Appendix 2: response to RIIO-2 Draft Determinations Finance Annex questions

September 2020

Contents

1 Overview

Electricity North West Limited (ENWL) is an Electricity Distribution Network Operator (DNO). Our interest stems from the potential consequential impact on the framework development for RIIO-ED2, commencing in 2023, as well as the impact the proposals will have on the energy sector as a whole and those consumers in our operating region. We urge that Ofgem consider the requirements for ED specifically and reflect this in the proposals made as part of that framework development for RIIO-ED2.

We have reviewed the Draft Determination proposals and would comment that issues remain on Finance where we consider Ofgem is making errors. We set these out in our response to the financing annex through our responses to question posed in the consultation.

The financing duty of Ofgem is to ensure that an efficient individual licensee can secure both debt and equity funding. In RIIO-2 Ofgem is wrongly interpreting this duty as being to a notionally geared, artificially identified group of companies, creating circumstances of windfalls to some companies at the expense of financeability and/or reduced equity returns (and therefore investment incentives) for others. We continue to disagree with the proposed approach to debt allowances which fails to fund efficiently incurred debt costs and urge that Ofgem ensures that licensees can secure both debt and equity finance consistent with its financing duty.

Further, RIIO-2 provides almost no opportunity for individual companies to absorb adverse effects of these financing issues in the round and this is compounded by the introduction of a Return Adjustment Mechanisms (RAMs) proposed to operate without considering financing and tax performance. The consequence is that companies like ourselves that perform strongly for our customers, set industry efficiency benchmarks at ED1, but have efficient debt taken out in the market ahead of the financial crisis are less able to achieve fair returns by offsetting debt underfunding by incentivised strong performance for customers. We do this in RIIO-ED1. We would urge that Ofgem includes finance and tax within RAMs as this would better protect customers and consumers from inappropriate returns resulting in RIIO-2. Further, Ofgem's proposal not to take derivatives into account in assessing the cost of debt is illogical. Derivatives are an important way to manage risks for our customers as well as shareholders. Our views should be familiar to Ofgem through our ongoing dialogue and we have shared our views with the CMA as part of our submissions on PR19[1].

We have worked to provide a substantial body of independent expert evidence to Ofgem's finance work stream through the ENA's RIIO-2 Finance Working Group. The independent consultant reports referenced within our response are being provided alongside through the Energy Networks Association's (ENA) response to this consultation and are therefore not appended to our individual response. A considerable body of evidence has been provided by the ENA which merits thorough consideration by Ofgem, including reviewing evidence that has already been considered as Ofgem is reaching incorrect conclusions, often based solely on Ofgem's own judgements justified with what appears to be weaker evidence.

We are concerned that Ofgem's approach to financial matters is skewed and represents an unbalanced settlement where extreme positions are selected in all components. Applying the extreme-end of a plausible scale in all areas risks driving unintended consequences and behaviours and leads to inadequate investor appetite to drive forward decarbonisation in line with government policy, worsening outcomes for consumers. We urge Ofgem to take a more balanced approach, adopting positions more credibly within the ranges of evidence rather than towards particular ends of

[1] https://assets.publishing.service.gov.uk/media/5ebebc46e90e071e33ce88a4/Electricity_North_West_Ltd_Redacted.pdf

a spectrum and to rebalance how Ofgem weights the needs to attract long term investment for future customers with short term bill reductions.

Here after is our response to specific questions posed in the Finance annex of the RIIO-2 Draft Determination consultation.

2 Allowed return on debt questions

FQ1. Do you agree with our approach to estimating efficient debt costs and setting allowances for debt costs?

As a general point of principle, we continue to have concerns over a one-size fits no one approach to setting the debt allowance. A full indexation methodology, calibrated to the expected sector debt costs, will provide cross-generational outperformance to those ‘lucky and large’ networks, while perpetuating financeability headwinds for others.

We understand the Ofgem desire to incentivise the networks to outperform the debt allowance, but do not believe that this outperformance should benefit the networks for decades after the end of a regulatory period.

We believe that the suitability of any approach is best measured with respect to its outcomes. Ensuring the financeability of individual networks, through the re-distribution of the sector debt allowances towards those networks with higher embedded debt costs, would provide significant benefits over the current approach without additional costs for UK consumers.

We recognise the concerns raised previously in respect of any straight pass-through of debt costs, and although we continue to believe it is more appropriate than the full indexation approach, we believe a modified approach that provides individual networks with pass-through of embedded costs only, can deliver incentivisation for new financing, while also protecting consumers interests through debt efficiency tests in Business Plan submissions.

