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# Transcript of IR call on 29th June

## Akshay Kaul

Good afternoon everybody, or good morning or good evening, depending on where you're joining us from around the world. I'm delighted to welcome you to this investor call on our ED2 Draft Determinations, which is an announcement that we made this morning. I'm delighted to have with me our Chief Executive Jonathan Brearley who will kick us off with some opening remarks setting the context for these price controls and then he'll hand over to Steven McMahon, who is Deputy Director for electricity distribution, who will talk us through some of the key points from the Draft Determinations from an outputs and totex and incentives perspective, followed by our Chief Finance Adviser, Jonathan Gorrie, who will talk us through the key finance points which I am sure will be of great interest to this audience. Overall, the presentation should take us somewhere between 30 to 40 minutes to cover the ground and then we will open up for Q&A. So if you do have questions, it would be great if you can just hold them back for the Q&A slot at the end. If there's anything immediately - I noticed there's a hand that's gone up - is there any urgent question to begin with? No, in that case, let me hand over to our Chief Executive Jonathan Brearley to set the scene for this investor call. Over to you Jonathan.

## Jonathan Brearley

Welcome everybody. Good morning, good afternoon, or good evening depending on where you are. It's good to be talking to you again and good to, as many of you know, come back to my home turf and where I started my work in Ofgem. I'm going to give you some context of price control. I'm going to give you some of the headline figures that you may already have seen but I'm going to hand over pretty quickly to Steve to take you through some of the detail of what we're describing.
What I want to say up front is the context for us is clearly very different than it has been for any price control in our history actually. The state of the international gas market and its implications for UK consumers is something that will weigh heavy on everything that we do, including the Draft Determination that I'm setting out here.
Now for me at a very macro level, I think that means two things. I mean, first of all, as ever, you would expect us as a regulator to be thoughtful and careful about the use of customers'

money, particularly at a time when we know so many customers in this country are going to be under huge financial pressure. But equally importantly, as well as thinking about the cost today, we have to think about how the country moves strategically from its position now where it is heavily reliant on gas, to one where we diversify our technologies away from gas, and to me this price control has a critical place to do that. So, the way we are thinking about this is making sure that we have a price control that sets out some key elements in terms of its architecture. So first of all, we have baseline funding that makes sure that networks are able to be funded for the things you absolutely need to do. And that was 20.9 billion pounds over the first five years. 2.7 billion of that is in network upgrades which will be connecting much more of the local and low carbon generation such as solar wind, and indeed storage like batteries, etc. But equally importantly, we're designing these price controls to be agile and adaptable, so we don't know how fast things are going to move. They may move a lot faster than we think. And so, in contrast to previous price controls, we want to design that into the system, so DNOs need more distribution, network companies need more that we develop the sorts of reopeners and the sorts of systems that will allow that to happen. So that's what I was describing on the revenue side. On the kind of expectation side, you know, the key thing for me, for the industry, is that if this additional funding goes in and there is significant additional investment which Steve will take you through, that that is paid back to consumers in terms of outcomes and the things that they receive as a result. So, in a world where we are going to see more electric vehicles connecting, we are going to see, for example, more onshore wind farms and other forms of generation connecting. We want to make sure that this price control delivers for all of those network customers to put it in that way. So, and then final point from me, you know, if you think about the shape of the companies themselves, you think about what they're really trying to achieve. This isn't just about building copper in the ground. So, we are expecting companies to enable their networks with data to bring in the technology that they need to bring in to make sure that costs are genuinely being optimised. Now that's in part around the price control settlement but it's also around some parallel thinking we're doing around how distribution networks are governed and run. But a big part of our thinking will be making sure we don't only have a system where we can investigate the couple that we need, but we have one that optimises overall and gives best value for consumers. So, I will leave Steve to take you through the rest of the figures. There's plenty more there and there's obviously the usual and often controversial question of cost of capital but I will handover to Steve, take you through that. Thank you.

## Steve McMahon

Okay, and thanks, Jonathan. So, I'm Steve McMahon. I'm Ofgem’s Deputy Director for price control setting and the SRO for the ED2 program. So, I'm going to spend a bit of time talking you through the substance of the Draft Determination proposals published this morning, I think with a particular focus on our main quality of service and cost of service or revenue or as Jonathan put it, proposals. I'll then hand over to my colleague, Jonathan Gorrie, who will cover the regulatory finance side of those Draft Determinations. I should say that we are running through just some slides that are visible to those that are joining on Teams. And then these have been circulated in advance, but hopefully for anyone that's joining just by telephone, it's clear enough for you just to follow the conversation. We can pick up any questions at the end. So just in terms of that broader context and picking up from Jonathan's introduction, so clearly the energy sector is undergoing a rapid period of change as we move towards a net zero carbon future. I think now up and down the country at this moment in time households and businesses are facing significant increases in their energy bills. Inflation is running at its highest for 40 years and the economic outlook remains highly uncertain. I think what does remain certain though, is the need to decarbonise our economy and this is one of the greatest challenges facing our generation, affecting every community across the country. A decarbonized energy system will be a cheaper form of energy system, I think than the current alternatives, and we must unlock the benefits of getting to net zero. So, over that next decade or through this ED2 period, which runs from 2023 to 2028, decarbonisation is going to bring major changes to lifestyles, whether that be how we refuel our vehicles, heat our homes, or how we generate our power. And for us, the regulatory problems are pretty clear. We need to secure sufficient distribution grid capacity, and speedy connections to accommodate that rapid growth in electric vehicles and heat pumps without any compromise or network reliability, while keeping costs as low as possible, including, as Jonathan said, by incentivising the maximum use of flexibility. Now our core objectives for the ED2 price control cover five main areas. First, ensuring that the networks can deliver the grid capacity we need to transition to net zero. Secondly, enabling that smarter, more flexible, digitally enabled local energy system. Third, delivering world class network services, including high levels of reliability, those speedy connections, and great customer service. Fourth, ensuring everyone can access the benefits of getting to net zero, including the vulnerable and the fuel poor, making sure that we don't leave anybody behind in this transition and then achieving all of this at lowest cost to customers, avoiding any further unnecessary pressure or network charges on bills. And I'm going to say a little bit about each of those in turn.

So, in terms of that first priority area, this is about making sure the networks can support that transition to net zero. We know that means that we need to invest in the grids to avoid them becoming a barrier, but we also know the stellar range of uncertainties that mean we need to be careful on how this is done to avoid unnecessary cost being passed on to consumers. For Ofgem, that means we need to be doing our job even better than ever before. Looking after every penny that passes through energy bills and in these Draft Determinations, we've sought to actually achieve an appropriate balance. We have, as Jonathan said, a baseline program of almost 21 billion pounds of investment, reflecting at this stage the costs that we think have been fully justified by the network companies and that are resilient to any potential net zero pathways. What we're also seeing clearly is that there is the potential for additional funding to come on top of that through a really flexible and agile set of uncertainty mechanisms, including four network upgrades. These mechanisms will allow investment to track the changes that the networks actually see over time and also ensuring that customers are only paying for work that is necessary. And I think getting this balance right will mean that we can ensure that investment in the grid is made in the right place, at the right time, for the right price. Now we also know that lowest cost decarbonisation will require all the technological innovation that the energy system can muster. And innovation offers us a huge opportunity to revolutionise how and when we use our energy so testing new technologies, new processes, new IT, and data opportunities that can help maximise efficiency as the way that we can reduce the cost of transition at the net zero. And our flagship intervention in this space is the RIIO-2 Strategic Innovation Fund, there’s been a lot of publicity on that over the last couple of years, and that we're running in partnership with Innovate UK and a key proposal for today is that we’re trying to extend that for the ED2 price control. And alongside that we've also set our proposals for some of the direct innovation allowances for each of the network companies, initially on a three-year basis. The idea there is that we can potentially look at across all of the network sectors, some wider reforms that we might bring in as we transition to the next set of price controls that are going to be starting from 2026. And I think achieving net zero at lowest cost means doing things differently in terms of how we organise and operate the networks to help unlock the network capacity that customers need in order to adapt and adopt these new low carbon technologies like electric vehicles, heat pumps, and more local low carbon generation at scale, something Jonathan talked about. We've seen significant growth and flexibility since we started the ED2 process and we're also seeing a wider evolution of those system operator capabilities, both at the national level through the future system operator and the local level. And as you see from the focus that we placed on this in our Draft

Determination proposals, we need to see this going further and faster. Harnessing the full potential of flexible technologies, the opportunities from investment in data and digitalised solutions and unlocking the potential from the significant innovations that we're inevitably going to see in this space over the next few years.

