

RIIO-ED2 Draft Determinations Finance Document Consultation response

Annex 3: Finance

August 2022



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1 Allowed return on debt questions

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

Part 1: Overview

As an overview, starting with Ofgem's notional company approach, we see four principal issues with the DD approach:

1. **The notional company approach for ENWL fails to take into account its circumstances as an infrequent issuer. This status, as fairly assessed, increases both its costs in absolute terms, and fails to recognise that this results in a different risk profile compared to the remainder of the sector.** *We have proposed a different infrequent issuer premium to address absolute differences in cost between infrequent issuers and the frequent issuers on which the notional company has been based, and a sharing factor specifically to address the difference in risk.*
2. **The basic principle that a licensee should be able to invest confident in the knowledge that its *efficiently incurred* debt costs will be funded is not met (even after noting the remedies in 1 above) by Ofgem's policy. The policy increases ENWL's risk of long term financeability issues, particularly during a rate reversion, and is not in the interests of customers.** This risk is exacerbated by the current economic circumstances and the importance to consumers of supporting the move to Net Zero. We reiterate our previous comments in this regard, which would also include consideration of a sharing factor, more widely applied, once the issues in 1. Above have been addressed.
3. **Index-linked derivatives are being excluded from the sector/licensee's cost base, despite being legitimate financing tools. In particular, there is inconsistent treatment particularly between index linked bonds and proxy index linked debt, both for no good reason and in contrast to Ofgem's position at the time that they were entered into.**
4. **In common with the sector, we argue that the calibration of the sector average is incorrect.**

We have fundamental concerns with both Ofgem's approach to estimating "efficient" debt costs and its approach to setting allowances for debt costs. We believe that the approach adopted by Ofgem introduces policy risk for the sector, impacting the ability of networks to recover efficiently incurred debt costs, ultimately resulting in higher bills for customers over the longer term. In this policy, it discriminates against ENWL as an infrequent issuer compared to the rest of the sector.

Proxy for "efficient" debt costs

Ofgem's approach is not to estimate **efficiently incurred** debt costs, but rather to assume that the sector costs on average should (broadly) be funded. Whilst Ofgem does not necessarily base its policy on the premise that these average costs are efficient (as distinct from efficiently incurred), the converse appears to be true: Ofgem appears to consider that if a network's costs are higher than the average it must be because it has been "inefficient".

Establishing whether the debt costs of a licensee are efficient, or conversely inefficient, has to involve an assessment as to whether the funding could have been secured at a lower cost, based upon the circumstances extant at the time of issuance, whether this is for embedded debt or yet-to-be-issued debt. It cannot be an acceptable approach to estimate debt costs as being inefficient, simply because if the debt had been issued at a different point in time then the pricing would have been different.

Applying this logic would be to describe the price paid for gas today as being “inefficient” as it would have been cheaper to buy gas a year ago.

We can see the attractiveness of having a single cost of debt (and therefore a single WACC) for the sector, noting the exceptions already introduced by Ofgem (which we discuss below). However, where the consequence of this policy results in the transfer of uncontrollable and unrewarded risks on to licensees, it is not in the long term interests of customers (as it introduces the risk of increased equity costs in the long term to reflect the risk). Where this policy works to create a material subsidy from equity to cover **efficiently incurred** debt costs, such that the returns to equity are below the level needed to raise equity, this results in a failure to have a proper regard to the financing duty, and is against customers’ interests in that it increases the risk that the investments they need DNOs to deliver, will need to be deferred until funding is available. This latter risk is even more important than in previous price controls as the needs to invest for Net Zero remains unabated even during a time when the economic climate is more volatile than before.

Frequent vs Infrequent Issuers

Ofgem’s policy does not delineate between risks faced by a frequent and an infrequent issuer in relation to embedded debt, and by basing the assessment on the average cost to the sector (in which only ENWL can fairly be treated as an infrequent issuer – see below), Ofgem treats everyone as a frequent issuer. This approach ignores material risk differentials relating to factors which ENWL, as a small infrequent issuer of debt, cannot control. In this context we are proposing:

1. An adjustment for the unavoidable incremental costs that a small, infrequent issuer occurs; and
2. the introduction of a cost of debt sharing factor to mitigate incremental risk for an infrequent issuer and to align risk with the average frequent issuer / DNO group.

These adjustments would put ENWL into a similar risk position to that of the rest of the electricity distribution sector.

However, a sharing factor for an infrequent issuer solution does not address the key issue raised by the question – which is that the regulatory policy for setting allowed debt costs does not reflect or support the natural principle that the cost of debt allowance should remunerate efficiently incurred debt costs. This is because *inter alia* the policy based on sector average costs measures efficiency ex post rather than on an ex ante basis, and sector average does not represent a robust proxy for efficient costs.

Part 2: Introduction

Minimising policy risk will keep bills lower over the long-term

We believe that it is in the long-term interests of customers that networks can invest, confident in the knowledge that, provided that they are efficient in raising finance, the costs of finance will be recovered. This was recognised in the past by both the CMA (BW PR14) and by Ofgem, but this has only been implemented by Ofgem at a sector level.

As equity investors only invest at the DNO Group level, the implementation only at a sector level does not reflect Ofgem's stated policy.