With respect to estimating debt costs, either under the proposed or any alternate approach to setting the debt allowance, we raise the following points of principle:

- The cost of derivatives should be included in any estimation. A key function of derivatives is risk management. To the extent that the efficiency of derivatives cannot be understood simply, networks should be asked to provide additional information in a form that Ofgem can use to better understand even those who have complex derivatives arrangements.
- We support the inclusion of all areas of financing – including transaction costs, liquidity management and pre-financing.
- To the extent that networks are exposed to RPI basis risk on financing following Ofgem’s decision to move to CPI or CPIH, the efficient cost of hedging this risk should be included in the estimation of debt costs.
- We recognise that intercompany loans need to be considered individually and should be considered for inclusion on a case-by-case basis.
- If it can be demonstrated that some networks suffer structurally higher financing costs, such as from being an infrequent issuer in capital markets, then the additional costs should be included for that network. We look forward to providing you with our evidence during the development of proposals for ED2 as to the levels required.
- Incorporating additional sectors into any calibrated average will accentuate the issues noted above, while providing minimal benefits to consumers.

- Debt allowance outperformance or underperformance should be seen as much of an incentive mechanism as any other incentive mechanism. If there is to be a Returns Adjustment Mechanism (RAM), this should include all returns to Equity, and therefore be struck after debt allowance performance which should also be included in the RAM.

We look forward to working with Ofgem in formulating an improved approach for setting RIIO-ED2 debt allowances and will provide additional detail in our response to FQ1 of the SSMC.

FQ2. Do you agree with our proposal to use the iBoxx GBP Utilities 10yr+ index rather than a combination of iBoxx GBP A and BBB 10yr + non-financial indices?

We note our existing concerns regarding Ofgem's approach in our response above to FQ1.

Providing that the primary objective holds - being to reimburse the estimated sector debt costs - the choice of reference index is of reduced importance, as any resulting allowance can be structured to be largely equivalent through the use of a wedge or a deduction. While such adjustments can be justified by reference to transaction costs, the halo effect, or similar, this process of justification is less critical than that of delivering on the primary objective and reimbursing networks with the appropriate allowance. We consider the appropriate allowance is set on a company specific basis.

We do not have a view at this stage on whether the Utilities index is ultimately more appropriate, but we look forward to working with Ofgem as part of the ENA Finance Working Group to understand the relative benefits and weaknesses of the proposal.

We note that the period covered by any index, and whether a constant timeframe or tromboning structure is adopted, is of arguably more importance than selection of the base index. If this structure is inappropriate, the allowance will not accurately match the refinancing profile of networks and would also expose those networks to significant underperformance in the event of any rate reversion.

This risk could be reduced through the adoption of a modified pass-through approach as discussed in FQ1.

FQ3. Do you agree with our proposal that the RAV growth profile of SHET continues to be materially different to other networks and therefore warrants continuation of a bespoke RAV weighted allowance calculation?

As noted in our response to FQ1, we do not support a one-size fits all approach to setting the debt allowance.

We support bespoke mechanisms in principle, particularly when this delivers additional wider benefits, such as ensuring the financeability of networks.

Ofgem should set allowances for debt costs as they do for other allowances, i.e. taking the individual circumstances of the licensee into account, including such as infrequent issuers in capital markets or the timing of efficiently incurred issuances.

FQ4. Do you have any views on the model to implement equity indexation, as published alongside this document, (the "WACC allowance model.xlsx") or on the annual update process?

The mechanical attempt to introduce indexation into the equity allowance has pitfalls. Equity investors into UK infrastructure provide patient capital and seek long-term stable returns.

While indexation may seem attractive to regulators, adjusting CAPM for short term fluctuations for risk-free rate in isolation is an error and provides a false sense of precision in the output, while also being disjointed from the expectations of investors, which are forward looking and long-term.

Following the revision to five-year price controls, we do not believe equity indexation is either necessary or a positive development for networks or consumers.

3 Equity beta questions

FQ5. In light of RIIO-2 Draft Determinations and Ofwat's final determinations for PR19, do you believe that energy networks will hold similar systematic risk during RIIO-2 to water networks during PR19?

We firmly support the conclusions drawn in Oxera's Cost of Equity for RIIO-2 Q4 2019 update where they find that it would be inappropriate to place a high weight on water network betas.

Systematic risk refers to the risk inherent in the entire market and beta is a measure of the systematic risk of the security (or sector) relative to the entire market.

We view that achievement of net-zero carbon, as prescribed by Government, affects the market as a whole and is not just single company or sector related. Further, some sectors, notably energy are affected more by this than others. We therefore do not agree with CEPA's assertion that such risk is idiosyncratic, but we do agree that there will be greater change in energy networks than water.