In terms of, just moving to the next slide, the fundamental role of the networks is to deliver high quality network services to the customers. This is something which generally speaking, RIIO-ED1 has been highly successful in enabling. I think that was backed by a strong incentive framework, encouraging the network companies to improve the service that they provided to the customers over time across key areas. And that's an approach that we've retained for ED2. Our Draft Determination proposals set out a suite of financial and reputational incentives that we think reflect the priority areas of customers. So, we see that we see these as being crucial and protecting consumers from the harmful or the risk of harmful underinvestment through the threat of sharp penalties. And by the same token, allowing for investment required to improve the quality of service through remuneration of rewards. As Jonathan said at the start, a key measure of the success of ED2 will be in how we facilitate the network upgrades required to support the speedy and efficient connections of the millions of electric vehicles, all those heat pumps that are going to become on stream in line with government ambitions. The recent UK Government British energy security statement also confirmed its intention to work with Ofgem to speed up the connections to the local distribution networks. So, we need to ensure therefore that appropriate arrangements to deliver this are in place before deployment or these technologies such as electric vehicles and heat pumps really, really start to ramp up in scale. And I think we'll return to the time to connect and centre for minor connections and say the proposed calibration of targets for the next period alongside the introduction of a new major connections' incentive and the general drive to speed up connections. And alongside that, we're proposing to undertake a broader review of the connection guaranteed standards through which we will consider a key gap in the current arrangements which is a minimum standard on the end-to-end time to connect. Our aim will be to complete that review as close to the start of ED2 as possible, but it may well take us a little bit longer, probably until 2024 before we can do that comprehensively. And that will cover time and aspects, penalties, scope of activities and any exemptions. Now I think is everybody aware the gas crisis is not the only thing that customers have had to deal with through this past winter period. We've had multiple storm events most notably Storm Arwen at the end of November last year into December and that caused significant disruption to the networks and show the scale of impact and public scrutiny that comes when things go wrong with the networks. And earlier this month we published our final review report from Storm Arwen and the lessons learned from these events. Now there's a number of actions that we're taking forward with industry. Some of these will be delivered ahead of our Final Determinations and in preparation for next winter but others will require further consideration on the costs and benefits for consumers. So, in our Draft Determination proposals, we've said out that there are arrangements that can ensure the industry has the necessary obligations and funding to deliver these in full and we've got a real plan that we proposed and to help us do that. Customer service is another key quality of service area in the Draft Determinations. Again, in general this has been a key success area with high levels of customer satisfaction with the local networks but again, just using the example of Storm Arwen, has given us good examples where customers should not have needed to endure the combination of being without power, having poor communications and inadequate response to their needs. So, we've sharpened up the requirements here, I think we've got the retention of the customer satisfaction survey, the complaints metric, ensuring the quality of service that’s seen by customers is in full synergy with our goal to meet our near zero climate change goals and like some of the pressures that we might see moving forward. Now keeping power flowing, the reliability of the networks, is one of the main priorities I think if you ask customers, it's certainly the feedback reflected in the companies’ plans. And overall reliability levels are very, very strong across the network, it’s probably some of the best figures you'll see across the world. And I think the net zero transition means that there'll be an even greater reliance on electricity for transport and heating purposes. So that requirement will increase. Increasing network capacity helps here but so does maintain an appropriate incentive for further improvement whilst avoiding customers paying a higher cost for those improvements than necessary. Those principles are reflected in the changes that we have proposed around the interruption’s incentive scheme, both in terms of the methodology that we're using for setting targets and the calibration of the associated rewards and penalties.

I think that was a key thing that if you go back to the National Audit Office report of electricity networks in 2020. The IIS and how significantly driven performance in RIIO-ED1 was something that they flagged up in the recommendation, so we have looked at that. I also just want to touch briefly on what this price control does for the vulnerable and fuel poor. Now the best thing that we can do for these customers is to keep costs low. That's our core responsibility. But we want to make sure nobody's left behind and all customers are able to access the benefits of getting to net zero. So, as well as the core license obligations, we're introducing a new vulnerability incentive to help drive behaviours through a set of common metrics, including Priority Service Register reach, vulnerable customer satisfaction, and a value of the services that's delivered in response to the vulnerability strategies. In practical terms, this might mean targets for legitimate interruption periods power supplies, so that for example, the use of battery packs or using generators to get the most vulnerable customers back on supply quickly. But it also extends to wider support services and partnerships that can harness the expertise of the network companies alongside others to provide advice and guidance, including around the programs and other interventions that may help improve energy efficiency, help reduce costs and alleviate fuel poverty. So that's a key thing, a key area of focus and just move it to the next slide please.

Just in terms of revenues or other costs of service. At this stage, the Draft Determinations reflect our assessment of the spending proposed by the network companies and their business plan with 20.9 billion of that, so almost 21 billion consider justified for inclusion and the baseline ex ante allowances. At this stage, this represents a 14% increase on annual average spend across the whole sector against ED1 levels. I think the chart that we've got on the right-hand side here clearly shows the discontinuity in spend that was proposed by the network companies through the ED2 period and I'll just walk you through some of the key considerations that we've had to make in terms of landing on that value. So maybe the next slide. So, here's just a summary of our approach. So basically, we've used the toolkit for our cost assessment process, comprising two key components. Firstly, the econometric benchmarking and then the disaggregated activity level analysis. But regardless of the new challenges associated with ED2, our core objective remains the same and that is to set the network companies allowance or efficient allowances to deliver a high-quality service to customers, while keeping that bill impact low. Our Cost Assessment Process straddles over several key stages starting with nominalisations and adjustments to ensure we have sufficient compatibility across the company plans and reflect any regional or company specific factors that we consider relevant. We then benchmark and assess those submitted costs using traditional econometric benchmarking tools and that activity level analysis and what that does is allow us to capture an engineering and qualitative review of business plans, which maybe challenges volumes and the proposed level of WACC and how that's been justified and gives us basically the production of a set of model costs. We then weight those econometric benchmarking and the disaggregated analysis and we've done that 50/50 for these Draft Determinations. And that's consistent with the approach that we took and set in the RIIO-ED1 price control. Our challenge on the submitted Totex values from the company comprises three key elements. Two billion is from that benchmarking process, we've got 300 million from the catch-up efficiency challenge, so moving a DNO closer to the frontier company based on a glide path from the 75th to the 85th percentile, so that's consistent with what we did in the GD2 price control a couple of years ago, and 1.3 billion comes from the 1.2% per annum ongoing efficiency challenge, which moves the frontier forward, challenging all network companies to get more efficient over time.

