SGN RESPONSE TO DRAFT UKRN GUIDANCE ON THE METHODLOGY FOR SETTING THE COST OF CAPITAL

Executive Summary

We understand the overall purpose of the UKRN report is to align cost of capital (WACC) methodologies where there isn't clear rationale for significant sector specific differences, and welcome the opportunity to respond. Also, as brought out on p3 of the UKRN Report[1], we are pleased the report recognises the trade-off between reducing customer bills and supporting the levels of investment and innovation necessary for longer term consumer interests - when setting the WACC.

However, we believe that, in a number of the cost of equity (CoE) parameters, assessment of the evidence is limited. There are a number of methodologies that could establish the range for each of the CoE parameters used. It is important that each of these methodologies is fully assessed and justified on its own basis as being credible and supported by both economic theory and quality of empirical evidence, in order to form part of the parameter range. Without this assessment of the quality of the methodologies being used to establish the CoE parameter ranges, they can be easily distorted by taking methodologies that are less credible or evidence based, thereby maintaining the downward asymmetry in the parameter ranges we believe existed in the RIIO-GD2/T2 determination.

The ENA has commissioned and submitted an Oxera report in response to the consultation, which reviews the UKRN's recommended methodology, and forms part of our submission. The Oxera report highlights the well substantiated evidence that needs to be taken into account when recommending methodologies for each CoE parameter.

One area where we believe there is limited scope for standardisation of CoE methodology across regulators is dealing with unique sector risk. We think it is important for the UKRN report to recognise that unique risks should be fully assessed and accounted for.

Below we focus on the more strategic considerations of the UKRN report as well particular aspects of WACC that weren't part of the Oxera Report, in our response to the consultation questions;

Qu. 1. Do you agree with the proposed recommendations?

Regulatory Process

As mentioned above we understand the overall purpose of this report, i.e. to align WACC methodologies where there isn't clear rationale for significant sector specific differences. However, we do have some concerns regarding aspects of the regulatory process here;

- Assessment of the methodology used to derive the WACC. WACC methodology is a complex process that draws information from multiple points of reference. The UKRN report lacks in-depth assessment of the appropriateness of different methodologies and how recommendations are derived. We are surprised there are only 21 pages (p9-29) covering the background, evidence, and recommendations for each aspect of the WACC. We recognise the need to be as succinct and concise as possible in such a report, however the complexity of the topics lends itself to the provision of further background and

[1] 'UKRN guidance for regulators on the methodology for setting the cost of capital—consultation', September 2022, p. 3 *'Ensuring this expected rate of return appropriately reflects the market risks taken by investors, given the underlying regulatory framework in each sector, is vital for promoting the long-term interests of consumers by encouraging investment and innovation, whilst protecting consumers from excessive prices'*

evidence in most parameters. Also, given the material implications of the WACC methodology, it is important to have a detailed examination and justification made publicly available.

- Basis of the UKRN report. The UKRN report (p3) states that regulators have worked together to *'identify areas where there is already significant alignment in cost of capital methodologies and areas where further alignment could be achieved'* in line with a BEIS request. We anticipate it will be an important point of precedence for future regulatory periods and thus it is important that networks and their investors have a clear process through which their views are considered and responded to, in subsequent drafts.

Also, the UKRN report aligns closely to the outcomes of the Ofgem GD2/T2 final determination rather than the outcomes of the CMA PR19 appeal. Given that the PR19 appeal was a re-determination of the WACC by the CMA, whilst GD2/T2 final determination was appealed against a much higher threshold of whether the regulator made a demonstrable error, it is our view that the CMA PR19 appeal is the appropriate starting point of reference for methodological recommendations.

The Need to Create a Credible Range for the Cost of Equity

This consultation has provided the opportunity for wider industry experts to review the UKRN report methodologies. It is important that these views are evaluated and responded to in a transparent manner. We are not sure this will be the case, as p7 of the UKRN report states '*This draft guidance document largely seeks to bring together and consolidate existing methodologies, rather than reopen theoretical debates, recognising the importance of consistency across sectors but also across time.'*

There are a number of methodologies that could establish the range of each CoE parameter. It is important that each methodology is reviewed and justified on its own basis as being credible and supported by both economic theory and quality of empirical evidence.

Without this check on the quality of the methodologies being used to establish the CoE parameter ranges, they can be easily distorted by taking methodologies that are less credible or evidence based. This in turn leads to a risk of downward asymmetry and bias being introduced in the construction of parameter ranges if there is an overriding focus on reducing customer bills rather than supporting levels of investment and innovation necessary for longer term consumer interests. This ultimately can't be picked up in an errors/margin of appreciation based CMA appeal process if regulatory discretion is considered on an individual parameter rather than cumulative basis. We note the need for balance between *'protecting consumers from excessive prices and promoting the long term interests of consumers, by encouraging investment and innovation'*, is recognised on p3 of the UKRN Report.

The UKRN report should be clear on the standards through which the credibility of the methodology, and the data points they establish, influence the CoE parameter ranges that are under consideration.

The overriding point is that when a credible range is considered by regulators, or in indeed when WACC methodologies are devised for the UKRN report, there needs to be a high bar of evidence supporting these methodologies.

Estimating Equity Beta

The UKRN report states (p19) that the first step in estimating equity beta for a sector, i.e. its risk, is to *'identify listed companies which could form suitable comparators for the regulated activities…'*, or *'estimate an appropriate beta by benchmarking or inferencing from other beta estimates or precedents*' where there are no suitable comparators.

