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By email: consultation.ukrn@caa.co.uk

Dear UKRN Consultation team

Citizens Advice response to UK Regulators Network (UKRN) guidance for regulators on the methodology for setting the cost of capital — Consultation

1. Citizens Advice welcomes the opportunity to respond to this Consultation as part of its statutory role to represent energy consumers in Great Britain. Our response is not confidential and may be freely published.

2. The UKRN Consultation follows the Government's call to the UK utilities regulators to promote investment and innovation – while delivering a fair deal for consumers – in particular:

   - *"[to] work together on the common challenges [the regulators] face in setting the periodic cost of capital [...via the] newly established [UKRN] Weighted Average Cost of Capital (**WACC**) Taskforce;*
   - *[to work] towards alignment where clear benefits can be identified;*
   - *[recognising that utilities] provide an essential service; [that] regulators must [therefore] ensure value for money and provide a fair deal for all consumers; and*

- *[to identify] opportunities [...] to ensure the general affordability of consumers' essential bills*"[1].

3. Citizens Advice agrees with a large part of the UKRN Consultation, especially its proposals for greater alignment.

4. Citizens Advice is nevertheless concerned that, overall, the Consultation's proposals do not adequately identify opportunities to ensure the affordability of consumers' essential bills, and therefore do not provide a fair deal for consumers. In particular, the Consultation proposals are not consistent with the Government's expectation that "*the methodology that regulators use to control prices [creates] a fair and effective process that [...] balances the interests of investors and consumers*"[2].

5. On the contrary, in our view, the Consultation process and proposals are not fair, nor do they balance the interests of investors and consumers. This is for a combination of reasons.

6. First, the Consultation process and proposals do not recognise the substantial asymmetries between consumer (and Government) stakeholders on the one hand – and investor (and company) stakeholders on the other, namely of:

   - ***Commercial interest***: Government and consumer bodies have a common interest in setting the *right* cost of capital (i.e. neither too high nor too low). In contrast, investors (and companies) have an unambiguous interest in the allowed cost of capital being as high as possible.
   - ***Resources***: Given the clear commercial interest to secure the highest possible allowed cost of capital, the regulated companies will devote considerable resources, both internally and via external advisers, to influence this outcome. Such resources can be several orders of magnitude greater than consumer bodies can employ.
   - ***Regulatory process***: While regulatory processes should seek to address the above asymmetries, in practice they can makes things worse. In particular, it is far harder, or impossible, for stakeholders other than the regulated companies to appeal regulatory determinations.

7. Second, the Consultation does not reflect the position of main consumer bodies in recent regulatory appeals, especially relating to the Consultation Recommendations for the equity risk premium, equity beta, and cost of debt. In our view, these Recommendations also depart in

[1] Department for Business, Energy & Industrial Strategy (**BEIS**) (and Secretary of State), Strategic priorities and cross-sectoral opportunities for the utilities sectors: open letter to regulators, 31 January 2022.
[2] BEIS, Economic Regulation Policy Paper, 2022, p. 19.

fundamental ways from the UKRN's landmark 2018 Cost of capital study[3]. The remainder of this response explains these points further.

8. In conclusion, Citizens Advice asks the UKRN Cost of capital taskforce to reconsider its proposed approach, in terms of both process and proposals, in particular, to:

   - expand its stakeholder engagement beyond this Consultation, by actively seeking to understand a wider set of views;
   - recognise and address the stakeholder asymmetries, and evaluate the views and concerns raised by Citizens Advice; and
   - consider commissioning an update of UKRN's 2018 Cost of capital study, especially on the matters that Citizens Advice has raised.

9. We recognise that this would mean extending the timescales beyond publication of a final version of the guidance paper in early 2023, as the UKRN anticipated, to complete this further work.

[3] "Estimating the cost of capital for implementation of price controls by UK Regulators", by Stephen Wright (Birkbeck, University of London), Phil Burns (Frontier Economics), Robin Mason (University of Birmingham), and Derry Pickford (Aon Hewitt) (**the 2018 UKRN Cost of Capital Study**).