Failure to deliver on this objective/policy places the additional risk on to equity that debt issuances, made at market rates at the time, could have to be significantly subsidised by future equity returns, because of the pattern of interest rates subsequent to a debt raising and/or the pattern of other networks' issuances. This additional risk will ultimately result in higher equity risk and therefore a higher cost of equity over the long-term, resulting in higher bills for customers, as well as material risk that expected returns are below required returns – with negative impacts on incentives and investment.

It is not reasonable to conclude that this policy risk is already reflected in past betas, as the market will typically expect regulators to minimise such risks through updating policy for each price control, particularly when there has been a significant change, in this case in the economic environment since RIIO-1. It is clear that interest rates have fallen further, and stayed lower for longer, than anyone expected or could have expected at the commencement of RIIO-1. If the regulator is now seen to be failing to respond to changing interest rate circumstances (noting the proposed change in policy regarding the changed inflation circumstances), then the market will start to factor in these risks. In this context, we note the significant reduction in equity allowances and in particular the absence of any aiming up that previously would have cushioned the impact of these risks.

We continue to stress that this issue relates as much to future yet-to-be issued debt, as it currently does to past issuances. Ofgem has, in the past, recognised the risk to customers' interests if interest rates rise, particularly if they rise above the trailing average, leaving licensees looking at raising debt at a cost above the index, an index that would take many years to catch up, and potentially never doing so. In this regard, we note the comments that PwC made in the report commissioned by Ofgem at DPCR5 – *"If Ofgem continues to set the allowed CoD in line with long-term market average levels then the DNOs run the potential risk of seeing their financeability threatened should the current market conditions persist or worsen over a prolonged period of time¹".* Whilst indexation is being applied for ED2, in effect the impact of changes in rates is muted as the allowance is primarily being set with reference to a long-term historic average.

In addition, the assumption that a licensee will be issuing 1/17th of its total debt per annum, to reflect the index, is unrelated to the circumstances particularly of ENWL, of its refinancing portfolio, but also of its past and future investment profiles, particularly taking into account the potential level of the uncertainty mechanisms.

That this risk is being presented to the networks at a time when the customers' needs for investment to deal with the move to Net Zero, exacerbates further the importance of the issue. That the current, increasingly uncertain, economic climate increases the chance of upwards interest rate movements

¹ PwC (2009), Ofgem Managing cost of debt fluctuations, pg 6

exacerbates this again. Future interest rate movements were a matter of concern for Ofgem at DPCR5, as noted by PwC for Ofgem, and must be even more concerning in the face of a significant planned level of investment, the criticality of Net Zero, and very large uncertainty mechanisms (UM) being introduced. *“The DNOs must finance a very substantial capex programme over DPCR5 (estimated at £7.85bn, or 65% higher than DPCR4 capex). Given the recent equity market turbulence, there is a risk that if an equity issuance is required to finance these investments, it may come at a time when equity prices are depressed. It is possible, therefore, that in practice even prudently operated DNOs may not be able to finance their operations when using a cost of capital figure underpinned by a CoD allowance set in line with the long-term trends. To ensure that Ofgem’s financeability duty is met, it is appropriate to have a mechanism in place to deal with potential extreme CoD scenarios.”*²

As a single licensee, we suffer disproportionately from this risk of underfunding, as we are unable to spread the risk and treasury activities over the extended asset base created by a number of licensees and the ability to time issuance activities. Groups of licensees are able to pool equity, interest rate and liquidity risk across a larger financing base, to arrange very significant Revolving Credit Facilities (RCF) as a Group, and to time frequent debt issuances at benchmark size allowing Groups to more closely align their debt issuance profiles with the flat trailing average proposed by Ofgem. This has not been recognised by Ofgem – the proposed Infrequent Issuer Premium completely ignores the impact of group treasury activities on individual licensees, with one exception for additional borrowing costs and cost of carry.

Importantly, this additional risk is a consequence of the (largely) ‘one-size-fits-all’ policy to setting the debt allowance. On an aggregate basis, customers are paying the sector debt costs, but the way that those allowances are awarded to networks creates significant winners and losers, and results in additional risk to equity. Ofgem has the capability to minimise this risk at Final Determination by re-allocating debt allowances (through a sharing factor or other means) to better reflect the timing of issuances and the efficient financing costs of individual networks. This would reduce equity risks over the long-term and ultimately keep financing costs as low as possible for customers.

We believe that Ofgem’s ‘one-size-fits-all’ approach to setting the debt allowance introduces policy risk to the sector and that this will ultimately result in higher bills for customers. It is therefore not in customers’ long-term interests.

When circumstances change, the regulator must adapt policy

Prior to RIIO-1, Ofgem applied a single, flat debt allowance to the sector. This was not indexed, but instead included some implicit headroom in the allowance to protect against interest rates above baseline expectations.

In the years after the financial crisis, there was increased uncertainty over the path of future interest rates. An indexation policy was introduced for RIIO-1, recognising not only that a single flat debt allowance could result in customers paying significantly more than needed over the eight-year price control, but also acknowledging that networks had no control over market rates and if rates were to increase, then the sector could be significantly under-funded leading to financeability issues. This was the focus of the PwC paper for Ofgem at DPCR5³.