CEPA state that:

> *"While the scope for change may be greater in energy networks, some of the risks and opportunities resulting from energy network transitions are likely to be idiosyncratic rather than systematic in nature. Based on current regulatory arrangements heightened uncertainty does not necessarily translate into heightened systematic risk exposure and, therefore, the risk premium that might be demanded by investors."*

It is clear that substantial investment in energy networks will be required to reach Government's Net Zero carbon challenges, and that energy networks will be expected to take the lead in achieving these unprecedented goals. These challenges deliver significant risk and uncertainty but are expected to happen in the energy sector. In contrast, CEPA reference that water also face infrastructure challenges (and therefore risk) and cite the potential need for investment to improve resilience against drought situations. It is clear that the first is a requirement and brings with it significant delivery risk; the second is uncertain.

It is also clear that the Electricity Distribution companies face far more technological and delivery challenges in delivering and spear-heading the move to net zero and should not be compared on a relative risk basis to water.

As outlined above, we do not believe the use of water companies, particularly for Electricity Distribution companies, is appropriate. Notwithstanding this, a further concern in their use is how equity returns are measured. If Ofgem include quoted water companies as the basis of investor expectations for equity returns, then they should ensure that debt outperformance included in quoted company results is stripped out before equity returns are measured.

FQ6. Is there evidence of a material difference in systematic risk between:
a) RIIO-1 and RIIO-2,
b) distribution and transmission networks,
c) gas transmission and electricity transmission,
d) gas and electricity?

There are clearly different risk delivery challenges between the sectors to achieve Government targets of Net Zero. Electricity Distribution networks face substantial delivery and technological challenges in not only meeting internal company-specific Net Zero targets but also acting as the leader and enabler to allow thousands of businesses and millions of customers to meet their own ambitions and targets. Given this diversity in our customer base and in the network circumstances, ED faces unique infrastructure challenges in meeting what will likely be an enormous variety of low-carbon challenges on the distribution network.

4 Step-2 implied cost of equity consultation questions

FQ7. Do you have any views on how we should consider further the gearing impact on beta and cost of capital estimates?

It appears Ofgem's current stance on this matter is born out of the NERL CMA challenge. Specifically, Ofgem state:

> *"…that given our combined assumptions for risk-free and TMR, common approaches to re-gearing asset betas have the effect of increasing the overall WACC estimate. The result holds, even when using high estimates of debt beta, after accounting for the impact of tax, and when using various re-gearing formulae options. The overall effect can imply that the cost of capital is approximately 10bps higher for each five percentage point increase in gearing. We also note that lower levels of debt beta exacerbate this effect, as anticipated in the SSMD,[97] making us further doubt arguments that we should assume a low debt beta."*[2]

As part of the PR19 CMA appeal Oxera have looked in to this issue and it appears that the assumptions Ofgem are using, particularly regarding the RfR, are the primary cause of this effect. We believe that use of an appropriate RfR (see Annex 1 of ENA submission to CMA review of Ofwat Price Determinations for PR19[3]) alongside reasonable CAPM assumptions can overcome this issue. We also believe that using this argument to justify a higher debt beta is misplaced.

FQ8. Do you agree with our interpretation of cross-checks?

ENA has provided evidence to caution on the interpretation of cross-checks Ofgem use such as MARs, OFTO's and investment management forecasts. As we have previously set out, we believe there is a great deal of subjectivity which gives rise to a range of answers and thereby significantly impact their ability to provide objective support to conclusions drawn from the CAPM.

Regarding MARs, Ofgem's proposals rely heavily on water companies. We are concerned about such significant use of water companies in the overall analysis (see response to FQ5 for example), and in particular the use in this instance to justify MARs based arguments on a false premise that they are in any way good proxies for energy companies, let alone Electricity Distribution companies.

[2] RIIO-2 Draft Determinations – Finance Annex, para 3.70, Ofgem
[3] ENA representation to CMA Annex 1, 'Are sovereign yields the risk-free rate for the CAPM?', Oxera, May 2020

Regarding OFTOs, we maintain this is not a valid cross-check due to the significant risk and structural differences between networks and OFTOs.

For ED2, we believe that calibration of cross-checks should be better targeted and more appropriate.

5 Step-3 allowed return on equity consultation questions

FQ9. What is your view on the overall in-the-round assessment of allowed returns to equity? Is our judgement of 3.95% at 60% notional gearing reflective of the combined analysis through Steps 1, 2, and 3?