I. *The Consultation process and proposals do not recognise the substantial asymmetries between consumer and investor stakeholders*

10. The Consultation rightly notes that companies, investors, and consumer bodies take a strong interest in how the allowed return used by regulators to set price controls in sectors subject to economic regulation[4]. Citizens Advice fully agrees. Indeed, Citizens Advice has a considerable – and longstanding – interest in how the allowed rate of return in sectors subject to economic regulation is set.

11. In particular, most recently, Citizens Advice was a granted permission to intervene in the 2021 Competition & Markets Authority (**CMA**) Energy Licence Modification Appeals – on the cost of capital (among other things). Citizens Advice also engaged extensively on the cost of capital in the 2020 CMA Ofwat Price Determinations.

12. Further, the UKRN Consultation highlights that "*ensuring that the allowed rate of return appropriately reflects the market risks taken by investors, given the underlying regulatory framework in each sector, is vital both for encouraging investment and innovation – and for protecting consumers from excessive prices*" (p. 3). Namely, the allowed rate of return should be neither too high nor too low.

13. Citizens Advice wholly agrees. Moreover, at the CMA appeals, Citizens repeatedly stressed the need to balance protecting consumers from excessive prices with the need for investment and innovation, i.e. that the rate of return should neither be too high nor too low. In contrast, investors (and companies) do not have such a balanced interest. To the contrary, investors' foremost objective is that the allowed rate of return is as *high* as possible.

14. Regulators nevertheless may assume that consumer bodies only want the allowed rate of return to be as *low* as possible – and therefore that regulators' role is to find a middle ground between consumer bodies and investors (and their respective positions). Such an assumption would be wrong and unfair though. It is also additionally unfair given the limited resources and competing priorities facing consumer bodies, even for Citizens Advice. In contrast, the fact that investors' overriding interest is for the allowed rate of return to be as high as possible means that they have much at stake and will therefore easily spend large sums to influence such regulatory outcomes (namely, orders of magnitude greater than is possible even for national consumer bodies such as Citizens Advice).

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[4] Page 3.

15. The same asymmetry of interests impacts regulatory appeals. Namely, as the Government rightly says: "*The process by which regulator decisions can be appealed **should** provide appropriate checks and balances to support the right outcome for consumers and the wider public interest [and that an] effective appeals process [**should**] ensure that investors, companies, and consumers can be confident that regulatory decisions are made in line with the legal duties of the regulators*"[5] (our emphasis added).

16. In reality though, it is considerably more difficult for consumer bodies than for the companies to appeal effectively against regulatory decisions, either owing to:
    - insufficient resources, as the Government acknowledges[6], especially owing to the considerable cost of bringing an appeal, and the associated adverse-cost risk in the event of losing; and
    - an outright bar from bringing an appeal in the case of full redetermination appeals, as the Government also acknowledges[7].

17. This is why, among other reasons, the Government says that it is intending to reform the regulatory appeals process, and especially, by planning "*on achieving an appeals system which delivers the best outcome for consumers and the wider public interest [and] appropriately checks and balances the decisions of sector regulators*"[8.]

18. In summary, there multiple large asymmetries in favour of investors in setting the allowed regulatory rate of return, i.e. a:
    - fundamental asymmetry of commercial interest;
    - similarly large asymmetry of resources; and
    - substantial asymmetry in the current appeals process.

19. The recent CMA energy and water appeals amply demonstrated all of these. For example, at the 2021 Energy Licence Modification Appeals, Citizens Advice estimates that the appellants submitted over 5,000 pages of newly created documents, the majority of which were prepared

[5] Economic Regulation Policy paper, p. 19 and 21.
[6] Page 23.
[7] Page 22.
[8] Page 23.

by external law firms and consulting firms[9]. This compares to less than 150 pages submitted by Citizens Advice (one of two interveners in the appeals), mostly prepared internally[10].