A big consideration of that is the wider circumstances I think for RIIO-ED2 including that investment and data and the digital capabilities alongside the load investment, so it is very much a grown price control. And we think there's opportunities for further efficiencies that are arising from that. We've also applied a post modelling adjustment to load related expenditure, the purpose of which is to control for the wide range of demand growth scenarios that were assumed by the DNOs in the plan. I think as you'll see from the chart here, the proposed uptick in spend varied quite significantly across the DNOs from network upgrades and there's an associated risk around the over investment and mistargeted expenditure. Accordingly, and reflecting the load related expenditure package as a whole, our proposals adopt an approach that sets a lower Baseline Allowance that has the ability to flex up so based more on the future energy scenarios system transformation scenario and then having the ability through the uncertainty mechanisms to flex up to the higher growth scenarios that you may see, for example, through the CCCs six carbon budget. And that's a much better approach we think in terms of protecting consumers rather than starting high and looking to flex allowances down for large sections of the sector. But even after these adjustments, our Draft Determination proposals still amount to a near doubling of spend on network upgrades. So that's a significant change against the ED1 position and does provide us that capacity to deliver with a net zero agenda across the country. Just moving to the next slide, please? So, as we've said, look, the proposal here is almost 21 billion in allowances and that's a reduction of 4.3 billion against the companies' plans. That equates to just over 17% on average in terms of the reduction across the sector compared to those submitted plans and those submitted costs, with a challenge ranging from around 9% to 24% across the DNOs licence areas. Some spend may come back and we've got a suite of uncertainty mechanisms that we've designed in the price control. I'll speak a little bit that about that later on. This could include for example, any expenditure that has been removed from those post model and adjustments on load or other areas where the needs case or scope of projects is not sufficiently clear at this stage.

And next slide please. Just in terms of the incentives, I have already talked you through some of the key quality of service proposals. Our package published today includes seven common financial output delivery incentives. Now four of these are carried forward from the existing RIIO-ED1 price control but reset to embed performance improvements that we've seen. Three of these incentives are new to ED2, albeit two of them are effectively replacing ED1 incentives that were targeted at some of the areas. The calibration of the RoRE ranges so that the overall return on regulatory equity is not dramatically different to what we have in the current ED1 price control. In theory, the maximum downside exposure is greater than the upside opportunity, but in practice, we expect the probability weighted low end RoRE to be significantly above 0%. And we still expect the notional company will still be able to outperform and I know Jonathan's going to cover that in a bit more detail as part of the update, and just on the next slide. And to wrap up, I'm just going to say a little bit about our approach to managing uncertainty. I think as Jonathan said at the start in his introduction, we're living in a very dynamic environment at the moment, there's still significant uncertainties around how society will achieve net zero and the pace of change that we're likely to see, I think policy decisions that affect investment will also keep coming beyond the regulatory timetable for determining ED2 at the end of this year. So we basically need a price control that can adapt to these changing demands over time. In total we have 34 common uncertainty mechanisms and three that are bespoked individual companies. These cover a broad range of areas whether that be protections for movements and input prices, such as for the labour and materials to mechanisms for additional spending on network upgrades, some of which are automatics or volume drivers, and others that are more in terms of administrative reopeners. And that gives us flexibility to provide additional funding where it's needed, or for example, to enact the recommendations coming from wider policy or regulatory changes, a good example of that may be the actions emerging from the recent Storm Arwen review, particularly around a network resilience. So as you can see, we’ve designed this deliberately so it is different in terms of that flexibility and agility and that ability to respond to new requirements that may well be placed on the networks over time and ensure that the funding flows behind that. So I'm going to stop there and I'm going to hand over to my colleague, Jonathan Gorrie, who's going to say a bit more about the finance package.

## Jonathan Gorrie

Steve, thanks. Good afternoon, everybody. Just by way of quick introduction, I joined Ofgem about three months ago as Chief Financial Advisor. I joined from UK government investments which is Treasury’s corporate finance arm and before UKGI, my background is in energy and infrastructure investment management. I started as a banker and then I moved on to BlackRock and most recently the BT pension scheme. Let me take you through the outline of the finance proposals that we are setting out today. So, I take you to slide 15. I've set out what I think probably the key themes are from the finance package. In general, we've sought to develop proposals that are consistent with our approach to risk and return that we've set out in the various ED2 consultations that you'll be familiar with, back from 2019 onwards. We've also sought to apply the learnings from the GD and T2 process, including the CMA appeals. So, where we consider issues are similar and the evidence is unchanged, we've tended to follow the same approach. As a result, we think what we're putting forward today should largely be an unsurprising set of outcomes. And I know from the straw poll that we did on cost of equity for example, ahead of this call, the number we've published today is very close to analyst consensus. However, we do believe that the ED2 control needs to reflect the specific circumstances of the sector, and we have been, and we continue to be open to changing the approach where the evidence supports this. And we've also tried to set out questions in the documents on areas where we think further evidence could be provided. We will continue to consider further evidence and market movements as part of the consultation as we go towards Final Determinations. Now while we've in general tried to be consistent and have a predictable approach here, there's obviously a danger that we lose sight of changes to the economic environment which might threaten the balance of risk and reward in the price control. And so, we've considered the implications of the broader macroeconomic landscape, which is obviously changing quickly, quite carefully. We already have in the proposals, indexation mechanisms for the cost of equity and the cost of debt and I can talk through the details of some of those as we go through. That allows the price control to evolve as yields and rates evolve. However, one significant macroeconomic impact that we're all focused on at the moment is the impact of higher inflation, where, as you'll know, outturn levels are around four times longer than expectations. This is something we're looking at carefully and we think it'd be strange to ignore the issue in this determination. Obviously, the issue is common to all of the price controls, and it's something we're keen to engage stakeholders on starting with this Draft Determination today. We've asked a number of questions, you'll see them in chapter four of the finance annex on the way we treat inflation. We're not today setting out alternative proposals or alternative approaches. We're not there in our thinking yet, but we are looking to engage with stakeholders to better understand the impact on consumers and networks. I'm conscious that we've published a very long document today so let me try and signpost you to the key parts of it as we go through.

If I take you to slide 16, starting with the cost of equity, we've retained the same three step methodology for cost of equity as we had in GD&T2, and so much of what is on this slide will be familiar to many of you. These parameters or many of these parameters went through lengthy debates during the CMA appeals process as well, and most were upheld as not wrong by the CMA. However, in line with the CMA determination, we are no longer proposing the outperformance wedge as part of step three, and I'm happy to talk about a little bit more about that if that's helpful. This results in a cost of equity of 4.75% in real CPIH terms, assuming 60% notional gearing, and that's a reduction from 6 to 6.4 in ED1, which was in RPI terms. I should note that all our return parameters are fixed as at the end of April and that just gives us enough time to run the analysis that we've published this morning, but they will all be updated as part of Final Determinations. So let me very quickly run you through the key CAPM parameters that we use in the first step of our three-step methodology to arrive at the cost of capital number. Consistent with what we did in GD&T2, we use the 20-year RPI linked gilts as the risk free benchmark and over the ED2 period as at the end of April, that carried an expected yield of about -0.74%. That number will be updated, our current proposal is to update it every October before the start of the April financial year. So this October we will rerun the numbers ahead of the April start for the ED2 price control and then annually thereafter. And we've published the models for doing that alongside the finance annex and other documents. We've maintained a TMR at 6.5% Real, that's in line with what we set out previously and with the GD&T process also upheld on appeal by the CMA. And on beta, this is something we've thought about quite carefully, but we've not seen any evidence that convinces us that electricity distribution should be considered to have a different systematic risk from GD&T2, nor that the data underpinning our GD&T2 analysis has materially changed since December 2020. And in general, we like to take a long run view of beta in any case, and so we're proposing to use the same unlevered beta which has a midpoint of point 0.311 and at 60% notional gearing this implies an equity beta midpoint of point 0.759. We've retained step two and step three as I said. In step two, we've updated our market cross-checks and our other cross-checks with the latest information. In particular, we've looked at market to asset ratios implied by recent regulated utility transactions, including WPD, Bristol Water, SGN, NGGT, and we've set out in the documents, potential inferences for cost of equity from the amounts paid. These cross-checks give us comfort of the CAPM implied cost of equity is appropriate. They potentially imply that the true cost of equity lies in the lower half of the CAPM range. At this stage and in consistency with our GD&T2 approach, we've decided not to modify the CAPM point estimates for the cross-checks. However, this is an area where we've welcomed feedback from stakeholders and we continue to review market evidence and we will continue to look particularly at any further transactions between now and Final Determinations. Finally, we have a third step, which we use to consider whether we should be making any amendments from allowed returns to ensure appropriate expected returns. As I said before, we've decided to remove the outperformance wedge following the CMA appeals process. And at this stage, we don't believe there are other reasons to aim off the midpoint of the CAPM range that we set out in step one, and therefore we're not proposing to make any further modifications in stage three.