Our view remains consistent with the Oxera's November 2019 update paper on the cost of equity.

The ENA has provided a substantive body of evidence to support the component parts of CAPM. Ofgem has routinely disregarded this evidence in favour of results that instead deliver lower CAPM equity returns, while providing only cursory explanation or evaluation.

The evidence disregarded is not simply a matter of judgement that can be dismissed. All data should be considered, with the weight of evidence then providing direction within the distribution of outcomes.

We are concerned that once again alleged evidence has been sought to justify the Stage 1 downside positions at stage 2, and that the evidence provided by the ENA through its consultants has been largely ignored.

The stage 3 adjustment (allowed v expected returns) should never be necessary in a well calibrated incentive-based regulatory regime – especially one that is now likely to include RAMs as an overall check to ensure returns remain within ranges Ofgem sets. Again though, evidence has seemingly been sought to attempt to substantiate yet another downside adjustment.

In each case Ofgem have erred on the downside resulting in a cherry-picked theoretical composite that is difficult to rationalise and not credible in a real-world situation. The overall approach is simply not balanced.

Ofgem state that a key aim is to support achievement of Government targets on net-zero carbon. This will require significant investment, particularly from Electricity Distribution companies, and due to the inherent uncertainty in how this will be achieved, could lead to further risk in the paths chosen to fulfil this ambition. This investment requirement is incompatible with the current calibration of the cost of equity.

FQ10. What is your view on the expected outperformance estimate of 0.25% at 60% notional gearing? Do you recommend alternative analysis techniques or do you have suggested improvements to the analytical files published alongside this consultation?

a) "AR-ER database.xlsx"
b) "Residual outperformance.xlsx"
c) "Simple MAR application model.xlsx"

As mentioned in FQ9 above, the stage 3 adjustment (allowed v expected returns) should never be necessary in a well calibrated incentive-based regulatory regime - it is curious that Ofgem appear to be the only regulator to feel the need to employ such a catch-all adjustment. Its inherent current and future uncertainty will result in erosion of investor confidence and increase the risk they face, as well as tempering their view of a stable and predictable regulator for future regulatory determinations. It is also likely to have adverse impacts on the incentive regime.

The behavioural impacts of such an adjustment were clearly explained in the Frontier paper prepared for the ENA "ADJUSTING BASELINE RETURNS FOR ANTICIPATED OUTPERFORMANCE – An assessment of Ofgem's proposals (March 2019)".

As for alternatives (a) to (c) above, the basis is all historical. There is a fundamental disconnect here in so much as RIIO2 is presenting a far tougher incentive regime, which contains substantial changes that tighten it, exposing companies to more downside risk than anything gone before, so basing an adjustment on historical evidence in attempting to adjust for future expected outperformance is conceptually wrong. An example is the selection of such a high efficiency bar for setting cost allowances at tougher than upper quartile.

Notwithstanding our concerns with the use of such an adjustment, an alternative approach to assess the balance of the whole package would be to assess the overall incentive/opportunity of outperformance against overall penalty/risk of underperformance. This should include all elements of the RIIO-2 package, including financing. Without this assessment it is impossible to justify a lowering of equity return rates against investor expectations.

FQ11. What is your view on an ex-post adjustment for baseline equity returns? Is there an alternative mechanism or implementation approach that you think could better meet our stated objectives? Do you have specific views on averaging, pooling or suggested simplifications?

Given our view of the initial adjustment as expressed in answers to questions FQ9 and FQ10 above, we don't think this is necessary and adds more uncertainty into the mix for investors, distorts incentives and other adverse impacts thereby adding to consumers long term costs and likely reducing the future benefits the regime to date has achieved.

That said, and specifically in answer to this question, the Draft Determination does not provide sufficient detail on the specifics of such a mechanism giving rise to a number of questions:

- What does performance mean?
- How will it be measured? Does it include financing and tax (it should)?
- Why apply a sector average? Will this be weighted? What are the consequences for individual company decision-making?
- Has any impact assessment been conducted?
- If in the event that Ofgem find that the sector underperforms due say to insufficient totex allowances being provided to cover the investment needed, will Ofgem provide a positive uplift adjustment?
- How will the impact of Ofgem's own within period decisions be treated on the substantial range of in period adjustment mechanism?
- What are the likely impacts for future price controls?
- Will future processes be consistent?
- Will this lead to a systemic position of winners and losers within sectors?
- What is the economic impact on a region of having a systemic loser or winner in the region?