20. Such asymmetries have also long been increasingly recognised in public policy research findings, for example:

> "*The design of regulation needs to take account [risk] of regulatory capture. [...] Given that public and private interests diverge, and information is asymmetric, regulatory capture is a process for exploiting this principal-agent problem [especially] with the added complexity of divergence in interests between the electorate and politicians, politicians and regulators, and regulators and regulatees [...] Much of the design of regulatory policy is motivated by the aim of combating regulatory capture—creating rules for deciding when to regulate, selecting regulatory instruments, and putting institutional architecture in place. It is the central organizing concept.*"[11]
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> "*Information capture thrives in regulatory arenas in which technical issues dominate [regulatory processes]. In these settings, diffuse beneficiaries, typically represented by public interest groups, face substantial impediments to participating in [regulatory processes that are] detailed, complex, technical, and involve issues that are difficult to translate into salient risks for the public, and the media.*
>
> *[But without] pressure from a diverse group of affected interests and absent a central arbiter with incentives to find balance in spite of such incomplete representation, regulatory outcomes risk becoming skewed in favour of the dominant interest group. [...]*
>
> *Instead of presiding over vigorous conflicts between interest groups that draw out the most important issues and test the reliability of key facts, the agency may stand alone, bracing itself against a continuous barrage of information from an unopposed, highly engaged interest group. [...]*
>
> *Using technical terms and frames of reference that require a high level of background information and technical expertise [...] these fully engaged stakeholders can deliberately*

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[9] Comprising the appellants' Notices of appeal, Witness statements, Expert reports, Responses to the CMA's Provisional determinations, hearing presentations, and other submissions.

[10] And mainly comprising Citizens Advice's application to intervene in the appeals.

[11] Dieter Helm, "Regulatory reform, capture, and the regulatory burden", *Oxford Review of Economic Policy*, Summer 2006, Vol. 22, No. 2.

hijack the proceedings. Aggressively gaming the system to raise the costs of participation ever higher will, in many cases, ensure the exclusion of public interest groups that lack the resources to continue to participate in the process. […]

In information capture, just as in old fashioned capture, the stakeholders with relatively greater resources are able to dominate the outcomes and often do so free of oversight by onlookers—[…] because the deals [that] have been struck […] are so technical and complicated that in practice they take place at an altitude that is out of the range of vision of the full set of normally engaged and affected parties."[12]

"*When economists talk about regulatory capture, [they] do not imply that regulators are corrupt or lack integrity. In fact, if regulatory capture were due solely to illegal behaviour, it would be simpler to fight. Regulatory capture is […] pervasive precisely because it is driven by standard economic incentives, which push even the most well-intentioned regulators to cater to the interests of the regulated.*"[13]

21. Accordingly, it is critical that such systematic asymmetries and risk of regulatory capture are recognised in the way that UK regulators set the allowed rate of return for sectors subject to economic regulation, in particular, by giving appropriate weight to the submissions of consumers bodies versus investors and the companies. Namely, regulators should give special weight and consideration to the submissions of consumer bodies, in reflection of their common interest with the public interest, in their limited resources, and in their limited regulatory appeal rights.

22. In contrast, regulators should treat the submissions of investors – via the companies and their advisers – with considerable caution, in reflection of investors' very substantial vested interest in the outcome of such regulatory decisions.

23. It is disappointing therefore that the current UKRN Consultation does not recognise those considerations or take that approach, especially:
    - in not reflecting the position of national consumer bodies – i.e. Citizens Advice – on the cost of capital, as set out and strongly endorsed in the most recent CMA regulatory appeals; and

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[12] Wendy E. Wagner, "Administrative law, filter failure, and information capture", *Duke Law Journal*, Vol. 59, 2010.

[13] Luigi Zingales, "Preventing Economists' Capture", in *Preventing Regulatory Capture: Special Interest Influence and How to Limit It*, edited by Daniel Carpenter and David Moss, Cambridge University Press, 2013.

- in implicitly accepting the established positions of the regulated companies, e.g. as reflected in the recent CMA regulatory appeals, while not acknowledging that there are also alternative positions that deserve meaningful scrutiny and attention.

24. The following section explains these points further.

II. The Consultation does not reflect the position of consumers – and departs in fundamental ways from the UKRN's landmark 2018 Cost of capital study

25. The Consultation explains that its primary focus is on "*the common parameters for the cost of equity and the overall framework for choosing a point estimate for the allowed return on equity, due to these areas having the greatest commonality across regulators*"[14]. Citizens Advice agrees with that focus.

26. The Consultation goes on to say that its proposals "*bring together and consolidate existing methodologies, recognising the importance of both consistency across sectors as well as across time and recognising the benefits brought about by aligning regulatory approaches to investors and customers […and that] regulators […] would commit to having regard to this guidance in their future price control decisions where this is permitted by their statutory duties and deviate only where they consider there are good reasons to depart from it*"[15].

