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RIIO-ED2 Draft Determinations Investor Call

14:00–15:30 – London time (GMT+1)

Wednesday 29 June 2022

OFG1161

Order of proceedings

- Welcome and Introduction – Akshay Kaul – Director, Network Price Controls
- Context and Headlines – Jonathan Brearley, CEO
- RIIO-ED2 Draft Determinations Overview – Steven McMahon, Deputy Director for Price Control Setting
- Finance Overview – Jonathan Gorrie, Chief Financial Advisor, Analysis & Assurance
- Q&A – Akshay Kaul to chair
- Timeline and next steps/Close – Akshay Kaul

Akshay Kaul
Director, Networks

- Today we have published our **Draft Determination proposals for the next electricity distribution** price control (known as RIIO-ED2).
- Covers **5-year spending plans** to March 2028 for the 14 GB Distribution Network Operators (DNOs).
- Our objective is to ensure the networks **deliver the infrastructure needed for net zero** but to **protect energy consumers** by ensuring this is done at lowest cost.
- Following consultation, we will confirm our **Final Determinations winter 2022**.

Jonathan Brearley
CEO

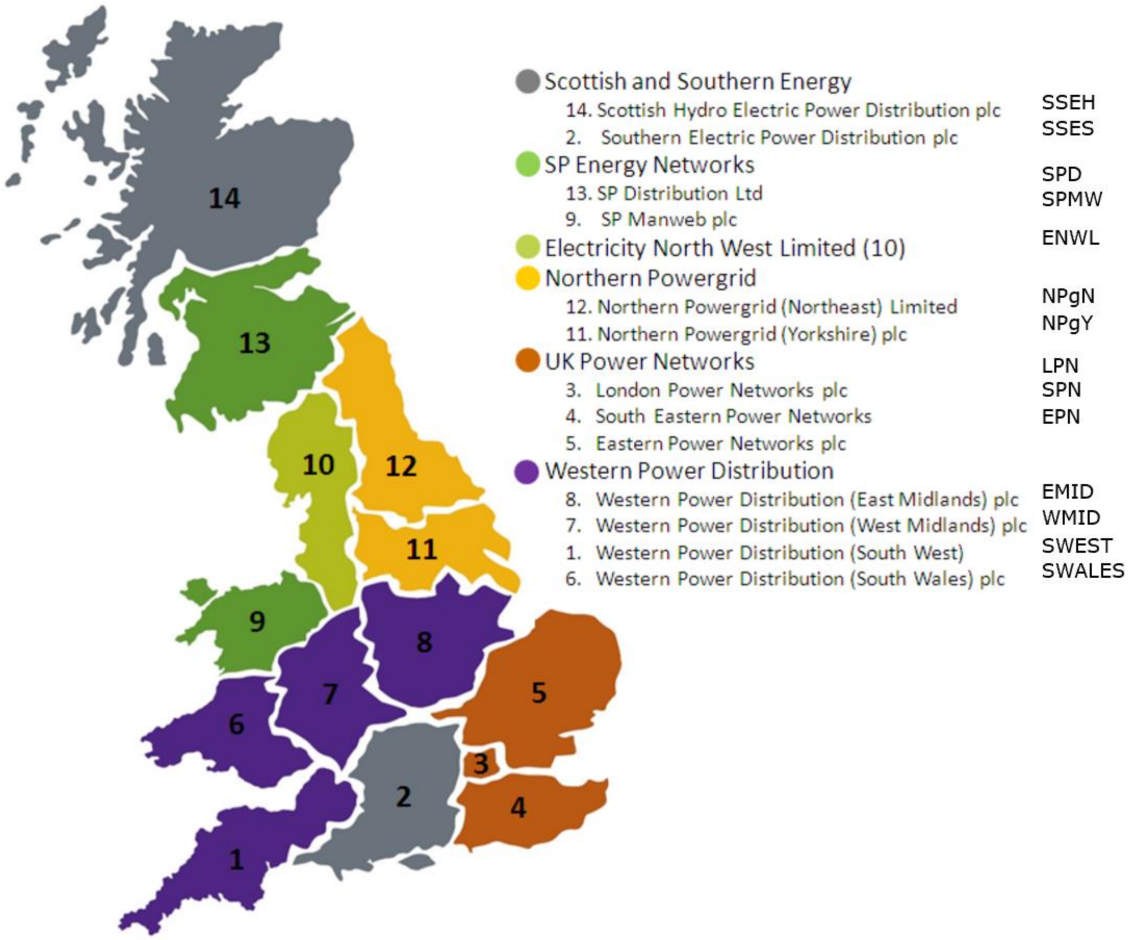
- **RIIO-ED2 will be at the forefront of the changes needed to support the decarbonisation of the economy through this decade.**
  - **£20.9bn in initial funding** for electricity distribution grids to facilitate transition to low carbon technologies such as electric vehicles.
  - Control designed to be **flexible and agile**, allowing investment to respond to rapid changes in policy and demand through uncertainty mechanisms.
  - Maximising opportunities from **smart technologies** and increasing the digitalisation of the networks.