If I go into cost of debt, which is on slide 17. Again, we're proposing to continue the same methodological approach which assesses debt costs for notional companies based on average sector wide costs, both for new and embedded debt, again, an approach that was tested and upheld on appeal in the GD&T process. We're currently assessing the cost of debt to be 226 basis points on average for ED2 for most companies, with a small uplift for companies that issue debt less frequently. We're proposing to use the iBoxx utilities 10 year+ index on a 17-year trailing average basis to calibrate the cost of debt. And we will retain full indexation, meaning that similar to the risk free rate for cost of equity, the value of the index will be updated at the end of each October every year, taking into account the values over the previous 17 years. Similar for GD&T2 we're proposing that we add 25 basis points to the index to account for issuance and other costs that we think networks have to bear. And as I said, we're proposing an additional six basis points for networks that are infrequent issuers of debt on a licensee basis and therefore don't issue benchmark sized bonds regularly, and that applies to the three networks that are on the slide. This analysis will be updated ahead of Final Determinations, including importantly the calibration of the index, and it may be that that index gets updated if the data suggests that's the most appropriate course of action. On the right hand side of the slide at 60% notional gearing that gives us a CPIH WACC of 3.26% for most licensees with a small uplift for infrequent issuers. As I said that was market data at the end of April. If you roll that forward to last Friday, the WACC would have been about 3.38%. Much of that change being accounted for by the movements and the risk free, although we have seen the iBoxx index go a bit wider as well. As I said, in October, we'll we're proposing to set those numbers ahead of Final Determinations. So really, we're consulting on a methodology as much as a number today.

On slide 19, a couple of other issues just to draw your attention to. We're proposing to retain the natural split between capex and opex like rates for totex capitalisation, and for depreciation we're proposing to follow the methodology we previously set out and that we used in ED1, which is a transition to a 45-year straight line depreciation basis. And we think that maintains intergenerational fairness given the expected increase usage of the system in the future. And as I said earlier on, we are proposing to reduce notional gearing from 65% to 60%, recognising the dynamics of this price control. On slide 20, we've set out what this means for returns which Steve's set out a little bit in his section of the presentation. The RoRE ranges for the ED2 package you'll see on the slide as well as the ED1 ranges and the outturn. This is clearly a highly powered price control, which we think is appropriate to ensure that networks are sufficiently incentivised to deliver Net Zero at lowest cost. It provides networks with an opportunity to outperform baseline cost of equity, but it will also ensure that less well performing firms or less well performing networks are strongly incentivised to improve and deliver for consumers. You'll see from the chart that the ODI incentives and particularly the interruption incentive scheme that Steve talked about are asymmetrical on an absolute basis. But we consider that when weighted by probability, companies have a fair chance of outperforming,

and we think the probability of being at the bottom end of these ranges or indeed at the top end of the ranges on a combined basis across all measures is actually very small. Finally, similar to GD&T2 we've maintained the return adjustment mechanism boundaries at 3% and 4%. So incremental returns are halved above and below 3% and reduced by 90% above and below 4%, and this mechanism is designed to ensure that the price control remains in balance for both consumers and investors and hasn't been miscalibrated.
On slide 21 we set out our thinking on financeability. To start with, we think we've set an appropriate cost of equity and debts which is one of the ways we think about financeability for the national company. But we also have looked at cashflow adequacy for notional firms using potential credit ratios and a notional gearing of 60%. And we've set out some of the illustrative numbers on the slide. And we think that in the baseline networks can continue to target a strong investment grade rating. We've also assessed financeability against higher totex cases acknowledging that more spending may come through the uncertainty mechanisms and against a range of downside scenarios. And in the finance annex, we've tried to be quite precise about how we've calibrated these stress tests so that you can see exactly how we're thinking about the financeability tests that we put companies through. You'll see that in chapter five of the finance annex. Looking at that analysis, we believe that companies are robust to a plausible but severe downside case as the other cases we've set out, which gives us comfort on the financeability side.
Finally on slide 22, let me turn to inflation, which as I say we discussed in chapter four of the finance annex. Currently the RIIO price controls as a whole, set a real WACC that embeds a long run inflation expectation of about 2% and we have a RAV that is inflated by outturn inflation. This means that in periods of high outturn inflation investors generate a higher nominal return and in periods of low inflation the reverse is true, and we do this to help maintain the purchasing power of investors capital. However, we also make assumptions about the notional company's financing structure. We assume a gearing rate and we assume an amount of fixed rate debt for the notional company. Obviously, this use of fixed rate debt, as you'll know, has a leveraging effect on equity returns under different inflationary circumstances, meaning that equity returns are geared to a higher or lower outturn inflation at a rate above one times. So should outturn inflation continue to be significantly higher than long run expectations, real equity returns for the notional company would therefore also be much higher than the allowed returns we set even though the real WACC consumers pay is unchanged, and obviously the inverse is true in periods where inflation is much lower than expected. Now, as I said, this is something we are looking at across our price controls. We're not proposing in our Draft Determinations today to change the approach. But in the interest of transparency, we wanted to consult on it to get stakeholders’ feedback and to make sure we understand that rather complex interactions of inflation on companies across all our price controls including ED2. So,

this is one of the areas where we're looking really to start a conversation with stakeholders today. So to finish, in summary, I think, we would characterise what we're setting out today very much as business as usual in line with GD&T2 and the CMA appeals, but with a clear acknowledgement of the specific circumstances within electricity distribution and of the changing macro environment. Let me pause there and I think I'll pass to Akshay for concluding thoughts and to go into

## Q&A

### Akshay Kaul

Thanks very much, Jonathan, for that really helpful run through. Because we have people joining us using different technological devices, I'm just going to run through very quickly the instructions for how we're going to run the Q&A. Obviously, if you're joining on teams online, simply raise your hand and I will bring you in and I can see that we already have some participants who have done that. If you are joining by phone, you will need to please type star five on your keypad to raise your hand and then when it is your turn, I will call you in and your microphone will be activated. I will read out the last four numbers of the phone number so that you know to identify yourself and you will need to then unmute yourself. So to unmute yourself, please type star six on your keypad. And then obviously, before asking a question, please do say your name and your institution for the record, that would be most helpful. So to begin the proceedings, let me invite Mark Freshney, who's ahead of the queue to ask the first question. Mark, please go ahead.

