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RIIO-2 appeals: CMA Final Determination

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The Competition and Markets Authority (CMA) has published its Final Determination (FD) of the appeals in respect of Ofgem's RIIO-GD2 and RIIO-T2 ('RIIO-2') price control reviews. Out of 12 grounds of appeal, it upheld five (partially or fully). In several areas, the CMA afforded Ofgem a 'margin of appreciation', whereby the CMA ruled that Ofgem did not make an error, even in areas where the CMA might have acted differently. The CMA's RIIO-2 decision provides valuable insights into the evidence required by companies and regulators to get decisions overturned or upheld in future appeals.

On 1 November 2021, the CMA published its FD of the appeals in respect of Ofgem's RIIO-2 price control review for transmission and gas distribution networks.[1] We have provided summaries of Ofgem's FDs[2] and the CMA's Provisional Determinations (PDs)[3] on our website. In the CMA's FD, all nine networks that are subject to Ofgem's price control appealed to the CMA,[4] and, out of four joint grounds and eight individual grounds of appeal, the CMA upheld five (fully or partially).[5]

In coming to a final decision, the CMA generally deferred to Ofgem's regulatory discretion or 'margin of appreciation'. For example, the CMA states:[6]

> [W]here GEMA has exercised regulatory judgement in selecting amongst various alternative solutions to a regulatory problem, we will not substitute GEMA's assessment or weighting of the evidence or reasoning with our own unless we are satisfied that GEMA's approach was wrong – for example, because there was a clearly superior alternative approach.

This reflects the legal framework of the RIIO-2 appeals: the CMA's role is limited to determining whether Ofgem was wrong on any of the specific grounds. Therefore, the 'burden of proof' is on the Appellants to demonstrate that Ofgem has made an error, and the evidential bar for determining an error is high.

The legal framework and the CMA's role in the regulatory process differ across sectors (a detailed discussion of the CMA's role in different sectors can be found on our website: https://bit.ly/3BKEUM1).[7] Indeed, there are several, material methodological 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.[8]

- **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 corporate bonds. 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,[9] which pushes the yields on government bonds below the required rate of return for a zero-beta asset.[10] 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 inflation series, 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'.[11]

- **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,[12] 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),[13] 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.[14]

- **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 premia 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.[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.[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. In deriving its conclusion, the CMA has found the following.

- There were **a number of errors in Ofgem's analysis** of the expected operational outperformance. There is no clear and compelling evidence of systematic outperformance in non-energy regulated sectors.[17] Within the energy sector, the CMA can draw no firm conclusions from Ofgem's analysis with respect to the likely scope for outperformance in RIIO-2.[18] Ofgem did not account for the sources of past outperformance and undertook a highly aggregated and averaged approach (across a wide range of different controls over time). Even if outperformance were to be expected in RIIO-2, Ofgem has not shown why such an outcome should be viewed as problematic, rather than as the normal operation of incentive arrangements in a way that would benefit consumers.[19] Ofgem has also not identified sufficiently why the set of tools it used for RIIO-2 should be regarded as providing insufficient protection for customers.[20]

- The outperformance wedge would be a **poorly targeted mechanism** to address Ofgem's concerns. The CMA considers there are ways in which GEMA can and does seek to lessen, counter and otherwise guard against the effects of information asymmetries that includes—but also goes well beyond—approaches to ODI and totex calibration. These include choices over metric definition and specification, the stringency of target setting, choice of incentive rates, and the use of caps, collars and deadbands.[21]

- There was also a realistic possibility that the outperformance wedge (if it were to be introduced) **would undermine broader regulatory integrity and certainty**, which could result in increased costs to consumers over time.[22] The wedge has potential adverse effects on performance improvement incentives in that there is a 'double ratchet' effect of past outperformance influencing the outperformance wedge and incentives in future price controls.[23]

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);[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 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.[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:[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.[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.[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.[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 ruled that Ofgem did not sufficiently account for this when setting the OE target.[30]

The CMA's critique of the uplift for innovation funding could provide a framework for establishing what, if any, evidence is required to alter the OE target from that based on the evidence suggested by the core OE analysis. Of course, a regulator or company making such arguments would need to consider the CMA's reasoning in its totality, rather than rely on isolated issues.