- **RIIO-ED2 will help to deliver net zero at lowest cost to consumers.**
  - Proposing **tough efficiency targets and baseline totex allowances** compared to company plans.
  - **Lowering the cost of capital** which reduces the pressure on bills.

Steven McMahon
Deputy Director, Onshore Networks, Price Control Setting

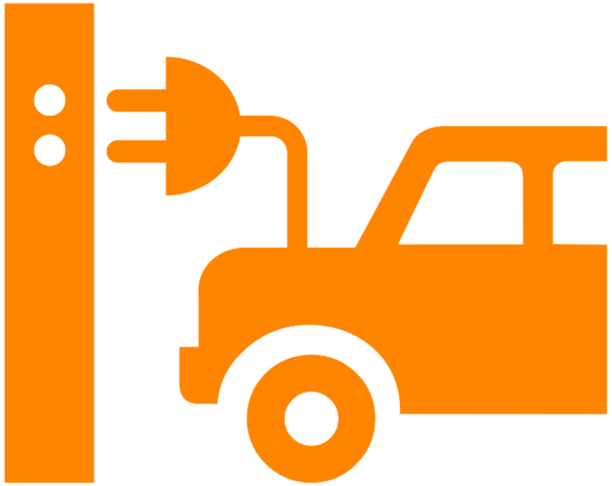
- What is in scope for the price control
- The regulatory challenge we face
- Supporting Net Zero
- Protecting the interests of the consumer
- Proposed totex allowances
- The incentive package
- Managing uncertainty

- RIIO-ED2 is a price control affecting the electricity distribution network.
- It will run from 1 April 2023 to 31 March 2028.
- It affects the allowances and returns of the 14 distribution network licence regions in GB.
- The 14 regions are owned by 6 different companies.
- The ED2 price control comes at a crucial juncture:
    - Need to secure sufficient grid capacity and speedy connections to accommodate a rapid growth in EVs, heat pumps and low carbon generation.
    - Responding to recommendations from Storm Arwen review, ensuring the networks can withstand increasingly extreme weather events and that customers get consistently high standards of service.
- We must ensure we adequately fund the transition to net zero while also ensuring we maintain a focus on ensuring lowest possible costs to consumers.



Preparing the networks to deliver net zero

- Baseline investment of £2.7bn in network upgrades to support the rollout of electric vehicles, heat pumps and connect more local, low carbon generation.
- An agile package of uncertainty mechanisms that will allow investment to adapt quicky to support higher volumes of low carbon technologies if networks are faced with sharper uptakes in demand for new connections.