There are probably many more questions to be considered on this proposal, especially at a sector level basis, which is likely to lead to differing conclusions. The uncertainty surrounding this proposal and its future implications seem to add to the confusion and risk of the price control outcome rather than alleviate it. This proposal was flawed from the start in principle, has been insufficiently developed, and is now being shaped with late evidence that should have been provided earlier and as developed has major changes far too late in the process.

With future Ofgem clarification, we expect to provide an answer to these questions during the ED process as our understanding of the process develops. We remain particularly convinced that there is no evidential basis for an adjustment downwards in returns in ED and that this would have detriment to customers as the energy system decentralises and decarbonises.

6 Financeability Questions

FQ12. Do you agree with our approach to assessing financeability?

We do not agree with Ofgem’s approach to assessing financeability.

As a fundamental principle, we consider that Ofgem’s legislative duty is to ensure the financeability of individual networks and not the notional company. As such, it follows that the regulator needs to have due regard to individual company circumstances to successfully discharge this duty.

We equally accept that this cannot represent carte-blanche for networks and there should be a requirement to identify any inefficient costs to avoid customers funding these. However, this financing duty is established to ensure that the long-term interests of consumers in each licence area are met.

It also cannot be appropriate to set equity returns independently and then expect equity to simply subsidise under funding associated with efficiently raised debt with no implications.

We look forward to working with Ofgem on the financeability assessment for the RIIO-ED2 price control.

FQ13. Do you agree with our approach to determining notional gearing for each notional company?

The results of the financeability assessment should not be used to justify the choice of notional gearing.

Notional company gearing is a determining factor in the long-term financing structure of networks. Regulatory consistency is critically important here and any decision to move from previous price controls needs to be carefully considered and well-justified.

The actual gearing levels of networks is an important consideration. If it can be demonstrated that these are consistently below the current notional gearing level and any change can also be justified with regard to customers interests then a well-signalled change, with transitionary arrangements may be appropriate.

The financeability assessment at the existing notional gearing level should be sense-checked as to whether the equity return, and debt allowance proposals are viable. The notional gearing level should not be used as a lever to make the assessment workable.

FQ14. Do you have any evidence that would suggest we should consider adjusting our notional company financing assumptions due to the impact of COVID-19?

The COVID-19 pandemic has highlighted three particular areas:

- The short-term volume risk that networks are exposed to.
- The requirement to maintain stress-test levels of liquidity and committed facilities.
- The value of structuring facilities with covenant headroom.

We have provided evidence to Ofgem on the impact of the pandemic as part of the Covid-19 Financial Monitoring.

We have not reviewed the notional company financing assumptions in detail but will provide feedback as part of the RIIO-ED2 process.

The areas highlighted above, to our minds, are important considerations when setting the debt allowance and equity returns.

The cost of maintaining appropriate levels of liquidity and committed facilities should be factored into the estimation of debt costs. While the related variability, and therefore risk, in equity returns arising from the pandemic should be an important cross-check for the CAPM derived equity return.

7 Corporation Tax questions

FQ15. Do you agree with our proposal to pursue Option A?

Out of the options put forward for consideration, we would agree that Option A is the most suitable.

FQ16. Do you agree with our proposals to roll forward capital allowance balances and to make allocation and allowance rates Variable Values in the RIIO-2 PCFM?

Although we agree in principle to making allocation and allowance rates Variable Values so that they are more aligned to actual results, we would like to see further guidance on how this will work in practice. In particular, for the change in allocation percentages, could the allocations be different for individual years and would the onus be on the company to calculate and revise the allocations on an annual basis? Would it be a requirement for companies to perform this calculation annually, even if they are not expecting the outcome to be materially different to the previous allocation? What methodology would be put in place to ensure a consistent approach is taken across the network operators? Furthermore, we would like to ensure that the simplification does not result in unintended consequences which have a detrimental effect on the calculation of the tax allowance.

FQ17. Do you agree with the proposed additional protections? In particular:

a) do you have any views on a materiality threshold for the tax reconciliation? Do you think that the "deadband" used in RIIO-1 is an appropriate threshold to use?

We agree that there should be a level of materiality in place. The current RIIO deadband affects allowances, rather than being a tool to make an assessment of materiality for a tax reconciliation. Therefore, at this stage, we would need to undertake further analysis to determine what would be an appropriate materiality threshold, which we anticipate performing for the RIIO ED2 process.

b) *Do you have any views on our proposals to retain the Tax Trigger and Tax Clawback mechanisms from RIIO-1?*

We are mindful of certain instances where the clawback mechanism might have the following unintended consequences, for example:

- The impact of Ofgem changing notional gearing
- Where interest costs are disallowed for tax
- If there is a timing difference, i.e. where the associated tax benefit was not received for the period in question.