### Mark Freshney (Credit Suisse)

Hey, thank you Akshay, I have two questions. Firstly, on aiming up where it has been used by regulators in the past. The CMA used it with water there was clearly a lot of pushback from regulators. Given potential for capex to rise and how quickly the macro is moving and how little of the rise in real rates is put through into allowed returns. Surely, there's a stronger argument now for aiming up than there has been in the past. So, I was interested to know why you're not talking more explicitly about that. And just secondly, on inflation I mean, inflation is a risk that's taken by investors and it's also a reward. It's been built into the regulation for quite a while since the mid 80s. When we've had, really, only high inflation for about nine months and you look at the chart, it's hugely volatile. I'm just wondering whether it's actually too early for you to be making changes now on inflation, and whether any changes you'd make would need to be symmetrical because every other year, we've had low inflation or high inflation as an issue for the sector. Thank you.

## Akshay Kaul

Yes, those are both really good questions Mark, thank you for kicking us off. And I will obviously draw in Jonathan in a minute. But let me just start off with the broader policy context on your first question on aiming up. I think our view on that hasn't really changed in that we do recognise that there are theoretical arguments in favour of aiming up and these were rehearsed as part of the CMA appeals in both the water and the GD&T sectors. But essentially, we draw our reassurance from the fact that we have this set of market cross-checks in step two of the methodology that Jonathan just ran through, which gives us great confidence that the starting number is not too low. And secondly, as you were pointing out there, we index the cost of equity so that it keeps current with changes in real interest rates all the time. But let me pass over to Jonathan just to amplify or give more colour to that first question on aiming up, Jonathan. And then the second question on inflation and whether it's premature to act on it.

## Jonathan Gorrie

Yes, thanks Akshay. I agree with exactly how you've put it in the way we've thought about it. And I think if you look at the recent transaction data, in particular, that to us strongly suggests that the cost of equity could be below the midpoint in the range that we have. We haven't sought to move the cost of equity down but it does give us the comfort that Akshay has talked about. And as Akshay says, the price control is responsive to changes in the macroeconomic landscape, including changing rates, which will update annually. Just let me pick up your point on inflation. I think it's a really good point to make. I think at this stage, we're looking to make sure we understand the issue properly. So we are looking to make sure that the price control, which will obviously be in place for five years, is robust to bigger changes in inflation than perhaps we've seen before. As I say, we're not setting out proposals today. We're not looking to make changes at this stage, we're looking to start that conversation really. But on your question around whether this would be symmetric, that is something that we'd have to look at as we go through the analysis. But there's certainly, in my mind at least, a logic to having a symmetrical approach to this because we recognise it's a risk and a reward that, as you say, investors take.

## Akshay Kaul

Very good. Thanks very much, Jonathan. Let's go next to Martin Young. Martin, please go ahead and I hope you're recovering well from your knee surgery. Martin, I think you're on mute.

## Martin Young (Investec)

Can you hear me?

## Akshay Kaul

We can hear you now.

## Martin Young (Investec)

Brilliant, thanks for that and thanks for the best wishes around the knee injury, gives me plenty of time to read Ofgem documentation though when I'm going through rehab. Couple of questions, both related to the inflation issue. Just sort of thinking about what you are saying here and how that can be related to the bigger picture and clearly you've presented through the presentation a need to get to get things done and having a stable and predictable regulatory landscape is one way to bring things forward and get things done. If you start to play around with that, then surely we run a risk of delaying or perhaps even jeopardising investment, so I just wonder whether it is actually better to leave things alone. And the second part of that would be if you do make changes, then surely this is the type of change that all regulators should be thinking about. So, what sort of conversations if any of you had with your counterparts at Ofwat and the like? And then the second question, and maybe it's too early in the game to be asking this, but is there any sort of early stage thinking of what type of mechanism that you might put in place? Could you be thinking about only intervening if inflation is above or below a certain level, so if it's within a range, then you leave alone, but if it gets outside that range, then you intervene? Just wondered if there's any early-stage thinking?

## Akshay Kaul

That's great. Thank you, Martin. And again, Jonathan, I think it would be good if you can take both of those. Let me just again, kick off on the broader policy context on this topic. Martin, I think you're right that it isn't just an energy sector issue. This spans a number of different sectors, including water, and you will have seen some comments from the water regulator recently on this aspect as well. I think the reason that we care about it is because if the price control is allowed to produce outcomes that are significantly at variance to expectations for reasons that have really nothing to do with, you know, the effort or otherwise of network companies, then I think we do run the risk of having the legitimacy of these controls being called into question. I think we want to just reassure ourselves, that the control is operating in the best interests of consumers on both sides, whether you have high inflation or you have deflation, we just want to reassure ourselves of that fact. And as you would expect we are discussing these matters, not just within Ofgem, but across with other regulators as well. Let me go now, Jonathan, to you just to pick up the other points that Martin raised in terms of the specifics of what we might be thinking.

## Jonathan Gorrie

Yes thanks, Akshay. Martin, thank you for your questions. I think your first question is exactly the sort of conversation we want to have or starts picking up exactly the issues and the trade-offs we want to make sure we're clear about. Clearly as you say there's value to predictability and stability, but we also need to be able to respond to circumstances as they change. And that's what we're looking to understand through the consultation questions and as I said in my presentation, we very much want to engage with stakeholders and understand the dynamics of that properly. We don't want to rush into something that's ill-thought through. In terms of engagement with other regulators, as Akshay says, we talk to our counterparts quite regularly. You'll know that Ofwat have highlighted this issue publicly. The CAA yesterday on their Heathrow determination also pointed to the impact of high inflation and I think, altered a couple of both their equity and debt methodologies to try and take that into account. So, it's definitely something that's on the mind of regulators generally. And it's something we will, I'm sure, continue to discuss as we go forward. In terms of early-stage thinking, I don't think we're at a point where we can talk you through potential options. I think we need to we need to do the work; we need to do the analysis and see what makes sense. I will say that doing nothing obviously remains an option and remains on the table. But in terms of proactive options, if I can put it like that, we need to do our homework first.

## Akshay Kaul

That's very good. Thank you, Jonathan. Let's go now to Deepa Venkateswaran, who's been waiting very patiently, Deepa, please go ahead.

## Deepa Venkateswaran (Bernstein)

Thanks, Akshay. I have two questions. Maybe I'll not start with the inflation question. So, I had a question on the Totex modelling. So obviously you've used econometric modelling and also some disaggregated modelling. But I do notice a very strange pattern that for every operating company, the disallowance across categories, whether that's capex, opex, anything from connections to tree felling, it's exactly the same. So, one of National Grid's DNOs, SWALES, generally has 24% disallowance across the board, or one of SSE's entities. So I was just wondering, clearly one would imagine that some company might at least be efficient on some cost items. I mean, it was quite surprising to see the uniformity across for every DNO across all types of categories. So just wondering whether there's any other driver that just predetermines where a company will land, or a DNO will land and then that's just applied to all the cost categories. So that was my first question. And then on the inflation point, obviously, your assumption might be that the notional company doesn't have any inflation linked debt, but in reality, of course, we find that there's weighty practice some companies have a lot of inflation linked debt, others don't, and some companies will see, and have already seen, an increase in their cost of debt. So clearly, they can't retire all this cost of debt, they've obviously been doing this for years, based on this real system. So I was just wondering when you do such a consultation and in you know, historically the idea has been to give industry. Because I don't think this is something that can be changed overnight. So I was wondering how you will take these company-specific differences into account. Because some companies, the investors will go out of pocket if you just blanketly disallow inflation on debt. So that obviously will be a cause for concern. So, any thoughts on the actual funding, based on obviously, historic precedents on how regulation in the UK has worked? Thank you.

## Akshay Kaul

Thanks, Deepa. Those are two really clear questions. So Steve, do you want to take the question on Totex modelling first and then perhaps hand over to Jonathan for the one on inflation?