Separately, Ofgem has also modified its approach to setting a single cost of capital allowance, notably for SHETL at both T1 and T2. The modification was justified on the basis of its individual characteristics. Having a single cost of debt allowance with a historic looking trailing average would have resulted in

² Ibid, pg 10

³ Ibid

significant discrepancy between SHETL's debt allowance and actual debt costs when its investment needs required a large amount of funding in a bond market where interest rates were materially below the trailing average. Therefore, quite rightly, Ofgem adjusted the notional company to take account of the weight of SHETL's debt issuances.

Ofgem has also proposed modifying at ED2, the single cost of debt approach through an infrequent issuer premium (following a similar adjustment for GDT2) which is discussed further below.

Ofgem is now consulting at DD on changing the debt allowance mechanism to take account of different, short term, higher inflation prospects.

These examples demonstrate how the regulator has been in the past, and is still currently, willing to consider the appropriateness of its prevailing policy and to make changes to ensure this policy remains fit for purpose, thereby reducing policy risk and minimising the cost of capital for consumers over the longer-term. Policy is not immutable.

In the context of ED2, the funding position of the networks at the start of this price control is more disparate than at the start of ED1 and DPCR4-5, driven by the unprecedented fall in interest rates between 2009 and 2021. Networks have had only varying ability to take advantage of this fall due to timing of maturing debt and investment profiles.

In addition, as a result of the numerous uncertainty mechanisms proposed in ED2, together with the risk surrounding future energy scenarios and the impact of the access SCR, there is material uncertainty over the level of debt financing that needs to be raised by the sector in ED2 (particularly with 98% capitalisation rates attached to volume drivers and re-openers).

As at the start of ED1, this risk is not under the control of networks and, as at the start of ED1, there is a significant risk that the prevailing debt allowance policy average significantly overfunds or underfunds the sector, with singleton networks at more risk of over or under funding than Groups which can issue debt at benchmark size on a far more frequent basis.

We note that this risk of over/under funding is not only related to the level of debt issuance in ED2, rather it is compounded by the fact that the proposed indexation methodology has a flat issuance profile, meaning that it is very slow to respond to movements in interest rates.

Overall, we believe strongly that Ofgem should re-evaluate the appropriateness of its proposed debt allowance, taking the past profile of market interest rates into account, as well as considering the impact of various scenarios for future interest rates, particularly at this point in the interest rate cycle. There are a range of solutions that could be implemented to reduce this policy risk, protecting consumers in the long-term. Among these include a second sharing factor on debt (as distinct from anything proposed to bring the risk of an infrequent issuer into that of the remainder of the sector) – a mechanism that is very simple to implement and would result in a minimal burden on the regulator, without necessarily increasing the cost to GB customers. Such a second sharing factor could be applied to all licensees, sharing the difference (positive or negative) between allowances and outturn costs for **all** aspects of the debt allowance. Such a sharing factor would reduce risk exposure but continue to expose all companies to sufficient risk to ensure incentivisation properties remain but reduce the risk that efficient costs will not be recovered driven by factors such as changes in market rates, or the timing of issuances of other sector participants, which cannot be controlled or predicted ex ante by any licensee.

We stress that we are referring to a second sharing factor. The proposal for an infrequent issuer premium and infrequent issuer sharing factor is aimed just at putting ENWL on the same level playing field as other participants in the sector.

Sector average does not equal 'efficiency' for debt financing costs

The principal variation in debt costs between licensees is caused, not by relative efficiency in execution, but rather by the timing of the issuances and the market rates that happen to be extant at the time.

We continue to stress that the decision as to what is efficient can only be made at the time that a fund raising takes place. Under Ofgem's proposed debt allowance, at a time of a debt issuance, a licensee would need to be able to predict both the future pattern of interest rates and the financing decisions and timings of other networks, in order to understand if its financing will be deemed 'efficient' and be recoverable, or 'inefficient' and require subsidisation from equity over multiple years. If equity is required to fund efficiently incurred debt costs it will mean that equity is receiving lower returns than the minimum needed to attract investment, i.e. a licensee's financeability is compromised.

In short, the timing of debt issuances, both those of the licensee itself and those of other licensees in the sector, should not be a criteria for assessing the efficiency of financing costs.

By virtue of the indexation process and the alignment of allowances to the sector average, it is perfectly feasible to envisage a situation where an issuance, or indeed an entire debt book, is considered efficient in one price control period and inefficient in another (or vice versa). That this is more likely to be the case for a smaller, infrequent issuer like ENWL, indicates a significant problem.

In the past, Ofgem has asserted that the timings of debt issuances are the decision of each network. In practice, this was never really the case, as debt issuances are, by necessity, driven by a combination of the timing of investments and the timing of maturities of earlier issuances. Networks individually only have limited overdraft and committed facilities, excepting those networks that are able to draw on very significant facilities backed by the DNO Group or wider ownership groups. These smaller facilities are typically utilised for working capital purposes and short-term liquidity and there is simply no capacity within these facilities to enable networks to fund investment or defer benchmark-sized issuances for any extended period of time. We already note the exception of Groups than can pool facilities across networks or other businesses.

As such, the timing headroom afforded by these facilities can only be seen as a way for networks to manage short term liquidity risk – ensuring that the licensee can continue to invest for a limited period of time, despite debt markets being closed (such as in the earlier stages of the COVID pandemic) – rather than being used to facilitate speculation that interest rates might move favourably in the near term, or otherwise time issuances to match an index.