Supporting a smarter, more flexible energy system

- A new framework of outputs and incentives for Distribution System Operation (DSO) with clearer executive level accountability for neutral decision-making between DSO and DNO business activities.
- Incentivising maximum use of flexibility and other technological possibilities, where significant innovation likely.
- Funding DNOs to improve their data and digital capabilities, increasing network monitoring and ensuring this information is open and available to industry.

Maintaining world class customer service

- Strong package of financial and reputational incentives to drive change in areas that matter to consumers, with tough targets for any reward and the opportunity to apply penalties for poor performance.
- Retain existing incentives that have delivered performance improvements in RIIO-ED1 in the time it takes to connect minor connection customers to the network, customer service and network reliability.
- Introduce new incentives which aim to protect vulnerable consumers through the cost-of-living crisis, improve service delivery for major connections customers and enable a flexible low carbon transition.
- Initial funding package of £5.2bn to ensure that key network assets are maintained, repaired, and replaced, with further funding to ensure that the networks remain resilient, including in relation to severe weather.

Ensuring that no one is left behind in the energy transition

- Funding to support the delivery of vulnerability strategies across all DNOs, including support during power interruptions, the delivery of advice and services relating to fuel poverty, and targeted support to overcome barriers related to low carbon technologies.
- Introduction of a new consumer vulnerability incentive framework with stretching targets and common metrics to drive further improvements in services, including to Priority Services Register (PSR) customers.

Proposed Totex Allowances

- DNOs total submitted costs for RIIO-ED2 were £25.2bn[1] , representing a significant increase (37%) in forecast annual expenditure compared to RIIO-ED1.
- Our proposal is to fund baseline allowances of £20.9bn.
- This represents 83% of the funding the DNOs sought (range 78-89% across the DNO groups).
- It is a 14% increase against RIIO-ED1 spend (range 6-26% across the DNO groups).
- We believe this funds what the DNOs have justified now, with agile uncertainty mechanisms able to flex investment as required within period.

Totex Forecasts, Allowances and Actuals from DPCR5 to RIIO-ED2 (£m, 2020/21 prices)

[1]. The £25.2bn figure is net costs, including our cost exclusions and reallocations and excluding RPEs, ongoing efficiency, non-controllable costs, and pass-through costs (except NTCC).

Totex: Where We Have Applied Reductions

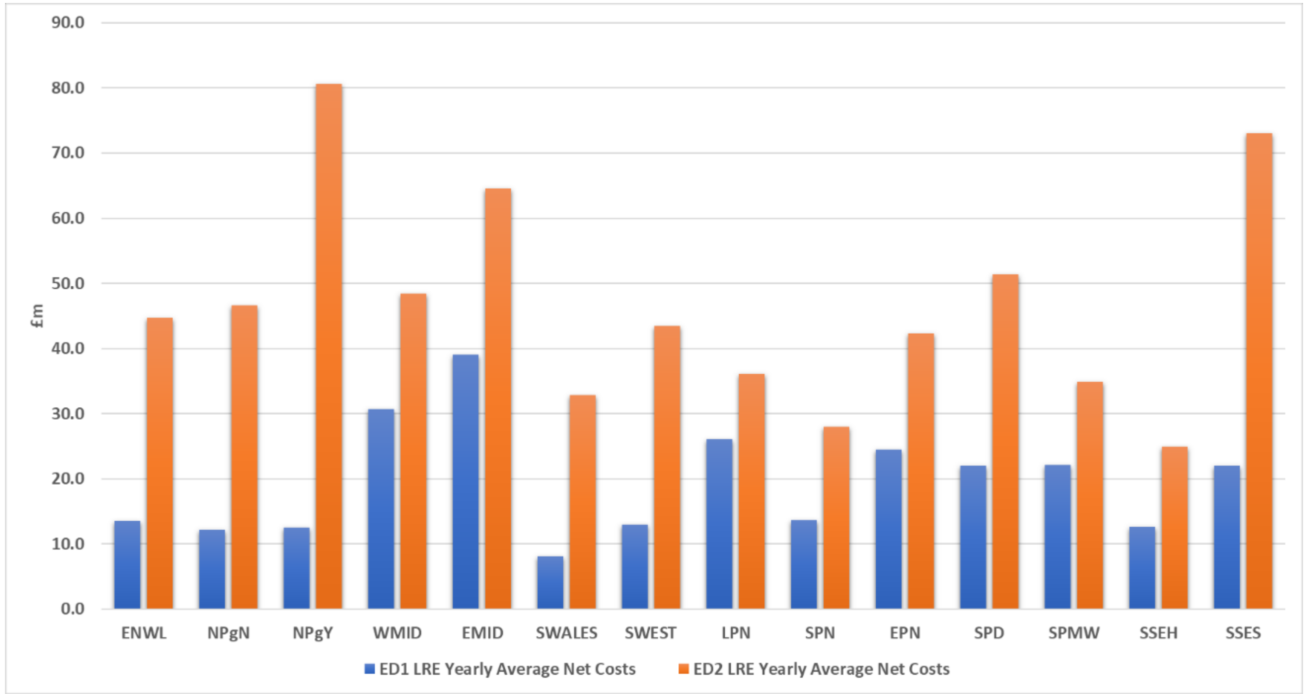
Benchmarking & Volume Adjustments: Applied at totex and disaggregated level with 50:50 split in weighting.