## Steve McMahon

Yes, I think on the Totex modelling, so our approach here, I have described it between econometrics and then the disaggregated. So, we have three Totex models with variations of Totex models and then the disaggregated model. And so, I think the issue here is more around the disaggregated modelling. So, we produce a Totex figure as a combination of everything taken together but then we split the allowances into categories based on an overall percentage cut. And that's really reflecting back in terms of when the companies submitted their plans to us last December, we reallocate that Totex back on the basis of the key component parts of that. So that's traditional just in terms of how we've done it before. So, I suspect that's what the issue is driving, that more consistency across some of the DNOs rather than anything else, deeply entrenched in that modelling process.

## Jonathan Gorrie

Should I pick up the inflation question, Deepa? Yes, it's a really good question. I think just for clarity for the notional company, we do assume some inflation linked debt, I think 25%. But obviously your point that that doesn't necessarily reflect the real world all the time, is exactly right. And again, I think this is part of the consultation process. We want to make sure we understand what the impact is both on the notional company and on actual companies. I think we are required to think about the real-world impact of our policies as we go through. And we also have statutory obligations as well that might influence that might influence our thinking. So those will all be things that are in the mix, as we consider what the right course to take here is. And as I say, we're not looking to do something hasty or off-the-cuff. We're looking to do this thoroughly and properly so that we understand exactly how this impacts both customers and companies, notional and actual.

## Akshay Kaul

Thanks, Jonathan. Great. Let's move on next to Chris Laybutt. Chris, please go ahead. Chris, you might still be on mute. You need to unmute yourself.

## Chris Laybutt (Morgan Stanley)

Good afternoon, everyone. Thank you very much for taking my questions this afternoon. I had two questions. One very simple and procedural just in relation to this notional inflation issue that has been a topic of discussion this afternoon. If you could just run through what the process will be, and whether we'll get any indication as to what you might be thinking about doing before you actually do it when you announce the final decisions later this year. Just so we can understand when I guess we'll get more information as you make decisions, post the consultations conclusion. And then I'll try and be succinct and my second question. If we're looking at page 107 of the finance document, you've got your capitalisation rates that you've set out, and there's quite a big difference between the ex-ante allowances and the reopener allowances in terms of capitalisation rates. And if we then turn to the slides in the slide deck, we can see on slide 20, that there's quite a big impact on financeability of the companies when you move from the base to the high case. And so, the question is, given the particularly the electricity transmission experience, with capex and Totex levels moving higher very quickly as we move into the second RIIO period, how realistic is it to assume that the companies will actually be spending in line with the base, and is it not more realistic to think that the companies will be spending more in line with a higher case? In which case, how do we circle the logic behind allowing really much lower capitalisation rates for the reopener additional capex and the impact on financeability that results?

### Akshay Kaul

Thank you, Chris. Those are both really clear questions. Jonathan, do you want to take both of those?

### Jonathan Gorrie

Yes, absolutely. So, on inflation and the process there. As I said, we're consulting on this broad issue today. I think if we were to consider options that deviated significantly from what we have today, it's very likely we would consult on those separately. And we would need to set out I think what we are thinking about and seek feedback on that. Obviously, if we do nothing, or we make very minor adjustments, you might just see that in the Final Determination document, but I would think, a substantial change, we'd probably be required to consult on. And in terms of process for that, that will depend on our analysis and the time it takes to do that internally. So, I don't have a timetable for you on that necessarily, today. On cap rates and the difference between ex-ante and the reopeners. We think companies are robust to both the baseline and the high Totex cases in terms of financeability. And we've made some assumptions about the amount of capex that we think might come through uncertainty mechanisms, and therefore might go on the RAV and the implications of that for financeability that we've set out here. We've also tested a number of other scenarios acknowledging as Steve said at the beginning, that there are a variety of possible outcomes here. But we do think that the base case is the most plausible baseline scenario at this point. And then in terms of the precise cap rates themselves, I think the ones we've used, particularly in the high case, follow network business plans at this stage. They are something we're consulting on and so we're open to some movements and changes in those. But the starting position has been one I think that has largely followed what companies have suggested.

## Akshay Kaul

That's great, thank you Jonathan. Let's move on next to Sharon Vieten. Sharon, please go ahead. You're on mute Sharon.

## Sharon Vieten (Columbia Threadneedle)

That works. Hi, thank you Akshay. A couple of questions on the asset base itself, actually. I'm just looking at the issuers at this stage. I'm just trying to understand what state do you think are the assets in, if not gold plated? And do you think they're fit to move on to the next transition phase? Or are there any areas in which you think management or the assets themselves that you feel that there's some catching up to do before they are fit to move on to the next phase? And in terms of the Totex plan, the differences between the company plans and yours, what particular areas do you think, where might the companies perhaps struggle improving their business case?

## Akshay Kaul

Great, thank you, Sharon, thanks.  I think, Steve, these are both for you. The first one, I think was on the quality of the asset base and probably resilience and then the second one on the business cases and where the companies will struggle.

## Steve McMahon

I think on the quality of the asset base, I mean, obviously, there's been a huge amount of investment that's been committed in previous price controls and the existing price controls in terms of asset replacement and refurbishment. I think generally, when you look across the boards, how would we measure that in terms of are they delivered against the outputs that we set under the network asset rest metric? And I think by and large, the answer is yes, they are delivering well against that. I think there is a question and particularly in response to Storm Arwen just in terms of well, what outcomes are being delivered? So just delivering your risk points doesn't necessarily mean you're necessarily delivering the outcomes that were proposed when you submitted your previous business plans. I think that's something that we're looking at quite carefully. I think, again, linked to some of the recommendations that are coming out of the Arwen report, so it's difficult to say exactly where things are going on that. And the second question was around?

### Akshay Kaul

It was around the business case, so we made cuts of about 17% so where are the DNOs likely to struggle to improve their justifications?

### Steve McMahon

Well I think that the opportunity exists for them to come back. I mean, we've been pretty clear and transparent around where we've made those adjustments. I think some of it comes through your traditional benchmark, and some of it is more like the bottom-up engineering assessment on the quality of the engineering justification papers that have been submitted, the cost benefit analysis. So clearly, there's an opportunity there, for things that might be deemed unjustified or only partially justified at this Draft Determination stage for the additional evidence that we require to make a more positive decision around that so that's clearly, I think, an area. There are other cases, for example, we talk a lot about strategic investment and the networks and on the load side, and I think from our point of view, we think that investing in any network companies should enable at the least cost investment paths, I think, investing ahead of demand to future proof the network when it makes sense to do so. What we looked for in our Draft Determinations is whether there’s sufficiently compelling evidence on why that makes sense and I think from that I mean, clearly demonstrating why a higher demand scenario is robust, clearly setting out what consumers are buying and why and ultimately, why doing it now ahead of need provides better value for consumers. So, I think one of the challenges that we had on that was that there wasn't really any discrete investment cases that we could assess it was more around well, our stakeholders want to see faster progress to net zero and we've ramped up our growth assumptions accordingly. So that's an area where the door is still open, but the case needs to be more compelling. And if we don't see that, it's not the end of the pathway, there's still going to be in with further opportunities through how they use the baseline allowances or how we use and assess the uncertainty mechanisms end period.

### Akshay Kaul

Thanks, Steve. Let's move on next to Verity Mitchell, Verity please go ahead.

### Verity Mitchell (HSBC)

Afternoon, everyone. This is a different topic. On page 35 you set out the RoRE range, but there are only two companies I can see that have bespoke ODIs, so why are not more being allowed? So, does that mean this price control is limiting scope innovation, compared with say the last two water reviews where there was a range of bespoke ODIs? And have the companies got the scope to actually propose more before the Final Determination?

### Akshay Kaul

Steve, I think that's one for you.