For ED2, particularly given the 98% capitalisation rates proposed for re-openers and volume drivers, there will be very limited opportunity to defer debt financings if investment needs are to be met. It is an important tenet of regulation that the regulator should not impose obligations on the licensees (e.g. the need to invest to meet customer investment needs) without ensuring that each licensee, acting efficiently of course, can reasonably be expected to finance these obligations. To assert that the licensee is able to defer fund raisings because, for example, interest rates have recently spiked and may fall again at some point in the future, but that that licensee should still be obligated to make investments based upon external needs, is not credible.

Ofgem may argue that, as networks took decisions in the past to issue debt with particular tenors, they effectively made the decision on a future refinancing date, thereby determining that the date of a refinancing had been the licensee's decision. We do not find that argument very convincing.

This argument translates into the concept that, when the licensee committed to a refinancing date, maybe 30 years ago, the market rates at that time, in which the refinancing takes place, are entirely the result of a management decision. It reduces the concept of management control to an absurdity and presupposes that decision as to tenor are entirely within the remit of issuers, for example ignoring investor appetite at the time of issuance. As highlighted earlier, Ofgem can adjust its 'one-size-fits-all' policy to reduce this risk, thereby ensuring that sector financing costs are minimised over the longer-term, acting in the best interests of customers.

Ofgem, in their approach to established pension deficit funding, recognised the detriment to long term customer interests posed by imposing unmanageable risk on to licensees, and decided that having customers fund risk (in this case pension liabilities) that was essentially uncontrollable by equity, was a more favourable decision to customers than to have customers fund the uncertainty of outcome.

In regard to the calculation of the sector average, we continue to iterate our previous comments regarding the inclusion of derivatives. We particularly note that inconsistent treatment between index linked debt and derivatives/nominal bonds used to create proxy index linked debt.

Adapted policy on debt allowances can retain incentivisation

It is a fundamental principle of the regulatory regime that efficiency should be encouraged. We have no disagreement with this and have deliberately excluded any debt costs that could be described as inefficient, when assessing our under-funding position. The use of incentive mechanisms is well embedded in the regulatory regime – for example Totex savings are incentivised through a sharing factor between the licensee (as a reward and incentive) and the customer.

However, in respect of the debt allowance, we have a number of issues with the positioning of the proposed cost of debt policy as supporting the right incentives:

1. Incentivisation only works where it is achievable and delivered through factors under management control. Given the nature of the global bond market, no licensee has an ability to issue debt at a price than is lower than the market for its credit ratings, **at the time of issuance**. As, certainly smaller, licensees are not in a position to significantly defer investment (noting earlier comments on banking facilities), they are limited in their ability to time their financings. As the principal cause of variation in interest costs between the networks is the timing of issuances and market conditions at issuance time, and that given that this timing is dictated by investment demands and the maturity of existing debt, both being outside of the network's control, there is little incentivisation benefit in retaining an allowance that penalises those companies which have had to raise money in the market at a time which, in hindsight, proved to be one of high interest rates.
2. The alignment of the index to a sector average reduces the risk of divergence of the larger licensee groups from the sector average. These groups, pooling equity risk and therefore able to act together, are able to issue benchmark-sized debt issuances more frequently over time, either by coordinating the issuances between the individual licensees and/or using a group treasury function to issue debt on a more collective basis. The incentive properties of and point in time risk implied by the proposed debt allowance mechanism varies between individual licensees and those able to act together as a coordinated group. Ofgem has not considered this variation in risk profile between licensees.

3. As part of our final business plan submission, we proposed a sharing factor as potential remedy to the issues faced by a 'one-size-fits-all' policy, in particular with a view to aligning ENWL to the same risk profile as larger, frequent issuers in the sector. Ofgem has indicated that they see any sharing factor applied to debt allowances as reducing incentives for companies to issue debt effectively. For example, Ofgem states that *"ENWL's proposals on debt performance sharing would have negative impacts on incentive properties for licensees to manage debt prudently and efficiently that setting a sector-wide cost of debt benchmarked to market trailing averages provides."*⁴. Whilst this is mathematically true insofar as the strength of incentive might be lower, the same statement also applies to incentivisation in respect of the Totex mechanism, where an approximate 50:50 sharing factor is considered by Ofgem to provide adequate incentivisation properties, and still provides customers with some benefit to the efficiency. We also note that, given the inherent risk profiles are different between smaller, infrequent, and larger, frequent, issuers, Ofgem is effectively applying different incentivisation properties between licensees in the sector.
4. We also contend that considering incentive properties on the basis of strength of incentive alone is too narrow and is not consistent with best practice for risk allocation published by Government. For example, we quote from the Government Commercial Function's "Risk Allocation and Pricing Approaches":
- *Successful outsourcing arrangements rely on **appropriately apportioning risks between government and suppliers** so that the party **best placed to manage the risk** is responsible for them. **It may be appropriate for some risks to be jointly owned and managed (or 'shared') by both parties.***
 - *Suppliers can often price and manage certain risks better (and more cost effectively) than government. There are some types of risks that suppliers are well placed to manage such as day-to-day operational delivery risk. There have, however, been examples of **less successful risk transfer, especially where risks that are beyond the supplier's control are transferred** from government*
 - *Transferring risk **appropriately** to a supplier can create incentives for that supplier to deliver the contracted requirements to the scheduled timeframes, costs and to the right standards and conditions in an efficient way.*⁵

In the remaining sections of our answer to FQ1, we go into further detail on specific issues identified with Ofgem's approach to setting the debt allowance. This work is supported by three external reports, from KPMG (2x)^{6,7} and Centrus Advisers⁸, that are included in the response to our draft determination response.