Catch Up Efficiency: moving a DNO closer to the frontier company based on a glidepath from the 75th to 85th percentile.

Ongoing Efficiency: a 1.2% p.a. ongoing efficiency challenge which moves the frontier forward challenging all DNOs to get more efficient over time.

Standardised Net Zero scenario: DNO Business Plans showed significant variations in projected spend increases and methodology based on their regional scenarios. We were not confident that this was protecting consumer interests so moved so adjusted volumes of activity to align with a common Net Zero pathway.

ED1 yearly average LRE spend v requested ED2 yearly average LRE allowances



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Totex: Allowance Reductions by DNO Licence Region

DNO Group	DNO	Submitted Totex	Proposed Totex	Difference	Difference (%)
ENWL	ENWL	2,015	1,640	375	-18.6%
NPg	NPgN	1,392	1,129	264	-18.9%
	NPgY	1,837	1,521	316	-17.2%
WPD	WMID	1,939	1,588	351	-18.1%
	EMID	2,062	1,697	365	-17.7%
	SWALES	1,144	953	192	-16.8%
	SWEST	1,762	1,343	419	-23.8%
UKPN	LPN	1,445	1,323	123	-8.5%
	SPN	1,551	1,394	158	-10.2%
	EPN	2,466	2,137	328	-13.3%
SPEN	SPD	1,676	1,451	225	-13.5%
	SPMW	1,721	1,477	244	-14.2%
SSEN	SSEH	1,406	1,087	319	-22.7%
	SSES	2,826	2,199	627	-22.2%
Total		25,244	20,939	-4,305	-17.1%

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Common Output Delivery Incentive Package

- We are retaining a strong package of quality of service incentives
- We are carrying 4 of our output delivery incentives from RIIO-ED1 into RIIO-ED2 but we are modifying the strength of IIS
- We are removing the Stakeholder Engagement and Consumer Vulnerability incentive and the Incentive on Connections Engagement
- We are introducing 3 new incentives covering Major Connections, Distribution System Operator and Vulnerability
- The overall incentive range for these common ODIs will be +1.95/-4.00%