We believe these consequences should be taken into consideration when ascertaining whether the tax clawback should be applied.

c) *Do you have any views on the proposed process for the Tax Review?*

We have concerns about the structure and balance of the proposed wording, especially when considered alongside the drafting for other such re-opener mechanisms. This has been underlined by Ofgem's response where they have stated that they do not necessarily expect this tax review mechanism to result in positive adjustments to the tax allowance (albeit they have stated that the drafting will remain silent on this). We believe there should be safeguards put in place that are in line with other re-opener mechanisms. We would like to see further guidance and clarification on the process that stakeholders must follow to notify Ofgem of a concern.

d) *Do you have any views on the proposed board assurance statement?*

The Board Assurance Statement as drafted appears to have two key objectives.

The first is to provide assurance to Ofgem that that information provided by networks in the tax reconciliation is accurate and reflects a true and fair view of the network's position. We do not feel a separate assurance statement is warranted in this area. The tax reconciliation will form part of the expanded RIG submission and it will be subject to the collective DAG control procedures with Director sign-off.

The second objective appears to be a request for Directors to confirm that "the notional tax allowance as calculated by the PCFM represents a fair reflection of the Licensee's actual tax liability". This can only ever be provided subject to the items included in the CT600 reconciliation, as such we do not understand this requirement. We do however understand that the wording is being reconsidered by Ofgem. This statement also needs to be qualified to take account of tax deductions and/or timings for which Ofgem has not given allowances within the current period. For instance, the licensees may have derivatives. To the extent that these are not taken into account by Ofgem in setting allowances, the tax effect should also be allowed as a reconciling adjustment.

Separately, we highlight the additional existing documentation and processes that support the legitimacy of a network's tax affairs, including the SAO certification, Fair Tax Mark and published Tax Strategy.

8 Return adjustment mechanism questions

FQ18. Do you agree with our proposal to introduce a symmetrical RAMs mechanism as described above?

We do not support the inclusion of RAMs within the RIIO-2 framework as these are not required if Ofgem sets an appropriate price control at the outset. RAMs distort the working of incentives, whose property has been one of the cornerstones of the success for consumers of Ofgem's regulatory regime.

The justification for the introduction of the Return Adjustment Mechanisms (RAMs) appears to be two-fold. Firstly, as a failsafe to cap any perceived excess returns generated by strongly performing networks and secondly, to protect the cash flows and financeability of underperforming networks.

While a symmetrical RAMs mechanism is attractive from a simplicity perspective, it does not accurately reflect the weight of consequences at each boundary. The shape of the RAM ought to be informed by the package in the round of the regulatory mechanisms, and what scope Ofgem wants to allow for company performance to drive the level of returns achieved. The design of the RAM might need to be company specific, and the elements included and not included in how the RAMs work might impact how it is designed symmetrically or otherwise.

We believe that Ofgem needs to give greater consideration to setting an appropriate floor level for the RAMs, ensuring that it is triggered at a level, and in a manner, that limits distress of the affected networks in a way that is proportional to those networks impacted at the RAMs ceiling. This will be an important factor both in assessing downside financeability and in discussions with ratings agencies.

FQ19. Do you agree with our proposal to introduce a single threshold level of 300 basis points either side of the baseline allowed return on equity?

A single threshold level benefits simplicity, but noting our response to FQ18, we do not necessarily support a symmetrical threshold either side of the baseline allowed return on equity.

Any RAM should be structured so that does not disincentivise networks from continuing to strive for innovation and further efficiency. The threshold level should be set in this context.

This Draft Determination is not in respect of Electricity Distribution; therefore, we do not feel it appropriate to opine on whether the 300 basis points is appropriate, but we look forward to considering any RAMs proposals in more detail as part of RIIO-ED2 process.

FQ20. Do you have any other comments on our proposals for RAMs in RIIO-2?

We have a fundamental issue with the current RAMs proposal which is that it is not in consumers interests to introduce this measure as it merely represents a fail-safe mechanism to give Ofgem confidence returns will be within certain bounds, moving us more towards rate of return regulation.

The RAMs proposal is clearly structured around equity returns, with adjustments triggered as those returns deviate materially from the baseline.

We do not see how it can be justified to base the RAMs assessment on an incomplete view of equity returns, which excludes financing and tax performance.

It is not unfeasible for a network that is poorly performing operationally to be granted additional effective subsidisation from customers, while also being overfunded in respect of its debt costs. This cannot be in the interests of customers.