There needs to be recognition of risks that may not be able to be assessed from market beta points or reasonable precedents. These need to be assessed case by case, and price control by price control, for specific sectors - as well as for individual companies within sectors. Therefore we don't believe the asset beta/equity beta methodology can be too prescriptive. Furthermore, we believe the methodology for assessing these risks can only be assessed at the time of the price control - when the nature of the risks is more fully understood.

A case in point is the unique risk that Gas Distribution Networks are exposed to with regards to significant asset and cost stranding if substantial electrification of heat takes place due to Net Zero.

There are several other pathways for the Future of Gas (FoG) and significant work is being undertaken to prove how transitioning to hydrogen, in combination with methane or instead of it, can provide a cost-efficient solution to achieving Net Zero targets vs substantial electrification of heat. However, whilst there are several other FoG pathways, in the absence of appropriately aligned government and regulatory policy on the decarbonisation of heat, there is still a risk of asset and cost stranding that needs to be allowed for in the CoE.

We believe the UKRN report should make specific reference to the risks of asset and cost stranding, and that these need to be accounted for in the relevant sectors' price control processes.

Cost of Debt

In principle we agree with Recommendation 8 of the UKRN report (p28), *'Regulators should estimate an allowance for an efficient company under the notional financial structure with actual debt costs suitably benchmarked against other market evidence.'*

However, we believe this should be expanded to note that the allowed cost of debt should include ALL the costs efficiently incurred when raising funding and managing risks positions for the notional company in the specific sector, noting that these risks have exacerbated in the current volatile macro-economic environment. This would include derivatives that have been transacted for hedging purposes, to help mitigate exposure across a number of areas including;

- Foreign exchange currency risk on non-GBP debt issuance
- Interest rate risk: where the CoD allowance is based on daily averaging of a market index, it is not actually possible for networks to closely hedge this exposure through daily debt issuance
- Inflation risk: to allow companies to hedge the inflation exposure in their assets and revenue base by flexibly managing their liabilities and cost base

Deflation of Cost of Debt

Whilst not being a major point of analysis the UKRN report states (p28), with regards to deflating a real cost of debt allowance from a nominal level, *'We recommend that typically the long term Bank of England target or long term official inflation projections should be used. However, there may be circumstances where an alternative forecast might be preferable, for example, if there is evidence that the long term Bank of England inflation target will not be met.'*

There are many further details which need to be considered – for example;

- Where the use of a long term forecast to deflate the nominal cost of debt is a well-established methodology, long term financing and risk management decisions will have been made on this basis, e.g. the degree of exposure/mitigation of inflation risk networks choose to adopt. Furthermore, financing and risk management decisions may well have been made on the basis of how these decisions impact KPIs, such as credit metrics.
- Inflation is deeply embedded within the mechanics of a price control, and the interlinkages of any potential change to cost of debt deflation and the wider price control framework would need to be fully assessed before any change is made in this complex area.
- Notwithstanding our disagreement with any such change, substantial analysis and consultation, and a long period of notice for companies to adjust their financing and risk management strategies, is required before any such fundamental change to using an alternative forecast is made.

However, to address the high level principle point in the UKRN report, there is no inherent reason to believe that over the long-run, out-turn inflation should be expected to be systematically above or below the established long term Bank of England forecast. To move away from this long term forecast, when inflation happens to be different from the long term forecast, would introduce significant regulatory instability and risk. This in turn would damage investor confidence and thus risk future levels of investment and innovation.

Financeability Cross Check of the Cost of Equity

The UKRN report states (p24) that *'It has been argued that where modelled cashflow ratios are too low regulators should adjust the allowed return on equity to remedy this',* but goes on to state (p25) that *'it is not clear that cash flow shortfalls or the need to meet specified levels of financial ratios should indicate that the cost of equity has been mis-estimated'* and *'alternatives to uplifting the allowed return on equity are likely to be more suitable remedies for financeability issues.'*

SGN believe the issue is more nuanced than this, i.e. the financeability assessment is an important cross check of the CoE and if it isn't passed the CoE methodology should be reviewed to ensure its robust, before any other suitable remedies are considered.

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

As highlighted above in our response to Qu. 1, we have the following concerns regarding the process in developing the guidance on WACC methodologies;

- lack of detailed examination and justification of the methodologies recommended, in such a complex and material area
- the basis of the report in terms of the need for transparent consideration of investor views given the recommendations are written by regulators to act as their future guidance
- the report closely aligns with the outcome of the GD2/T2 final determination, rather than the outcomes of the CMA PR19 appeal which was subject to a full re determination

The final version of the UKRN's guidance should incorporate the above points, and these should be central to any further evolution of the guidance.

We agree the guidance should be reviewed (and thus also consulted on) by regulators on a periodic basis. Every two years seems a reasonable balance between keeping it as a up to date as possible, and the resource and time involved in reviewing and consulting. So we would recommend the next consultation is published by September 2024.

Given the materiality of even slight changes in the WACC and the importance to investor confidence of having an appropriate methodology assessment, there needs to be a transparent review process with opportunity for comment and expert input prior to the publication of the draft, and a formal process set out for the review of comments and evidence in the draft consultation process.

If there are material developments in market conditions, finance theory and the statutory frameworks regulators operate under, in-between periodic UKRN consultations, these should be consulted on by individual regulators if they occur during a price control process. There should also be a formal route for investors to be able to raise material developments impacting WACC methodology. Finally the reasons to depart from the current guidance must be very well justified, to avoid wholesale changes being made in individual sectors in-between periodic UKRN consultations, undermining the rationale for common WACC methodologies.