ODI-F name	Purpose	New or existing ED1 incentive	Incentive Rate as % RoRE
Customer Satisfaction Survey	Encourage DNOs to improve the quality of customer service	Existing	+0.40% / -0.40%
Complaints Metric	Ensure good performance from DNOs when handling complaints	Existing	0% / -0.20%
Time to Connect	Incentivise DNOs to reduce the time it takes to connect minor connection customers to the network	Existing	+0.15% / -0.15%
Major Connections	Ensure DNOs provide quality service to major customers seeking to connect to the network	New	0% / -0.35%
Interruptions Incentive Scheme (IIS)	Incentivise DNOs to improve network reliability and reduce outages	Existing	+1.00% / -2.50%
Vulnerability	Incentivise the provision of appropriate support services to consumers in vulnerable situations	New	+0.20% / -0.20%
DSO	Drive DNOs to more efficiently develop and use their network, considering flexible and smart alternatives to network reinforcement	New	+0.20% / -0.20%

Managing Uncertainty

- Significant uncertainty ahead, particularly around the speed of transition to net zero and the associated investment required.

- We are proposing 34 common uncertainty mechanisms (UMs), and 3 bespoke mechanisms affecting ENWL and SSEN.

- Many of the common UMs have been carried over from RIIO-ED1.

- Key additions to our UM toolkit in RIIO-ED2:
  - Suite of UMs to support additional in-period investment including an automatic volume driver for secondary reinforcement and unlooping services, both key to EV and heat pump uptake, and a reopener for primary reinforcement.
  - A Net Zero re-opener to adapt to major changes in government policy.
  - A Storm Arwen re-opener to adapt allowances should the reviews following on from our report necessitate it.
  - Re-openers to adapt to new requirements on digitalisation or should new recommendations emerge on DSO governance during the price control.

Jonathan Gorrie
Chief Financial Advisor, Analysis & Assurance

- Key themes
- Cost of Equity
- Cost of Debt & WACC
- Other Financial Parameters
- RoRE and RAMs
- Financeability
- Inflation

A consistent approach to risk and return…

Overall **approach to risk / return is consistent** with Framework Decision (2019), Sector Specific Methodology Consultation (2020), and Sector Specific Methodology Decision (2021).

Applies **RIIO-2 Gas Distribution and Transmission learnings** where relevant – including the **outcome of CMA appeals**.

Considers **specific circumstances of electricity distribution sector** and updates evidence base with latest information.

Takes into account **current macroeconomic environment** – and in particular asks several questions on **inflation**.

Cost of Equity Allowances

- Baseline **4.75% cost of equity allowance** (CPIH real, 60% notional gearing).
- 3 step methodology – consistent with RIIO-GD&T2.
- Draft Determination parameters are fixed as at the end of April 2022. They will be updated ahead of Final Determinations and indexed during RIIO-ED2.

Cost of Equity Methodology

Step 1:
- CAPM approach
- 20-year RPI-linked gilts, used as the risk-free benchmark
- Total Market Return (TMR) consistent with RIIO-GD&T2
- No change in approach to deriving equity beta

Step 2:
- Market cross-checks updated with latest information
- No change to CoE on basis of cross checks

Step 3:
- No deduction for outperformance as per CMA's decision
- No other evidence sufficiently strong to warrant higher or lower baseline allowed return

Comparison to RIIO-GD&T2

	GD&T2 FDs	ED2 DDs
RFR	-1.58%	-0.74%
TMR	6.5%	6.5%
Equity beta	0.759	0.759
CoE	4.55%	4.75%

RIIO-ED2 Finance Annex, Chapter 3. RIIO-ED2 market data as at 29 April 2022. RIIO-GD&T2 FDs chapter 4. CPIH real, 60% notional gearing.

Comparison to RIIO-ED1

	ED1 (RPI)	ED2 DDs (CPIH)
WPD	6.4%	4.75%
Others	6.0%	4.75%

RIIO-ED2 Finance Annex, Chapter 3. RIIO-ED2 market data as at 29 April 2022. RIIO-ED1 decisions.

Cost of Debt Allowances

- Baseline **cost of debt allowance of 2.26% (frequent issuer) or 2.32% (infrequent issuer)** over RIIO-ED2:
  - iBoxx Utilities 10 year+ index on a 17-year trailing average basis.
  - Full indexation - value of the index will be updated at the end of October every year.
  - Includes **25bps** additional allowance, in order to account for transaction costs, cost of carry, RCF costs, and RPI/CPI basis costs.
  - **Additional 6bps** for companies that are infrequent issuers on a licensee basis (LPN, NPgN, SWALES), giving a cost of debt of **2.32%**.