It is essential for the technical integrity of the mechanism that RAMs include financing and tax performance – i.e. include all net returns to equity and not some. Whilst RAMs are not in consumers interest, improperly implementing the policy measure will worsen this measures impact on consumers.

The price control mechanism already includes various existing measures to control the levels of out and under performance in specific areas. The rationale to include another measure in respect of certain specific items only is limited, while it is misleading to present it as a solution to perceived excess returns while it remains an incomplete view of excess returns itself (i.e. excludes tax and financing as currently proposed).

As a final point, in the context of a price control including RAMs, we do not see the justification for also including an adjustment to equity returns for allowed versus expected returns. Ofgem is introducing layers of complexity into the price control in areas such uncertainty mechanisms, while refusing to consider alternate approaches elsewhere on the grounds of regulatory consistency and simplicity.

Should Ofgem continue with both RAMs and an adjustment to equity returns, the baseline equity return must be set at the expected return level and the RAM should be set around the baseline equity return pre-any adjustment. The logic of this is clear if one considers a situation with a larger allowed versus expected adjustment was proposed – say 200bps. In this scenario, Ofgem would be setting allowed returns 200bps below the return level required by investors on the basis that they will outperform. However, if the current RAM proposal was also adopted with baseline returns set at the allowed return level, returns would then start to be adjusted when they were only 100bps higher the expected level (or indeed 500bps below). This is clearly an undesirable outcome.

FQ21. Do you agree with our proposal to implement CPIH inflation?

The problems inherent in the Retail Price Index are well understood. While so, as highlighted in 9.5, steps are underway to reform the index, with changes potentially introduced from 2025, two years into RIIO-ED2.

Any move away from RPI is problematic for networks. Adopting RPI-linked financing, either directly as index linked bonds or through the use of derivatives, has helped manage inflation risk in networks for many years. Much of this RPI-linked financing is structural and long-term, it cannot be restructured easily without cost. If CPI or CPIH is adopted, then this could not have been foreseen by networks and debt allowances should be adjusted to include the cost of removing any resulting basis risk.

While there was a strong rationale to implement an alternate measure of inflation in RIIO-2, we believe this rationale has diminished following the reform proposals. Noting the negative impact associated with the change, we do not believe the ‘ends’ justify the ‘means’ and we request that Ofgem reconsiders this strategy for RIIO-ED2.

FQ22. Do you agree with our proposals, including the policy alignment for GT and GD, and to recover backlog depreciation for GT RAV additions (2002 to 2021) over 20 years from the start of RIIO-2?

As a general principle we would support the adjustment of capitalisation rates to limit the intergenerational mismatch of asset usage and charges, as well as any perceived RAV stranding risk. We are not close enough to the detail on the respective sectors to opine on any adjustment mechanism.

FQ23. Do you agree with our proposed assumptions for capitalisation rates?

As a starting reference point, we would agree with estimating capitalisation rates from accounting distinctions. However, if deviations can be justified and agreed by networks and Ofgem, we also support moderate deviations from this natural rate if in the wider interests of consumers. However, excessive deviation will become an issue if the ratings agencies view it as an artificial construct.

FQ24. For one or more of the aggregations of totex we display in Table 40, should we update rates ex-post to reflect reported outturn proportions for capex and opex?

There are number of approximations in the assessment of capitalisation rates and it will never be perfectly accurate. Neither does it need to be. The benefits of predictability and certainty over capitalisation rates are significant and, in this area, they should not be disregarded in the pursuit of greater alignment with historic accounting distinctions.

The scope for a material restatement of RAV following an ex-post adjustment is a real concern and this could inadvertently lead to breach of financial covenants and financial distress.

For these reasons, we do not support the use of ex-post adjustments for capitalisation rates.

To the extent that additional totex awarded through uncertainty mechanisms has a materially different natural capitalisation rate, the specific capitalisation rate for this spend should be agreed ex-ante as part of the award, if the individual or cumulative amount is significant.

9 RAV opening balance questions

FQ25. Do you agree with our proposal to use the closing RIIO-1 RAV balances as opening balances for RIIO-2?

We are comfortable with Ofgem's proposal to use closing RIIO-1 RAV balances as opening balances for RIIO-2. This maintains regulatory consistency and underpins long-term financial planning.

FQ26. Do you agree with our proposal to use estimated opening RIIO-2 balances until we have finalised the closing RIIO-1 RAV balances?

We are comfortable with using estimated opening RIIO-2 balances on an interim basis subject to:

1. There being a clear audit trail as to how opening balances are derived, and therefore a clear path to truing them up and;
2. The close-out process being determined in advance of RIIO-1 closing and being implemented in as short a time period as possible to avoid unnecessary and prolonged uncertainty.