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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[1] Competition and Markets Authority (2021), 'Energy Licence Modification Appeals 2021', 1 November, accessed 1 November 2021 at: https://bit.ly/3nWydBI.

[2] Oxera (2020), 'RIIO-2 Final Determinations: how final?', 14 December, accessed 11 August 2021 at: https://bit.ly/2YfVNQW.

[3] Oxera (2021), 'RIIO-2 appeals—CMA provisional findings', 13 August, accessed 1 November 2021 at: https://bit.ly/3bGU9uY.

[4] On 3 March 2021, Cadent Gas, National Grid Electricity Transmission, National Grid Gas, Northern Gas Networks, Southern Gas Networks, Scotland Gas Networks, Scottish Hydro Electric Transmission, SP Transmission, and Wales & West Utilities appealed on various grounds. National Grid Electricity Transmission and National Grid Gas, as well as Southern Gas Networks and Scotland Gas Networks, had joint appeals as National Grid and SGN.

[5] Details of the grounds of appeal and the CMA's provisional decision on each area can be found in Oxera (2021), 'RIIO-2 appeals—CMA provisional findings', 13 August, accessed 1 November 2021 at: https://bit.ly/3bGU9uY. The success or failure of the grounds of appeal did not change between the PDs and the FD.

[6] Competition and Markets Authority (2021), 'Final determination Volume 1: Introductory chapters', October, para. 3.77.

[7] Oxera (2018), 'Regulatory appeals: do the UK's appeal regimes stand up to critical review?', 19 March, accessed 1 November at: https://bit.ly/3BKEUM1.

[8] The following outlines a brief summary of the CMA's position on each of the cost of equity parameters. For more details on the arguments presented by the Appellants, please visit our website: Oxera (2021), 'RIIO-2 appeals—CMA provisional findings', Agenda, 13 August, accessed 3 November 2021 at: https://bit.ly/3bGU9uY.

[9] Competition and Markets Authority (2021), 'Final determination Volume 2A: Joined Grounds: Cost of equity', October, para. 5.68.

[10] The concept of 'convenience yield' was brought to the CMA's attention by Oxera in its consultancy outputs for the PR19 appeals. For more details, see CMA (2021), 'Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations – final report', 17 March, para. 9.80, accessed 3 November 2021 at: https://bit.ly/3wfjKEB.

[11] Competition and Markets Authority (2021), 'Final determination Volume 2A: Joined Grounds: Cost of equity', October, para. 5.266.

[12] Ibid., para. 5.585.

[13] For example, see ibid., para. 5.672 and para. 5.715.

[14] Ibid., para. 5.717.

[15] Wales & West Utilities (2021), 'Notice of Appeal. Energy licence modification. RIIO-GD2 price control (2021-2026)', A3.11 (a).

[16] Competition and Markets Authority (2021), 'Final determination Volume 2A: Joined Grounds: Cost of equity', October, para. 5.975.

[17] Competition and Markets Authority (2021), 'Final determination Volume 2B: Joined Grounds B, C and D', October, para. 6.108.

[18] Ibid., para. 6.120.

[19] Ibid., para. 6.135.

[20] Ibid., para. 6.148.

[21] Ibid., para. 6.157.

[22] Ibid., para. 6.181.

[23] Paras 6.167–6.168. We note that the CMA was not persuaded by evidence that the outperformance wedge would be likely to have a material impact on marginal investment incentives. The CMA reasons that there is a broad range of factors that can be expected to affect investment decisions. See CMA (2021), 'Final determination Volume 2B: Joined Grounds B, C and D', October, paras 6.173–6.174.

[24] See CEPA (2020), 'RIIO-GD2 and T2: Cost Assessment – Advice on Frontier Shift policy for Final Determinations', November, p. 7.

[25] Competition and Markets Authority (2021), 'Final determination Volume 2B: Joined Grounds B, C and D', October, paras 7.293 and 7.345.

[26] Ibid., paras. 7.146–7.147.

[27] Ibid., para. 7.512.

[28] Ibid., para. 7.552.

[29] Ibid., para. 7.608.

[30] Ibid., para. 7.634.