WACC Allowance

	RIIO-ED2 *(CPIH)*	
	Frequent issuer	*Infrequent issuer*
Debt	2.26%	2.32%
Equity	4.75%	4.75%
Gearing	60%	60%
WACC	3.26%	3.29%

RIIO-ED2 Finance Annex, Chapter 4. RIIO-ED2 market data as at 29 April 2022

Other Finance Parameters

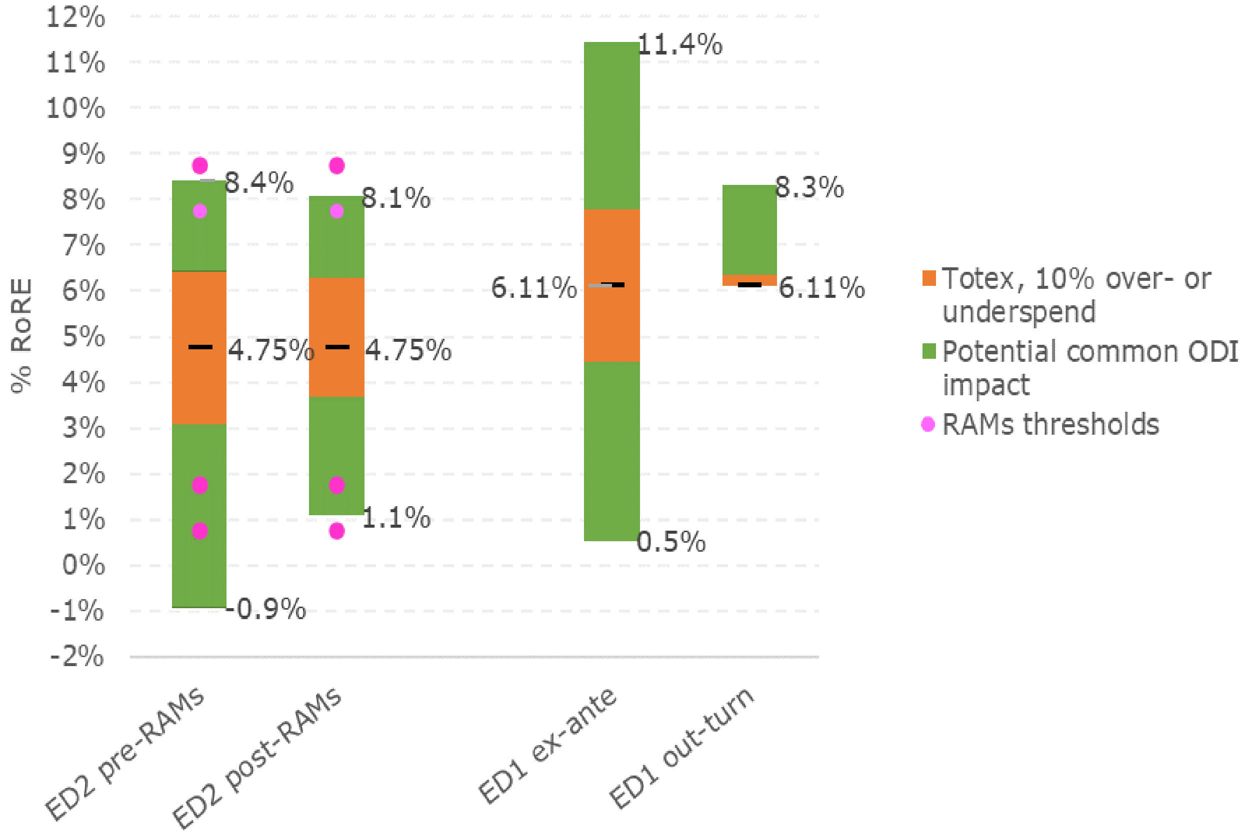
- **Capitalisation:** set using natural capitalisation rates
- **Depreciation**: 45-year straight line, taking into account asset lives and intergenerational fairness
- **Notional gearing**: Reduction of 5% from 65% (RIIO-ED1) to 60% (RIIO-ED2)

