem could have calibrated certain cross-checks better (i.e. Modigliani–Miller and OFTO returns), the CMA does not consider that such evidence is sufficient to show that Ofgem has erred. In relation to Oxera’s asset risk premium relative to debt risk premium (ARP–DRP) cross-check, the CMA accepts that it ‘might ultimately gain more general acceptance as a relevant cross-check within regulatory price control processes’, but is not convinced that the high cost of equity implied by this cross-check is sufficient to negate the evidence from other cross-checks performed by Ofgem.

- **The decision to aim up (or not) in the point estimate is at Ofgem’s regulatory discretion.** The CMA concluded that market-to-asset ratios (MARs) indicate that Ofgem’s cost of equity is not too low. In particular, the CMA placed weight on two transactions of GB energy networks that occurred at premium to the regulated asset value during the appeals. In contrast, in PR19, the CMA explicitly aimed up by 25bps above the mid-point of the estimated cost of equity range.

Lastly, we note that one of the Appellants, Wales & West Utilities (WWU), challenged Ofgem’s legal interpretation of its
financeability duty. WWU’s case was that the duty cannot be satisfied by reference to a notional company, but relates to actual licence holders.\textsuperscript{15} However, the CMA has not accepted this case and concludes that it is sufficient to only assess financeability of a notional company, as defined by Ofgem.\textsuperscript{16}

Similarly, the CMA has concluded that it was not wrong for Ofgem to use an average cost of debt across the networks to set the allowance or to exclude derivatives from the assessment, as also challenged by WWU. On the latter point, however, the CMA has acknowledged that, in theory, it would be useful to account for some types of derivatives in the cost of debt allowance assessment, especially those used to replicate index-linked debt instruments.

### Outperformance wedge

Ofgem argued that there is an expectation of outperformance in RIIO-2, and therefore proposed a 22–25bp downward adjustment to the cost of equity allowance. This adjustment is defined as an outperformance wedge. The CMA has concluded that Ofgem was incorrect in introducing the outperformance wedge. The CMA has acknowledged that, in theory, it would be useful to account for some types of derivatives in the cost of debt allowance assessment, especially those used to replicate index-linked debt instruments.

#### Ongoing efficiency

Ongoing efficiency (OE) relates to the ability of the most efficient firms in an industry to improve productivity—for example, through technological progress. These productivity improvements advance the current frontier of best practice for the industry, and are additional to any catch-up efficiency (i.e. improvements to get closer to the current best practice).

At the FDs, Ofgem set an OE challenge of 1.15% p.a. for CAPEX and REPEX, and an OE challenge of 1.25% p.a. for OPEX, based on:

1. **Growth Accounting (GA) analysis**, where productivity growth is calculated in competitive sectors of the UK economy. Ofgem concluded that such evidence leads to a ‘core’ OE target of 0.95% p.a. for CAPEX and REPEX, and 1.05% p.a. for OPEX. These targets are at the top end of the range of OE targets estimated by Ofgem’s consultant (CEPA).\textsuperscript{24}

2. **Uplift for innovation funding**, where Ofgem assumes that companies can achieve greater productivity improvements than the wider economy due to past innovation stimulus to the networks. This led to an uplift of 0.2% p.a. for all three expenditure categories.

In its final determination, the CMA agreed that Ofgem had made two errors when setting the core OE target: (i) Ofgem had used companies’ business plan incorrectly; and (ii) Ofgem had incorrectly calculated the past rate of productivity improvement for the frontier company.\textsuperscript{25} However, the CMA determined that these errors did not undermine Ofgem’s overall core OE challenge as it considered that this was supported by other parts of Ofgem’s evidence base. That is, the CMA retained Ofgem’s core OE challenge of 0.95% p.a. and 1.05% p.a.

It is important to note that, while the CMA only identified two errors, it made several comments on how Ofgem had applied its regulatory discretion when determining the core OE target. For example, while the CMA did not determine that Ofgem made an error in selecting the appropriate measure of productivity, it stated:\textsuperscript{26}

> The appropriate weighting to attach to the VA productivity measure and the GO measure is a matter of regulatory judgement and different regulators can take different views on this topic [...] we will apply appropriate restraint and, in principle, not question issues of judgement unless we are satisfied that GEMA’s decision is wrong.

Therefore, it would be inappropriate for regulators to take the CMA’s decision and apply it in future price controls without appropriate scrutiny, especially in sectors where the legal context is different.

The CMA also decided to remove the 0.2% p.a. uplift related to past innovation funding based on four errors in Ofgem’s approach:

- Ofgem had assumed that all innovation funding was used for cost reduction. The Appellants provided quantitative and qualitative evidence that the majority of innovation funding was used for service quality improvements. Therefore, the CMA ruled that this assumption constituted an error in Ofgem’s approach.\textsuperscript{27}

- Ofgem had assumed that innovation funding allows network companies to improve their productivity relative to comparator sectors in the economy (that were used to set the core OE target). However, Appellants argued that comparator sectors had access to substantial R&D funding, so the impact of innovation funding on productivity was already embedded in the core OE target. The CMA determined that Ofgem had not appropriately accounted for this when applying the uplift.\textsuperscript{28}

- Appellants argued that the impact of innovation funding on future expenditure was already embedded in companies’ business plans and, therefore, Ofgem’s uplift resulted in a double-count. The CMA decided that Ofgem did not sufficiently account for this when applying the uplift.\textsuperscript{29} The CMA noted that Ofgem’s own consultant had also identified this as an issue.

- Appellants argued that applying an uplift for innovation funding distorted the incentives of companies to invest in innovative projects. The CMA
Implications for the future

In the RIIO-2 appeals, the CMA's approach was not to substitute Ofgem's judgement and weighting of the evidence with its own. Rather, the Appellants had to demonstrate that Ofgem had erred in its decision and, if applicable, that there was a clearly superior alternative approach. As a result, there are several differences between the outcomes of this appeal and the PR19 appeals earlier this year.

Final business plans for the electricity distribution sector are due in early December 2021. Companies and Ofgem will be mindful of the CMA's findings as the determination process progresses.

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