10 RIIO-1 close-out questions

FQ27. Do you agree with the three categories of adjustments outlined below?

We are comfortable with the proposed high-level process.

FQ28. Do you agree with our approach in using estimated values for closeout adjustments until we are able to close out the RIIO-1 price controls?

Yes, we are happy that estimates are used. An absence of estimates could lead to unnecessary lumpy revenue profiles, and fair estimates ensure companies are appropriately compensated at the right time.

11 Disposal of assets questions

FQ29. Do you agree that proceeds from the disposal of assets during RIIO-2 should be netted-off against totex from the year in which the proceeds occur?

We are happy with this. It is consistent with the ED1 approach.

FQ30. Do you agree that we should carry out a review where an asset is transferred to a holding company and then subsequently sold to a third party?

We agree that Ofgem should have some oversight in this regard. In such circumstances it might be preferable to have an independent review to assure any adjustment to totex. However, the process should be quick and only apply to an onward disposal taking place within a reasonable period of time after the initial transfer, reasonable being a function of the value involved.

12 Time value of money questions

FQ31. Do you agree with our proposal to apply one interest rate to revisions to PCFM

We do not believe the proposal of applying one interest rate to all revisions is appropriate.

We do recognise that a bank rate plus a margin can be suitable for those instances where it is purely a short-term timing difference and a network can reasonably be expected to accommodate through existing cash or short-term bank facilities.

However, we believe the WACC remains the correct discount rate when adjustments reflect permanent corrections to the price control, or a more substantial timing adjustment that impacts shareholder dividends, thereby being effectively financed through a mix of capital.

FQ32. Do you agree with the margin-based approach, and the methodology used to calculate a margin of 110bps?

In broad terms, we agree with a margin-based approach for certain PCFM revisions. The methodology used to calculate the margin of 110bps also appears reasonable but should be calibrated against short-term funding costs of the networks.

FQ33. Do you have any reason why the marginal cost of capital for revisions to PCFM inputs and charging errors should remain distinct from each other, or why WACC may remain a more appropriate time value of money for a particular subset of prior year adjustments?

As outlined in our response to FQ31, we consider that a bank rate plus a margin can be suitable in those instances where it is purely a timing difference and a network can reasonably be expected to accommodate this timing difference through existing cash or short-term bank facilities.

However, we believe the WACC remains the correct discount rate when adjustments reflect permanent corrections, or a more substantial timing adjustment that impacts shareholder dividends, thereby being effectively financed through a mix of equity and debt capital.

13 Revenue forecasting questions

FQ34. Do you agree with our proposal to include forecasts for most PCFM variable values for the purposes of the AIP?

At this very early stage, it is difficult to either agree or disagree with the proposal given the insufficient detail on both licence drafting and modelling to fully understand the impacts. This needs careful consideration, particularly regarding any impact on the licence, to ensure any new process is fully understood and doesn't have unintended consequences. We prefer to comment on this when the proposal is more fully developed, and therefore anticipate providing a response for the ED2 process.

FQ35. Considering re-openers as set out in these Draft Determinations, do you agree with our proposal to exclude them from any forecasting? If not, please submit specific examples or analysis of the potential materiality of actual spend versus initial allowances.

It is too early for us to provide an answer to this. We will consider this during the ED2 process.

FQ36. Do you agree that additional reporting on executive pay/remuneration and dividend policies will help to improve the legitimacy and transparency of a company's performance under the price control?

We do not agree that additional reporting on executive pay/remuneration and dividend policies will help to improve the legitimacy and transparency of a company's performance under the price control. We believe that current reporting requirements, under various statutory provisions, provide a level of disclosure that is both sufficient and consistent. We believe that there will be insufficient consistency and context available in the public domain (due to commercial sensitivity, data protection, etc) to enable fair comparison and assessment of such disclosure. It should be noted that disclosure of executive pay creates a barrier to promotion and recruitment/ retention of talent which the industry needs to be able to attract. Regarding reporting of dividend policies, having set an expected rate of return and an incentive/penalty regime around this, coupled with a gearing limitation, we fail to see the purpose of publishing dividend policies. If the purpose is to restrict dividends, then this represents a restriction on equity earnings and needs to be factored into the overall equity return allowance.

14 Base Revenue definition and ODI cap/collar questions

FQ37. Do you agree with the proposed definition of Base Revenue?

Please refer to FQ34 response.

FQ38. Do you agree with the proposal to fix the values used for ODI caps and collars at final determinations?

Please refer to FQ34 response.