Return on Regulated Equity

- High powered price control that provides opportunity for outperformance and incentivises outcomes and cost efficiency.
- Ranges carefully calibrated, with very low probability of outturn being at extremes given RIIO-ED1 performance and structure of ODIs.
- Probability of triggering RAMs boundaries also considered to be small.

Return Adjustment Mechanisms (RAMs)

- Sculpted sharing mechanism designed to ensure that the price control does not get out of balance for either investors or consumers.
- 50% sharing at +/- 300bps RoRE
- 90% sharing at +/- 400bps RoRE



RIIO-ED2 RoRE Ranges: Figure 6, Chapter 5

Approach to Financeability

- 'In the round' consideration of financeability, taking into account impact of price control (including totex, allowed return, notional gearing, depreciation, and capitalisation rates).
- All networks considered financeable on a notional basis at 60% gearing.
- We don't target a particular credit rating or financial ratio but consider all DNOs can achieve a strong investment grade rating in the baseline.
- We have also assessed financeability against:
  - higher totex cases – acknowledging that more spending may come through uncertainty mechanisms.
  - a range of downside cases – see Chapter 5 of the Finance Annex for detailed overview of calibration downside.
  - future changes in macroeconomic environment.

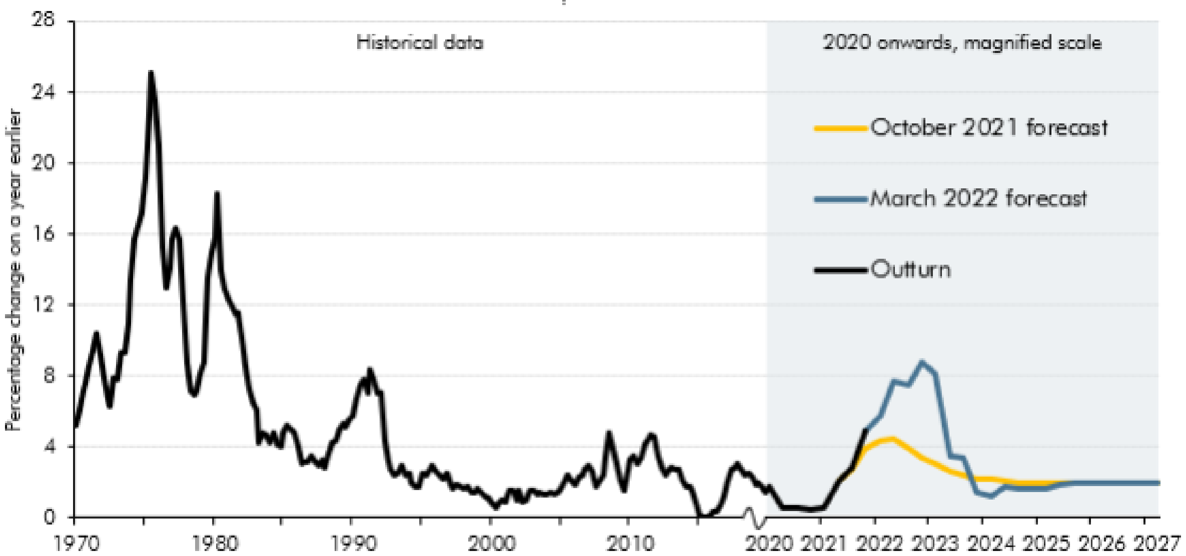
	Base Case Totex			**High Case Totex**		
Licensee	*Adjusted AICR*	*FFO / net debt*	*Credit rating*	*Adjusted AICR*	*FFO / net debt*	*Credit rating*
ENWL	1.30	11.40%	Baa1	1.31	11.30%	Baa2
NPgN	1.30	12.00%	Baa1	1.28	11.50%	Baa1
NPgY	1.39	11.90%	A3	1.37	11.40%	Baa1
WMID	1.43	12.90%	A3	1.42	12.50%	A3
EMID	1.42	12.50%	A3	1.39	11.80%	Baa1
SWALES	1.37	11.10%	Baa1	1.35	10.70%	Baa1
SWEST	1.41	11.10%	A3	1.39	10.70%	Baa1
LPN	1.43	13.20%	A3	1.41	12.80%	A3
SPN	1.42	13.20%	A3	1.41	12.90%	A3
EPN	1.43	13.40%	A3	1.41	12.90%	A3
SPD	1.40	12.80%	A3	1.39	12.50%	Baa1
SPMW	1.40	12.20%	A3	1.39	11.90%	Baa1
SSEH	1.40	11.50%	Baa1	1.36	10.20%	Baa2
SSES	1.39	11.80%	Baa1	1.38	11.10%	Baa2