### Steve McMahon

Yes, we looked at these. We laid out the opportunity for bespoke ODIs and UMs, and we would look at them, and if we were satisfied that the criteria was met, then we could include those in the control. And some that have been proposed we think make sense across the whole industry, and we've applied that accordingly. Other individual ones we've looked at we don't see any basis for them because maybe it's not necessarily delivering the right outcome for consumers, or it conflates with another mechanism that we're already proposing. So there's different factors that we take into account. I wouldn't say that we are stifling innovation. I think where there are opportunities for innovation and where there are opportunities to deliver value for consumers then we have looked to pursue that. But we wouldn't invite or expect any new propositions to come forward at this stage. I think there is still the window there for additional evidence on proposals that had been submitted in the final business plans last December, and we would look at any additional evidence that was submitted around those.

**Akshay Kaul**

Okay, great. Now we're going to take our first question from the phone. So, it's the phone number ending in 0318. Please do unmute yourself, and of course, it would be really helpful if you state your name and your institution.

**Sam Arie (UBS)**

Hi, Sam Meredith from UBS. Can you hear me okay?

**Akshay Kaul**

There's a slight echo. But yes, go ahead. We can hear you.

**Sam Arie (UBS)**

Okay. I'll press on. Listen, first of all, thank you very much for this call and everything you've published today. I think we'll jump into our questions but it's worth just recognizing, again, the massive amount of work that you guys have put out, and also the generally very open way in which you communicate what you're doing, and even what you're thinking about doing. So, I for one just want to say hats off Ofgem and thank you for that.
And then into my questions. I mean, I think the first one is, if I remember the last set of Draft Determinations, my memory is there was a bigger haircut at that stage of the company plans and there was, on the equivalent quarter to this one, I remember you guys complaining that at least one or two of the companies had not given you all the information that you wanted about their plans. And so I'm just wondering if you looked at the haircuts of plans that you've applied this time, which looks a bit lower, is it safe to assume now that you've got all the information at the level that you wanted from all the companies, and so this is a relatively good view of what the final approved Totex can be, or are there still some companies where we really don't feel, like last time, that you've got the information that you wanted, and so there is potential to see more movement there? I don't know if I'm clear with my question, but maybe I'll pause on that and do my second one in a minute and, you tell me if the question makes any sense?

## Akshay Kaul

Yes. It's a very clear question. And also, thank you for your comments at the beginning. I think I'll kick off and then Steve, you can comment on the specifics of the reductions in the company allowances. I think when you compare it to the other sectors, they are slightly different. Even last time, I think we applied cuts of the order of about 12 or 13% in the gas distribution case and about 20 to 23% in the transmission case. And this sector, electricity distribution, at 17% is kind of in the middle of the two. They are very different, as you note, in terms of their characteristics, because in the transmission case, you do get a lot of this bottom-up project appraisal, because there isn't a lot of comparability and there's not a lot of benchmarking. So you have to just grind your way through the bottom-up assessment of what work is needed and how much it should cost. I think on the distribution side, both in gas and electricity, there is more comparability, there is more benchmarking, and therefore there is comparatively less reliance on the bottom-up assessments, but it's not zero. And I think that's where, Steve, you can come in and just explain why there are these differences across when you look across the companies. There are some companies that have also submitted very well justified business plans and have had the lightest cuts applied to their spending plans, whereas others have had more. Steve?

## Steve McMahon

Yes, I think that's fair. I mean, on average, we're at 17% across the sector, but there's still a range across the DNOs. I think it's stretching from 9% up to 24%. We don't target a particular value at Draft Determinations. I think ED2 come two years after the other controls, that was probably, from a DNO perspective, they've been able to reflect on that process. We were able to sharpen up the guidance in terms of what our expectations were for Business Plans. So, I think that's been reflected back into the overall quality of the plans that we saw and our Draft Determinations. I think what happens from now until final determinations really depends on the feedback that we get from the companies and wider stakeholders. We don't have a list of issues that we would say, subject to this, then we'll change our position. But ultimately, the companies will be able to see, and we set out transparently, in terms of where those challenges on Totex have come from, they are different. Well, there are some that are consistent across the board, but there's regional issues, there's company specific issues that affect where each individual DNO has landed. And some of that reflects the plan we had, and Akshay mentioned the contestability and compatibility. We've got pretty different plans coming in. Like on, for example, proposals around load-related expenditure, the actual ask, I think, ranged from 18% increase in annual spend against ED1 up to 50%. So clearly, you're seeing quite a bit of variation there and that's something that has been controlled for in our Draft Determinations. But really what happens next depends on what the feedback that we get from the companies, and then where there's any merit in those arguments, then we'll certainly reflect them in our final determinations.

### Akshay Kaul

And Steve, it's fair to say, isn't it, that the general standard of the plans has been definitely better in this round of price controls. I suppose people have learned as well from the first round compared to GD&T. And that's, I suppose, illustrated by the fact that none of the companies that really failed stage one of the business plan incentive which was about the quality of the plans that will pass that threshold.

### Steve McMahon

That's true. I think that the company's own customer engagement groups have been engaged in the process a lot longer. They've been running for three years effectively since we started this. The challenge group, that has an important role as well in terms of the support and the challenge to the companies as well as Ofgem's own policy development. I think there's been lots of lessons that we learned from the first tranche of RIIO-2 controls that have been reflected into the process for ED2. And also more stability in terms of moving from the methodology phase, into the business planning phase, into the determinations phase. So overall I think that had a positive impact. Obviously, when you're looking at reductions of 17%, there's clearly not perfection there, but a very good constructive base for us to move forward from.

### Akshay Kaul

Very good. Okay. Well, back to question. I think there was a second question wasn't there?

### Sam Arie (UBS)

Well, yes, I did want to ask just one other point but thanks for your answer on that one. And my understanding on the first question is no companies on the naughty step this time, as you sort of put it last time. That's helpful, that's reassuring. And then the second question I wanted to ask was on this inflation consultation. I think everyone's had a question on that, but me too. I think at this stage of the call it's pretty clear what you're talking about, and what your thoughts are. So, there was a bit of nervousness around this in the market this morning. So can I just give you guys an opportunity to say, in a really short and simple answer. Let's say for the record that, if I'm understanding this correctly, you're not looking to undo any of the basic principles of a real return framework or to take away the inflation protection that's essentially baked into that, you're just looking at a secondary marginal question about fixed and indexed debt and the potential of that to give a bit of leverage on the real return versus what you expected. So, is that right? And can you confirm that for me?

## Akshay Kaul

Sure. Jonathan, do you want to come in on that?

## Jonathan Gorrie

Yes, absolutely. I think that the bit we're really focused on, Sam, is this leveraging effect that you've talked about that allows investors potentially to generate real returns that are different, and potentially very different, from what we set at the beginning. And the question we're really asking ourselves is has that pushed the price control out of balance and therefore does it shift that risk and reward in the price control and have knock on impact for the incentive properties of it and so forth. We're open minded about whether the answer to that question is yes or no at this stage, which is why we're consulting on it in the way we are. And we do recognize the value of protecting investor capital in real terms over time and the role that plays in the in the regulatory system. Obviously, our role is to protect consumers and what we want to do is come up with an answer to this challenging question that protects consumers to the greatest extent.

## Sam Arie (UBS)

Okay, that's not exactly what I was expecting you to say. But I'll have a think about it. And I'll read the transcript again when it comes out. Thank you very much, appreciate it. All done.

## Akshay Kaul

Thanks for your questions, Sam. All right, great. I think we've got to the end of the hands but as always, I'll just pause for a minute in case anybody in the audience has further questions. Excellent. We've got the next one already. So, Chris Lever please go ahead.

## Chris Laybutt (Morgan Stanley)

Thank you. Thank you for taking my follow up. Just a very brief follow up on that last answer. Am I hearing correctly that any adjustment will be applied as a standard across the industry? Or will this be company by company?