27. Citizens Advice strongly agrees with the need to bring together existing methodologies and of the importance of consistency. Citizens Advice is concerned though that the Consultation's overall approach is likely to stifle (or even prevent) future debate about the cost of capital, and thereby preclude future new evidence and necessary evolution of approach. Accordingly, Citizens Advice is concerned that the Consultation's proposed approach makes it even more important to explore the questions raised by consumer bodies (i.e. in recent regulatory appeals) now, i.e. by UKRN Cost of Capital taskforce, rather than be left ignored.

28. Nonetheless, of the Consultations' overall recommendations, Citizens Advice strongly agrees with six out of nine of them, namely:
    - ***Recommendation 1 – Notional company***: that regulators should continue to estimate the allowed rate of return based on a notional firm;
    - ***Recommendation 2 – CAPM***: that regulators should continue to use the capital asset pricing model (CAPM) as their primary approach for estimating the cost of equity;
    - ***Recommendation 3 – Risk-free rate***: that regulators should use recent yields on the index-linked gilts, with a maturity which matches the assumed investment horizon for their sector;
    - ***Recommendation 6 – CAPM point estimate***: that the mid-point of the estimated risk-free rate (RFR), total market return (TMR), and equity beta ranges should be used as the central estimate of the cost of equity;

[14] Page 3.
[15] Page 3.

- ***Recommendation 7 – Cross-checks***: that regulators should only deviate from the mid-point of the CAPM cost of equity range if there are strong reasons to do so; and
- ***Recommendation 9 – Gearing***: that the notional gearing assumption should reflect the balance of risks facing the regulated company and a wide range of benchmarks on gearing levels.

29. Citizens Advice nevertheless has major concerns with ***Recommendations 4 – Equity risk premium***; ***5 – Equity beta***; and ***8 – Cost of debt***.
30. The following sections discuss each of these in turn.

Recommendation 4 (Equity risk premium) conflates the equity risk premium with the market risk premium

31. Consultation Recommendation 4 says that: "*Regulators should estimate the equity risk premium (**ERP**) within the CAPM as the difference between the total market return (**TMR**) and the risk-free rate (**RFR**) […with the] TMR […] primarily based on historical ex post and historical ex ante evidence*" (p. 4). The Consultation then explains that the TMR is a measure of "*the return expected by the marginal investor from holding a diversified portfolio of all investible securities*" and that "*regulators have tended to use a broad index of equities as a proxy for the market of investible securities*" (p. 13).

32. Citizens Advice is concerned however that this statement makes two important errors.
    - First, the TMR is not merely the return on "*all investible securities*". On the contrary, it is the return on *all* assets in the economy.
    - Second, the fact that "*regulators have tended to use a broad index of equities as a proxy for the market of investible securities*" does not make it the right approach.

33. Indeed, UKRN's 2018 Cost of capital study highlighted that:

> "*[In] the original CAPM formulation, the market return should be the return on a portfolio consisting of **<u>all</u>** the assets in the economy, of which the stock market actually represents only a **<u>small fraction</u>**. The longstanding tradition of proxying the market return by the return on a broad stock market index is itself a **<u>significant compromise</u>** […].*" (p. 36) (our emphasis added)

34. Citizens Advice raised this same matter at the water and energy appeals, while at the same time also providing long-run historic evidence of the return on all assets in the economy, based on historic national accounting data across various countries[16]. Citizens Advice explained to the CMA that this was based on extensive research by many economists – which indicated that long-run (real) returns on all assets in the economy are likely to be appreciably lower than the corresponding long-run returns for equities. This is also unsurprising given that equities generally exhibit much greater systematic risk (i.e. correlation with macro-economic events) than all assets generally.

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[16] See CMA Energy Licence Modification Appeals 2021, Final determination, Volume 2A: Joined Grounds: Cost of equity (**CMA Energy Appeals Final determination: Cost of equity**) para. 5.194-5.197 (and Citizens Advice's Response to the CMA's Energy Licence Modification Appeals 2021 Provisional Determinations, para. 21-27).

35. This is appropriate also given that almost all the investors in the UK companies subject to economic regulation (especially in the energy and water sectors) are themselves highly diversified global investors[17], themselves investing in all types of assets in the (global) economy, of which UK regulated firms represent a small component[18].