⁴ - RIIO-ED2 Draft Determinations – Finance Annex, para 2.72

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https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/987140/Risk_allocation_and_pricing_approaches_guidance_note_May_2021.pdf

⁶ 'Infrequent Issuer Premium for ED2', KPMG, August 2022

⁷ 'An assessment of risk allocation implied by the cost of debt in RIIO ED2', KPMG, August 2022

⁸ 'ENWL 2038 Inflation Linked Derivatives and Counterfactual Analysis', Centrus, August 2022

Part 3: Calibration of the debt allowance for ED2

Ofgem's proposed calibration of the index for ED2 implies no headroom to manage risk in a highly uncertain macroeconomic environment and where the risk to customers' interests is increased by the need to deliver Net Zero.

It underfunds the all-in economic costs for example costs associated with derivatives in the base case. Ofgem should recalibrate the length of the trailing average in ED2 to ensure headroom that is, at least, commensurate to that provided in GD&T2 (25 – 29 bps headroom) and allows the recovery of the all-in economic costs including derivatives.

The treatment of index linked debt and derivatives/nominal bond combinations used to create proxy index linked debt should be consistent.

Headroom implied in the calibration

The calibration of the index for ED2 implies that forecast debt costs for the sector (excluding derivatives) would be underfunded by 2bps⁹. Including derivatives this increases to 18bps¹⁰. The lack of headroom in an increasingly uncertain macroeconomic environment could give rise to significant financeability challenges at ED2, given the scale of the financing required and the likelihood of rate reversion on interest rates.

Ofgem calibrated the debt allowance for GD&T2 to overfund the sector by 26-29bps¹¹ thereby providing some headroom against the sector's debt costs. The proposed calibration at ED2 means the sector as a whole is underfunded despite the fact that Ofgem elsewhere recognises that DNO debt costs are greater than for other energy sectors¹². This introduces an ex ante downward bias in the calibration.

In addition, the analysis carried out by Ofgem to stress test the calibration of the allowance is not robust and is not sufficient to conclude that the proposed calibration is appropriate. This is because:

- The calibration of the allowance should be stress tested under plausible and severe cases for interest rates and inflation – 100bps sensitivities are likely to be understated based on the market consensus regarding the evolution of rates in the near to medium term, and recent experience. Ofgem does not appear to have considered a plausible range of macroeconomic outcomes or considered how combination scenarios which include step changes in interest rates together with operational shocks and material changes to the scale of investment could impact on financeability and networks' ability to deliver key policy objectives.
- Ofgem also does not appear to have properly and fully considered the risk differentials for an infrequent issuer and hence has not assessed whether – taking into account differentiated risk

⁹ ED2 DD Finance Annex, Table 7

¹⁰ ED2 DD Finance Annex, para 2.62

¹¹ GD&T2 FD Finance Annex, Table 5

¹² Ofgem's recognition is implicit in the trailing average length, i.e. the projected sector average debt cost for ED2 corresponded to a longer trailing average (17 years) than the GD&T2 (10 – 14 years)

exposure in the past and future – an infrequent issuer is exposed to a material risk differential which could create financeability issues, additional costs, and/or perverse incentives.

Treatment of derivatives in sector average cost calibration

The inclusion of derivatives in the calibration of the ED2 allowance would exacerbate the underfunding of the sector's debt and derivatives costs by 16bps. In contrast, at GD&T2 the allowance was sufficient to cover the costs of derivatives and intercompany debt¹³.

In the WWU appeal the CMA's conclusions in relation to treatment of derivatives partially relied on evidence that the allowance was calibrated to include headroom which funded these costs:

GEMA has provided evidence which demonstrates that, when measured at an aggregate level, the sector's actual cost of debt including derivatives is not significantly different to the measure excluding derivatives – and that both 'actual' measures sit below the index-based allowance used by GEMA¹⁴.

GEMA has presented evidence that the inclusion of all derivative costs would not have had a material impact on its estimate of the sectors' actual debt costs, and both approaches (including and excluding derivatives) give a result that is lower than the cost of debt allowed by GEMA¹⁵.

This does not hold for ED2 where there is no such headroom in the proposed calibration and the impact of derivatives on debt costs is material (16bps impact¹⁶ vs 5bps for GD&T2). The requirement for the calibration to cover derivative costs is further supported by:

- Swaps are a standard tool to mitigate rather than to enhance financial risk, in line with corporate financial management policy. This is in the customer interest. Ofgem recognise this with respect to currency swaps but applies an inconsistent approach with respect to index linked swaps.
- For example, a number of swaps across the sector are inflation linked and are used in the energy sector mainly to manage risk driven by the regulatory framework – inflation is a key risk because of the mismatch between the allowed revenues (real basis) and costs (nominal basis). This is in the customer interest as it supports low bills over the long term. This is consistent with the CMA's view:

Derivatives are a generally accepted and widely used tool within corporate treasury departments. This is especially true if derivatives are used to replicate instruments such as index-linked debt, which are useful debt instruments in a regulatory framework¹⁷.

