Global Infrastructure Investor Association
Promoting Private Investment in Infrastructure

UK Regulators Network (UKRN) Consultation Response

Global Infrastructure Investor Association (GIIA)

Introduction

GIIA is the membership body for the world's leading institutional investors in infrastructure and advisors to the sector, with our members collectively responsible for over £1 trillion of infrastructure assets under management, across 70 countries. GIIA's investor member base is diverse – ranging from fund managers and pension funds, to insurers, corporate investors and sovereign wealth funds (a full list of GIIA members can be found appended to this document).

GIIA members hold assets across a range of core sectors- from digital and utilities to social, renewables, transport and beyond. Our members are investing today, to help deliver the smart, resilient and sustainable infrastructure of the future- ensuring we are able to keep pace with a growing population.

In response to the UK Regulators Network (UKRN)'s consultation on the methodology for setting the cost of capital, we are writing to offer a high-level perspective, that reflects a range of views from within our membership.

Historically, the UK was perceived by investors as demonstrating the gold standard in economic regulation. Over time, however, the framework has evolved into an overtly complex and cumbersome structure, often with clear disparities between different regulated sectors.

As a core investment pillar, regulation is a key variable in benchmarking investor confidence within any given market. GIIA, in partnership with Alvarez & Marsal, produce a half-yearly '*Pulse Survey'* that serves as a litmus test for investor sentiment. As our latest edition[1] illustrates, an unattractive regulatory regime is considered to be the foremost barrier to investment in the UK, alongside political instability.

In order to stabilise investor confidence, reforms to help simplify and streamline the existing system must be introduced, as set out in GIIA's *'Regulating for Investment'* report[2].

Question 1: Do you agree with the proposed recommendations?

Members were in broad agreement with a number of the nine recommendations put forward by UKRN. Arguably, however, the proposals could be considered as not going far enough to address areas for improvement within the regulatory system. Areas that warrant further exploration, are outlined below.

GIIA members agreed with the proposal that regulators should continue to estimate the allowed rate of return in price controls on the WACC for a notionally financed firm in the sector, and that regulators should continue to use CAPM as the primary approach for estimating the cost of equity.

More broadly, members also supported the recommendation to estimate equity beta for the notional company using comparable listed companies/standard regression techniques and that the RFR, TMR and (re-levered) equity beta assumptions should be combined using the CAPM to produce a cost of equity range.

[1] Pulse Q4 2022 final.pdf (giia.net)
[2] GIIA-Regulating-for-Investment-Report.pdf

An area for further consideration, included the suggestion that regulators should only deviate from the mid-point of the CAPM cost of equity range if there are strong reasons to do so. Members were broadly in agreement with this suggestion, although a core reason for “aiming up” could arguably be necessitated given the UK seeking record levels of new investment at a politically and economically unstable moment. Given the lack of predictability, GIIA would argue that the risk of slightly overpaying companies, brought about by erring towards the upside in such a predicament, would be outweighed by the dangerous consequences of companies failing to finance themselves.

More broadly, it can also be argued that biased ranges can be produced as a result of regulators exercising a frugal approach to the top-end, while remaining content to keep things low at the bottom-end, when identifying a range. Further considerations include that the public welfare case for “aiming up” has also been strongly demonstrated in mathematical terms and that an increase in risk-free rates in the last few months, means the costs of equity ranges identified by regulators are overlapping the actual cost of debt. Crucially, it is not credible for the disparity between the cost of equity and debt to be small (or negative) and retaining the appropriate relationship could require regulators to revert to the top of the range in the cost of equity.

The recommendation that regulators should estimate an allowance for an efficient company under the notional financial structure, with actual debt costs suitably benchmarked against other market evidence, also warrants a more nuanced perspective. While GIIA members agreed with the overarching steer, there is a notable appetite for pushing the parameters of what can be agreed. From the investor perspective, greater attention and commitment to resolving questions raised by PR19 appeals (such as the non-application of a discount to indices for water companies) would be welcomed.

Turning to the proposal for regulators to estimate the RFR within the CAPM, using recent yields on the index-linked gilts, with a maturity which matches the assumed investment horizon for their sector – members expressed a preference for regulators to consider AAA corporates because gilt markets (particularly index-linked gilt markets) can be skewed in turbulent markets.

A further recommendation is for regulators to estimate the equity risk premium within CAPM as the difference between the TMR (primarily based on historical ex-post and historical ex-ante evidence) and RFR. GIIA would argue that this should be applied in such a way that the real cost of equity is still correlated to risk-free rates. Recent market turbulence has seen share prices of listed water companies (and other yield stocks such as listed infrastructure funds), fall sharply, as gilt rates rose. The falls in these stocks was sharper than in the wider market.

Finally, the UKRN proposed that the notional gearing assumption should reflect the balance of risks facing the regulated company and a wide range of benchmarks on gearing levels, not just that of the actual company (or companies) in question. We would assert that regulators should challenge themselves if the target level of gearing is going down (which suggests they are making the sector riskier), this means the WACC should be increasing. On the broader point- if target gearing is going down, that means historical beta estimates may understate the forward-looking cost of equity.

Question 2: Do you have views on how this guidance could evolve over time, including potential issues for further investigation?

GIIA would suggest that the UKRN's longer-term efforts should be directed towards ending the reconfiguration of WACC at each price review. More broadly, the duplication of work between regulators at price reviews, should also be deterred. As a key example of how this could work in practice – for PR24, if Ofwat were to accept the CMA's PR19 WACC decision and update this to reflect the latest market data, this would give rise to a largely impenetrable WACC.

APPENDIX ONE – GIIA MEMBER COMPANIES