36. In reply, the CMA said that "*we agree with Citizens Advice's argument that [...] the TMR should reflect the return on all assets in the economy, and that there is some evidence suggesting that total returns across all asset classes are lower than those on equities alone, and potentially materially lower*" and that regulators should give due consideration to this approach[19].

37. We are disappointed therefore that the UKRN Consultation has not reflected Citizens Advice's position on the TMR, documented by the CMA, nor the CMA's findings. We therefore ask the UKRN Cost of capital taskforce to revisit its approach.

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[17] Namely, including among the world's largest sovereign wealth funds, asset managers, infrastructure investors, pension funds, banks, and insurance companies.
[18] Citizens Advice estimates at less than 1%.
[19] CMA Energy Appeals Final determination: Cost of equity, para. 5.199-5.202.

Recommendation 5 (Equity beta) is likely substantially to overstate the equity beta

38. Recommendation 5 of the Consultation says that "*Regulators should estimate equity beta for the notional company using comparable listed companies and standard regression techniques (i.e. ordinary least squares).*" (p. 4)

39. Citizens Advice is concerned though that "*standard regression techniques*" may result in a substantial biases in estimating the true equity beta – reflecting the actual relevant risks facing the regulated companies – especially short-term beta estimates. Citizens Advice explained the reasons for this at the water and energy appeals[20]. Namely, one of the chief insights of the CAPM is the benefit to investors of index-investing (also called passive investing). Indeed, the CAPM has undeniably led to the inexorable growth of index-investing over the last 50 years, now accounting for one third of open-ended investment funds globally, and much higher still in the UK.

40. At the same time, extensive market evidence shows that movements in securities prices do not necessarily follow the expected risk characteristics of the CAPM, namely:

> "*Classical finance models [i.e., the CAPM] share the prediction that the prices of securities move together only in response to correlated shocks to expected cash flows or common variations in discount rates. [...] However, [... such models] are difficult to reconcile with abundant evidence that security prices can move together either too little or too much to be justified by fundamentals.*"[21]

41. In explanation for this, has now been a growing recognition though by financial economists that such divergence from the CAPM – especially in the short-run – is itself explained by the effect of index investing:

> "*[One] driver of co-movement of returns is commonality in trading activity [...] simply by virtue of being part of the stock index [...] exhibit excessive covariation in their returns [...especially] in the short run [...whereas] at long horizons, returns [...] revert to reflect fundamentals.*"[22]

> "*[Growth of index investing means that] trading is driven by investor flows or index*

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[20] See CMA Energy Appeals Final determination: Cost of equity, para. 5.485.

[21] Robin M. Greenwood and Nathan Sosner, "Trading Patterns and Excess Comovement of Stock Returns", *Financial Analysts Journal*, Sep. - Oct., 2007, Vol. 63, No. 5.

[22] Robin M. Greenwood and Nathan Sosner, "Trading Patterns and Excess Comovement of Stock Returns", *Financial Analysts Journal*, Sep. - Oct., 2007, Vol. 63, No. 5.

changes rather than through stock selection [...and this] amplifies stock market volatility and induces excess correlations among index stocks."[23]

"*Investors' equity portfolios are increasingly moving in lockstep with [...] the overall market. [...So] the entirety of stocks within a given index tend to move together [...] equity betas have not only risen but also converged in recent years.*"[24]

42. Indeed, the London Stock Exchange itself highlights that: "*The FTSE [100] constituents are reviewed every quarter. At each review some companies will exit and other will enter, this impacts share price and is a busy day of trading.*"[25]

43. In reply to this, the CMA said that it *"[recognised] the submission made by Citizens Advice with regard to index-investing and note its views on the negative impact that this may have on shorter term betas*"[26].

44. This is also essentially the same underlying reason for the UKRN 2018 Cost of capital study's **Recommendation Two (Horizon)** that:

"*[We] are in favour of choosing a fairly long horizon, for example, 10 years, in estimating the CAPM-WACC [...and moreover] that all components of the CAPM-WACC are estimated using a methodology that is consistent with the chosen horizon. [...]*

[This is to avoid a] disconnect between the horizons of the (notional) investor and the expected life of the assets employed. [...]