## Akshay Kaul

Do you mean in terms of the inflation issue?

## Chris Laybutt (Morgan Stanley)

Yes. So directly following on from Sam's last question.

## Akshay Kaul

Jonathan?

## Jonathan Gorrie

I don't think I have an answer to that yet. As I say we, the way in which we approach this problem is still open. We're alive to the issues that have been raised around the impact that this could have on companies and the investibility of those companies. But we need to, as I said before, do our homework on this and make sure we understand the impacts particularly.

## Akshay Kaul

I think one thing it is fair to say Chris is that, as we said in the slide deck, this issue is not specific to ED2. So, if we did decide to do something, there's no reason why we would single out ED2 as a sector. I think we would, if we were going to make an adjustment, seek to make it across the sectors in a consistent way.

## Chris Laybutt (Morgan Stanley)

Thanks, Akshay. Thank you, Jonathan.

## Akshay Kaul

Great, any other questions? Okay, we got Andrew Moulder next, Andrew, please go ahead. You will need to unmute yourself.

## Andrew Moulder (Credit Sights)

Better now?

Yep. Perfect. Thank you.

Yes. Okay. Hi, Andrew Mould from Credit Suisse. Just a couple of quick questions on the cost of debt allowances. You've included 25 basis points additional allowance, but I did notice in the document that all of the companies said that it ought to be higher than that. And I just wonder, is that still up for consultation or is the 25 basis points a final number? And secondly, on the full indexation, you say that you're indexing the value at the end of October every year. But given how quickly the markets are changing, do you think that doing it once a year is actually adequate? Or are you perhaps again consulting on whether you should be changing the index or updating the index on a more regular basis?

## Jonathan Gorrie

Andrew, thanks for those let me pick them up. On the 25 basis points we’re absolutely open to further evidence that suggests that that number ought to be higher or indeed lower. It's obviously higher than what the CMA I think allowed in the PR 19 redetermination for example. It's a little bit higher, I think, than what the CAA had. So obviously, we think at this stage, it's a reasonable number. But if there's further evidence that suggests it should be higher, we're absolutely open to considering that. In terms of the updates again, something that we're open to considering, I suppose on cost of debt because it's a 17-year average, the annual update has a relatively small impact on the overall index. But if it looks to us that the way we calibrate the index and the way we update it doesn't quite capture what we're trying to then that's something we're absolutely open to reconsidering.

## Andrew Moulder (Credit Sights)

Okay, it can seem to me that with a very long 17-year, average and fast changing markets at the moment that the cost of debt within your cost of capital may not accurately reflect the cost of debt that the companies are incurring.

### Jonathan Gorrie

Yes and that's a dynamic we look at very carefully when we're calibrating this index. And as I said, we think that the 17-year index is the most appropriate one at the moment but that is something we'll continue to look at as we as we get towards final determinations. And if that index is either inappropriate, or our mechanism isn't responsive enough, it's something we'll revisit.

### Andrew Moulder (Credit Sights)

Okay, thank you.

### Akshay Kaul

Thank you, Andrew. Any other questions? Okay, next one comes from Summayah Leghari. Please go ahead.

### Summayah Leghari (PA Consulting)

Can you hear me?

### Akshay Kaul

Yep, we can hear you. Go ahead.

### Summayah Leghari (PA Consulting)

Perfect. I'm Summayah. I just wanted to ask one question on financeability. So, am I correct to assume that Ofgem wants companies to target a comfortable credit rating, a comfortable investment grade credit rating such as the Baa1 or BBB+? And if that is the case, then I think in the table 20 of your Finance Annex, it seems that ENWL has been given a credit rating of Baa1 in the base case whereas it could not possibly have that credit rating because it's AICR is less than 1.4 and the FFO/net debt that is around 11%. This says that there's something there's something going on there- I just wanted to check.

## Jonathan Gorrie

Yes, it's a really good question. Look, we don't target a specific credit rating for any of our notional companies. Although in general, we think a level of robustness to downside scenarios, and therefore some headroom to Baa3 or BBB- is sensible. On what we've got on the slide, as hopefully we're clear on, it's important to note that these are illustrative numbers that you get if you push the financials through the Moody’s scorecard (we use that because it’s the most open methodology) mechanically. And we don't target specific credit ratios. And when you push the numbers through the scorecard, that's the rating you come out with. We're not suggesting that is the rating that the company would get but it is if you apply the scorecard in the way that Moody's set out, that is the rating you come out with. Moody's obviously will take their own view and they take as we do an in-the-round view that isn't focused on an individual metric either. But that's how we've approached financeability to give us some comfort that these companies have some robustness to downside cases, for example.

## Summayah Leghari (PA Consulting)

Thank you, that's great. The other thing too, the follow-on question from there is that if you look at high totex scenarios in your table 20 of the finance annex, the ratings and ratios tend to be higher than the base case totex, which doesn't make intuitive sense to me. So again, I think something to consider whether the AICR metric is working correctly in that scenario or not, or are we interpreting it incorrectly?

## Jonathan Gorrie

I think for most companies, we would see AICRs drop slightly in higher totex cases. Often because of the need to borrow debt immediately and the growth in the RAV being slower. And I think if I look at slide 20 of my presentation, that's broadly what you see in most cases. So, I think we do see that the high case results in slightly lower credit ratings on an illustrative basis for some companies. You had ENWL dropping to Baa2 for example, for reasons we set out in a bit of detail in the finance annex. We're comfortable with that, and we think the companies are financeable under a range of outturn totex scenarios, including the high case that we've set out.

## Summayah Leghari (PA Consulting)

Okay, thank you.

### Akshay Kaul

Great thank you Summayah. Let's go next to Bartlomiej Kubicki. I hope I'm pronouncing your name correctly, Bartlomiej. Please go ahead.

### Bartek Kubicki (Societe Generale)

Hey, just one thing, got a technical question on the cost of debt. As I understand correctly, you will be taking the nominal average from the last 17 years and then sort of translating into the real one using inflation forecasts as of today. Don't you think it's a little bit inconsistent because nominal yields from the past will be taking into account historical view on inflation while the translation will be on current view on inflation hence, the actual real cost of debt may be miscalculated.

### Jonathan Gorrie

It's a really, really good question. I think from memory we actually, for historical numbers, deflated by the long-run inflation forecast at the time. I think if you look at the WACC allowance model that we've published today, you'll see that. So, we've tried to be consistent across time with the way we've treated inflation. But if it's helpful to follow up offline on that and walk you through the model in a bit more detail, so you can see what we've done, we'd be very happy to do that.

### Bartek Kubicki (Societe Generale)

Okay, thank you.

## Akshay Kaul

Thank you Bartlomiej. Any other questions? Okay, very good. Well, in that case, we're just coming up to half past the hour and let me first of all, just say a big thank you to our two speakers. And a big thank you to everybody who's participated with such excellent questions. This is just the start of the conversations, the start of the consultation period, and we're really keen to carry on the engagement with all groups of stakeholders, including particularly the investor community, which this audience represents. The consultation will close on the 25th of August. And we are planning to publish our final determinations on the back of that by the end of the year, probably in December of this year, followed by the usual license drafting consultation process, with the view to being ready for these new controls to be in place from the 1st of April 2023. So please do carry on engaging with the team and me. If there's anything else that strikes you after the call that you wanted to ask but didn't have time to on the call, please do get in touch with one of us and we will be very happy to engage. And of course, if there's anything we can do to make it easier for you to access the documentation and work your way through the consultation material, please don't hesitate to get in touch. But with that, let me wish you a lovely week ahead and I look forward to continued engagement over the months in front of us.

Thank you, everybody.