¹³ Ofgem carried out analysis in GD&T2 (GD&T2 FD Finance Annex, Table 6) that suggested the debt allowance for GD&T2 was sufficient to cover the combined debt and derivatives costs for the sector. This supported its decision to exclude derivatives from the calibration of the trailing average.

¹⁴ CMA (2021), RIIO-2 Final Determinations, Volume 3: Individual Grounds, para 14.227

¹⁵ Ibid, para 14.229

¹⁶ Draft Determination Finance Annex, Ofgem, June 2022, para 2.62

¹⁷ Ibid, para 14.219

- At the time of ENWL entering into the 2008/2038 derivative, Ofgem had accepted the use of index linked derivatives to create proxy index linked bonds:

" The issuing of index-linked debt by a regulated company (given the current regulatory approach to setting price controls) would provide a better match between cash inflow received from consumers and cash outflow to investors. This is because index-linked debt has an interest cost that reflects a real rather than a nominal coupon. The same effect can be produced through adopting financial swaps that convert the company's liability to pay from nominal interest to real interest (with the inflation added to the principal sum borrowed) or by manufacturing synthetic index-linked debt instruments with the help of financial intermediaries. "¹⁸

- Companies' current portfolios include swaps that were entered into during times of illiquidity in the IL bond/debt market (as in the case of ENWL) or where the most efficient method of obtaining an inflation hedged position has been through synthetics. In effect, these, coupled with the underlying nominal bonds create proxy index linked debt. Companies continue to bear the costs of such instruments, and this should be recognised by Ofgem.
- Excluding hedging derivatives would ignore legitimate costs that companies have incurred in securing low costs and managing risks. As such, this presents a misleading view of actual borrowing costs and understates all-in costs.
- Any proposal by Ofgem to adjust the treatment of inflation in respect of debt costs, should, in all fairness, take account of, at a licensee level, all existing derivative positions.
- Delineation between pure debt and swaps introduces a false distinction for the allocation of risk. There is no difference in practice in the nature of risk exposure between these two positions, and it is not clear why for example index linked debt (which hedges inflation risk) should be considered a risk borne by customers and included in the sector average, and proxy inflation debt, which achieves the same outcome, should be considered a risk to be borne solely by equity.

Ofgem should recalibrate the length of the trailing average in ED2 to provide headroom that is, at least, commensurate to that provided in GD&T2. A 20Y trailing average +25 bps additional borrowing costs would provide a broadly equivalent position to GD&T2 and would allow for the remuneration of all in-economic costs in line with the GD&T2 outcome.

Ofgem should include the cost of index linked derivatives, particularly where these are used to create proxy bonds, (for example ENWL's 2038 derivatives¹⁹²⁰), into the sector average cost assessment.

¹⁸ 'Financing Networks: A discussion paper', Ofwat/Ofgem, February 2006, para 146

¹⁹ The transaction was entered into in line with the premise that, provided always that it was efficiently incurred, there was a reasonable expectation that it would be funded over time. Although Ofgem had had the policy of setting a single cost of debt allowance for the sector, this had been to a background of reasonably stable interest rates over time, rather than in the light of the then current market conditions which then led to the commissioning of the 2009 PwC report.

²⁰ 'ENWL 2038 Inflation Linked Derivatives and Counterfactual Analysis', Centrus, August 2022

Part 4: Additional remuneration for factors outside company control/ Infrequent Issuer Considerations

Ofgem has provided three licensees with a premium of 6bps to remunerate the risks associated with infrequent issuance but has not included any other adjustments to its sector-wide allowance to account for factors outside of company control.

This section evaluates Ofgem's approach to remunerate the risks and costs arising from factors outside company control as follows:

- First, it establishes the principles that should underpin a best practice policy for risk allocation and incentivisation and considers whether Ofgem's proposed approach is consistent with this;
- Second, it considers the risks and costs that could reasonably expected to arise for an infrequent issuer;
- Third, it considers the criteria used by Ofgem to identify infrequent issuers for consistency with market practice and data and assesses whether ENWL would be classified as an infrequent issuer under a robust specification of the tests; and
- Fourth, it considers the appropriate mechanisms to price the risks and costs associated with the infrequent issuer profile and how these compare to Ofgem's approach.

Part 4A: Evaluation of Ofgem's approach against principles that should underpin a best practice policy for risk allocation and incentivisation

Ofgem's starting point of a one-size-fits-all allowance rewards and penalises companies for factors that companies do not control and allocates too much risk to companies, particularly infrequent issuers, does not price in efficient costs and is inconsistent with competitive market outcomes.

As Ofgem's starting point of a one-size-fits-all allowance does not consider drivers of debt performance outside of company control, it is particularly important to make sure that adjustments to capture material differences in risk and/or costs due these factors are robustly captured by regulatory policy.