[If regulators] are concerned to assess the nature of systematic risk at long horizons, [then they] should ensure that our estimation techniques are consistent with that horizon."

45. Furthermore, the effect of estimating equity betas by regression against UK equity market indices – rather than indices of all (global) assets is itself likely to create a further upward bias in UK regulated company beta estimates. This reflects that movements in UK regulated company share prices will be far more correlated with UK share prices generally than with movements in

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[23] Nan Qin and Vijay Singal, "Indexing and Stock Price Efficiency", *Financial Management*, WINTER 2015, Vol. 44, No. 4.
[24] Rodney N. Sullivan and James X. Xiong, "How Index Trading Increases Market Vulnerability", *Financial Analysts Journal*, March/April 2012, Vol. 68, No. 2.
[25] London Stock Exchange website (FTSE 100 page).
[26] CMA Energy Appeals Final determination: Cost of equity, para. 5.494.

all global asset prices. This matters of course, because equity betas are intended to reflect the correlation between an individual equity's systematic risk and the systematic risk of all assets, not just a small subset of such assets.

46. This is also especially relevant given that the investors in UK regulated companies are themselves among the world's largest diversified investors, investing in all asset classes across all geographies, of which UK equities comprises only a small component.

47. It is disappointing therefore that the UKRN Consultation has not acknowledged these factors in its discussion or recommendations, and makes no specific recommendation to use longer-term beta estimates, as raised by Citizens Advice and endorsed in the recent CMA regulatory appeals. Citizens Advice therefore asks the UKRN Cost of capital taskforce to consider its proposed approach further.

Recommendation 8 – Cost of debt

48. We note that the UKRN 2018 Cost of capital study **Recommendation 8 (Estimating Default Risk on Corporate Debt)** recommended to regulators that: "*For consistency with the definition of the CAPM-WACC as an expected return, cost of debt estimates that feed into estimates of the CAPM-WACC should include an adjustment to corporate bond yields to convert these to expected returns.*"

49. We do not believe however that the UKRN Consultation proposals reflect this approach, in particular, that they do not recommend estimating expected returns net of default risk on corporate debt. Omission of this will necessarily tend to overstate the allowed cost of debt.

III. ***The Cost of capital taskforce should review it process around developing its cost of capital guidance, including fully independent review***

50. In summary, the combined effect of the UKRN Consultation proposals on the cost of equity and cost of debt is likely to mean a potentially substantial upward bias in the UKRN's proposed approach to setting the allowed cost of capital. In our view, this is not compatible with the Government's call for the UKRN Cost of capital taskforce to ensure that the setting of the periodic cost of capital must ensure value for money and provide a fair deal for all consumers, and accordingly, to ensure the general affordability of consumers' essential bills.

51. Furthermore, in the light of now rapidly rising UK interest rates – which will put a substantial added upward pressure on the cost of capital (via the risk-free rate and cost of debt) – it has become even more vital that the UKRN's proposed approach provides a fair deal for consumers and seeks every opportunity to ensure the affordability of consumer bills.

52. The UKRN process around producing the cost of capital guidance should therefore seek to address the underlying stakeholder asymmetries. Part of this must be to engage with a wide range of interested parties and actively seek views, which are then fully considered. This Consultation is the only engagement activity that we are aware of and states that final guidance will be published in the early part of next year. This does not appear to leave sufficient time for issues that are raised through this consultation to be fully considered.

53. The process should also be extended to allow the UKRN taskforce to evaluate consultation responses as part of a wider engagement process.

54. Robust assurance over recommendations is also of course important to address the structural asymmetry. The UKRN Consultation says that its proposed approach "*has been subject to independent peer review by John Earwaker and Craig Lonie*" (p. 3). We are concerned though that Mr Earwaker and Mr Lonie are both industry consultants – to corporate clients and investors in the energy and water sectors – and so cannot provide the diversity of perspective that is required to provide effective assurance.

55. Further, in the light of the Government's objectives for the UKRN Cost of capital taskforce, and the concerns that Citizens Advice has raised about the UKRN's proposed approach, we call on the UKRN to commission an update of the UKRN's 2018 Cost of capital study. We suggest that UKRN should approach the authors of the study, and for them to address the issues that Citizens Advice has raised in its consultation response (among other wider matters).

Please contact me to discuss our response further.

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