RIIO-ED2 Table 20, Chapter 5. Credit ratings are for illustration only, based on Moody's scorecard, and based on notional companies, not actual capital structures

Impact of High Inflation

- Outturn inflation **currently about four times** long run expectations used to set allowed returns.
- Current approach is to **inflate RAV** using outturn CPIH.
- Use of fixed rate debt by notional company means **nominal equity returns are geared to inflation**, so investors generate higher (or lower) real equity returns when outturn inflation is higher (or lower) than long-run expectations.
- We are consulting on whether this is an **appropriate way to treat inflation** – not proposing changes at this stage but looking to understand impact of issue.
- Issue is common to RIIO-2 controls, including RIIO-GD&T2.

CPI Inflation



Source: Bank of England, ONS, OBR

Consultation Questions

Q Do you think we should adjust our approach to allowed returns (noting our approach to expected inflation for WACC and outturn inflation for RAV) so that outturn inflation does not permit the notional company to generate real equity returns that are materially higher or lower than our cost of equity allowance? What would be the consequences to consumers and DNOs of doing so?

Q If you believe we should make such an adjustment, what is the best method for making it?

Q If you don't believe we should make such an adjustment, how should we ensure that the fairness of the price control is maintained to prevent ex post returns from deviating from ex ante expectations for both consumers and investors?

Akshay Kaul to chair

- To ask a question, please use the hand raise function.
- If you are joining via phone, please type *5 on your keypad to raise your hand.
- When it is your turn, your microphone will be activated. You will need to unmute yourself.
- Please type *6 on your keypad to unmute yourself.
- Before asking question, please say your name and your institution.

RIIO-ED2

- Draft Determinations launched 29th June 2022.
- Statutory Consultation closes on the 25th August 2022.
- Final Determinations will be published winter 2022

Further information

https://www.ofgem.gov.uk/about-us/contact-us/investor-relations

IR contact: Investor.Relations@ofgem.gov.uk

Jamie Tunnicliffe
Head of Investor Relations

Steven Alcorn
Head of Strategic Financial Planning

Christos Anastasopoulos
Manager, Investor Relations

Making a positive difference
for energy consumers

Ofgem is the Office of Gas and Electricity Markets. We are a non-ministerial government department and an independent National Regulatory Authority, recognised by EU Directives. Our role is to protect consumers now and in the future by working to deliver a greener, fairer energy system.

We do this by:

- **working with Government, industry and consumer groups to deliver a net zero economy at the lowest cost to consumers.**
- **stamping out sharp and bad practice, ensuring fair treatment for all consumers, especially the vulnerable.**
- **enabling competition and innovation, which drives down prices and results in new products and services for consumers.**

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