Ofgem's starting point is a one-size-fits-all allowance for the cost of debt based on projected sector average financing costs. Below we evaluate this policy against the following principles that should underpin a best practice policy for risk allocation and incentivisation on cost of debt:

- To create the right incentives and robust risk allocation, regulatory policy should not impose risk onto companies they cannot control. This is consistent with the best practice principle for risk management and pricing that risks should be allocated to the party best placed to manage them with appropriate WACC adjustment. The degree of control each party has over a given risk is a material factor for determining who is best placed to manage it, and, crucially, to what extent they should bear the risk. In other areas of the RIIO regulatory framework risk sharing mechanisms have been introduced to take into account the limited controllability of underlying factors by companies.

- Regulatory policy should remunerate efficiently incurred debt costs, which contributes to a low WACC in utilities. An explicit decision that this is not a regulatory principle, and that networks are exposed to debt costs that they cannot control, will have a negative outcome on the perception of equity risk.
- Regulatory policy should be consistent with competitive market outcomes – that regulation is designed to proxy – and should not introduce distortions.

To create the right incentives, regulatory policy should not impose risk onto companies that they cannot control

The use of incentive mechanisms is well embedded in the regulatory regime – for example Totex savings are incentivised through an approximately 50:50 sharing factor between the licensee (as a reward and incentive) and the customer.

Incentivisation only works where it is achievable based on factors which companies can control. In the context of debt costs, companies should be incentivised to incur efficient costs based on what is *controllable by the company*. However, many of the factors that drive a company's performance against the debt allowance for electricity distribution companies are outside their control, as follows:

Timing of issuance: Companies may have some choice as to what debt they issue in terms of tenor and debt type (both being affected by market/investor conditions at the time). They have limited choice as to when they issue debt and in what quantum because they are constrained by refinancing timings and capex requirements which cannot be funded too early (without unavoidable carry costs) or deferred for too long (without compromising delivery of capex programmes). For ED2 there will be very limited opportunity to defer debt financing if investment needs are to be met.

Networks, particularly individual licensees, cannot defer longer term issuances as they have only limited overdraft/RCF borrowing capacity. This timing headroom is best employed to manage short term liquidity risk – ensuring that the licensee can continue to invest despite debt markets being closed (such as in the earlier stages of the COVID pandemic) – rather than being used to facilitate speculation that interest rates might move favourably in the near term.

The decisions around the tenor of past issuances can affect the timing of current issuances (as they drive when the refinancing needs to take place) but this does not mean that networks can fully control timing of issuance and point in time risk:

- First, whilst companies may have some control on the timing of refinancing needs via past issuance tenor, they have very limited control over the timing of the funding required for Capex needs.
- Second, the decisions around tenor are to some extent constrained by:
 - the need to issue long-term debt to mirror the duration of cashflows implied by the regulatory framework – i.e. the widely accepted asset-liability matching principle – and manage refinancing risk in this context;
 - the need to avoid the concentration of maturities in a given window to avoid liquidity and refinancing risk;
 - investor appetite on tenor and debt type at any given point in time; and

- the extant and expected future market conditions at the time of issuance which have a bearing on the attractiveness (cost vs benefit) and/or availability of specific tenors – however, these past decisions may still be out of the money in the future as outturn market conditions can and do differ materially from expectations based on the best available information at the time.

Changes in market conditions: macroeconomic conditions have varied materially over the last twenty years and the evolution of market rates – with a number of structural breaks such as post financial crisis – could not have been predicted ex ante. There is significant macroeconomic uncertainty ahead of ED2 with high volatility, deteriorating outlook and heightened risk of recession.

Group capital structures and implications for risk exposure: Networks are governed by the appetite of the debt investor community at the time that an issuance is launched. Currently the widely accepted benchmark size of public debt issuance in the UK market is £250m which enables investors to look to a secondary market if they chose not to hold to the bonds to maturity and ultimately attracts a bigger investor pool and keener pricing.

However, not all companies are able to issue benchmark size bonds on a frequent basis given smaller size and smaller financing requirements. On the other hand, infrequent issuance itself results in additional costs and risks, some of which are recognised by Ofgem’s infrequent issuer uplift.

Furthermore, Ofgem’s allowance is RAV weighted – in consequence smaller companies also have less influence on the average as less weight is attached to their costs than larger issuers, or individual issuers acting in concert (i.e. Network Groups).

Treasury strategies of other electricity distribution companies: the current, and presumably future, calibration of the trailing average critically depends on the sector average projected debt costs which is governed by the debt strategies of other companies in the sector and is outside any individual company’s control

Evolution of the regulatory policy: companies cannot control changes in regulatory policy over time. The regulatory methodology for setting the cost of debt has not been consistent over the last 20 years. The absence of a consistent regulatory benchmark to inform company debt strategies on an ex-ante basis can contribute to a wide range of debt strategies across the sector and can also give rise to the risk that once the policy changes past efficient issuances may be left out of the money.

In 2010, the Competition Commission (CC) recognised that some of the factors affecting cost of debt performance are outside company control, stating that *“one of the main factors affecting the cost of fixed-rate debt is the time it was taken out, and interest rates fluctuate over time. As debt issuance may be affected by company-specific factors (for instance, the timing of capex) and the cost of fixed-rate debt is affected by unpredictable changes in interest rates, there may be a danger of this approach penalizing companies that need to borrow at times of high interest rates. It might prove unsustainable if such companies are unable to finance their functions, or in order to avoid this, it might require headroom over and above the actual average to the detriment of consumers.”*

It follows from the above that the factors that companies can control are limited to whether the debt was efficiently issued against benchmarks at the time of issuance, debt type and to (to some degree) tenor.

