

HIGHER REGIONAL COURT DÜSSELDORF ANNULS EQUITY YIELD RATE DETERMINATION FOR THIRD REGULATORY PERIOD

The complaints brought forward by the electricity and gas network operators against the determination of the equity yield rate for electricity and gas for the third regulatory period were successful. The Higher Regional Court Düsseldorf has classified the interest rates set by the Federal Network Agency due to methodological faults as defective and repealed the determination.

BACKGROUND

On 5 October 2016, the Federal Network Agency as competent German regulatory authority has issued the determination of the equity yield rates for the third regulatory period for electricity and gas network operators (BK 4-16-160 and BK4-16-161). In contrast to the second regulatory period, the Federal Network Agency reduced the interest rates uniformly from 9.05 per cent to 6.91 per cent for new assets and from 7.14 per cent to 5.12 per cent for old assets (values are before taxes). The return on equity represents the essential basis for network operators, but also for investors, in order to be able to continue investments in the grid and thus to secure the network infrastructure and to promote the necessary grid expansion. A cut in interest rates by one per cent represents a total volume of approximately EUR 1 billion.

Approximately 1,100 network operators filed complaints with the 3rd Cartel Senate of the Higher Regional Court Düsseldorf. On 22 March 2018, the Senate decided on 29 model cases.

METHODICALLY INCORRECT DETERMINATION

The equity yield rates for the operators of electricity and gas networks are to be derived pursuant to the Energy Industry Act and associated regulations from a base interest rate plus a **risk allowance**. The latter is intended to cover the network-specific entrepreneurial risks.

According to the Court, the base interest rate of 2.49 per cent as calculated by the Federal Network Agency is reasonable and lawful. However, the risk allowance was determined methodically incorrect by the Federal Network Agency. The regulator's evaluation of the entrepreneurial risk was **not scientifically justified**.

Key issues

- The regulatory equity yield rate determines the return on equity and is therefore a crucial parameter for network operators as well as for infrastructure investors.
- Pursuant to the Court's decision, this valuation-relevant factor is too low based on the current determination.
- The determination of the market risk premium has to reflect the current situation on the financial markets.
- Studies reveal a market risk premium between 4 per cent and 6 per cent or between 3 per cent and 7 per cent, respectively. The Court considers that a value at the higher end of these ranges is required.

Basically, the Capital Asset Pricing Model ("CAPM") as a method for determining the risk allowance is generally compatible with the requirements of section 7 paragraph 4 and 5 of the German grid fee ordinances. Alternative approaches such as the Total Market Return model or other ex-ante models are not preferable over the CAPM.

However, the Federal Network Agency has only used historical data to derive the market risk premium without taking into account the current **developments in the financial markets**. This was erroneous in the opinion of the Court. Past financial crises, the historic low of interest rates in 2015 and the current monetary policy including the lowering of key interest rates were not taken into account appropriately. Even long-dated government bonds have very low returns. Moreover, the necessary plausibility check and the assessment of alternative methods were not applied for the determination of the market risk premium.

Other than the Federal Network Agency's determination of market risk premiums, numerous studies would result in between 4 per cent and 6 per cent, and between 3 per cent and 7 per cent respectively. Only a **determination at the higher end** of this range would sufficiently take into account the structural break in the financial and capital markets triggered by the financial and debt crisis, the Court clarified.

FORECAST

The Federal Network Agency now has to re-determine the equity yield rate, taking into account the legal opinion of the Court. The decision is not legally binding, yet. The appeal to the Federal Court of Justice was allowed. We will inform you about the further progress of the procedure.

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