The combination of these uncontrollable factors drives material differences in cost of debt outcomes between the companies²¹, which Ofgem's starting point of a one-size-fits-all allowance does not capture. All companies are exposed to volatility of debt costs and potential for divergence from the sector average, so there will inevitably be winners and losers from Ofgem's policy, but this does not mean that the regulatory policy sets the right incentives, appropriately allocates risk, or rewards efficient performance. To put it differently, the fact that this policy necessarily results in some companies outperforming and others underperforming their allowances, cannot be taken as evidence that its policy creates the right incentives.

Ofgem's approach explicitly²² and implicitly exposes companies to the combined risk from these factors and implies that companies can make decisions in relation to these factors ex ante and 'control' performance. Under this policy, even when companies issue debt at the most efficient cost available to them in the market at a given point in time, they are still exposed to significant risks of a mismatch between their (efficient) costs and regulatory allowances in the future. These risks are created by the combination of the pattern of future interest rates and (through the sector averaging process) and the timing of issuances of others in the sector.

Ofgem's approach rewards and penalises companies for factors that companies do not control rather than factors they do control (e.g. whether the debt was efficiently issued against benchmarks at the time of issuance) meaning that there is little incentivisation benefit from it.

To the extent that regulatory policy changes, or the nuances of regulatory policy changes, pre-existing conditions need to be fairly adjusted for by the regulator

We note with concern that Ofgem's proposal to compensate the basis risk arising from Ofgem's decision to move from a RPI based approach to a CPI-H approach is based on, we presume, the average RPI linked exposure for the sector, but excluding derivatives and therefore proxy IL bonds. This is reasonable for future debt issuances as networks can manage the risk prospectively. However, in respect of the debt outstanding at the decision point, licensees have embedded positions, fairly entered into to manage the mismatch of funding based upon a real coupon cost plus RPI linked RAV accretion, on the one hand, and notional debt coupon on the other. Ofgem should apply the basis risk compensation based upon the actual positions of the licensees, rather than the average position. These actual positions should include all derivative positions. Whilst Ofgem could argue that it was the licensee's decision to put his hedging in place, this was in the circumstances of a stable RPI based system.

A similar argument can be raised in respect of ENWL's embedded debt portfolio. This was put in place before the regulator introduce the concept of a trailing average which assumes that (for the case of ED2) 1/17th of the debt book has been raised evenly for each of the last 17 years. Clearly it is not possible for the licensees to move to match this profile (if this is even possible – see section on infrequent issuers) until existing debt comes up for refinancing.

²¹ This can be observed from the analysis undertaken by KPMG for ENWL.

²² For example, Ofgem notes that *"an alternative approach would involve placing weight on actual company debt costs, as proposed by one DNO. This would expose each network's customers to that network's **decisions on debt type, tenor, timing and risk management**"*

We are also extremely concerned that Ofgem is using the short draft determination consultation window to consult on extremely significant, but very uncertain proposals, to change a fundamental tenet of the investment proposition, namely the approach to inflation on the WACC. Whilst we note our broader concerns elsewhere, we stress here the importance of regulatory policy that pre-existing conditions need to be fairly adjusted for by the regulator. Notably, any proposal affecting inflation should take into account the actual circumstances of the licensee at the time of the policy change, not the average of the sector's circumstances, and should include all pre-existing derivatives and proxy index linked debt positions.

Regulatory policy should be consistent with the core tenet of UK regulation to remunerate efficiently incurred debt costs

As acknowledged by Ofgem,²³ the remuneration of efficiently incurred debt costs is a core tenet of UK regulation and contributes to a low WACC. Both debt and equity investors in regulated utilities make long-term financing decisions, including debt financing of up to 30 years' maturity²⁴, reflecting the asset lives of the underlying infrastructure in which they are investing. This is supported by the reasonable expectation that investors will, on average, be able to recover their efficiently-incurred financing costs.

Ofgem's concept (subject to exceptions) of a one-size-fits-all allowance for the cost of debt is not consistent with the recovery of efficiently incurred debt costs. Under this approach:

- Companies are exposed to the risk of divergence with the allowance which is driven materially by factors outside their control
- Prudent financial decision-making based on the best available information on forecast market rates and efficient issuance against benchmarks at the time of issuance could be left out of money over the long term.
- Companies' past decisions are assessed with the benefit of hindsight against a policy that did not exist when those decisions were made. These decisions are not assessed based on their efficiency, rather with reference to how factors outside company control have evolved to affect its costs and the allowance. We recognise that Ofgem notes that the sector average may not represent an efficient benchmark: "*setting allowances to equal sector average costs is not necessarily the same as setting allowances to match efficient costs*"²⁵. This means that a company's efficient costs could be unfunded because they diverge from the allowance which itself may not be efficient. Most significantly, the approach of judging efficiency from the average, or using the average as a proxy for efficient, theoretically means that debt may effectively be classified as "efficient" in one price control, but then deemed "inefficient" in a subsequent price control.
- Companies could go consecutive price controls being under/over funded which then could become embedded in their financing positions (e.g., through rating actions and corresponding impacts on debt pricing). These positions across the sector may take a long time to converge given long debt tenors observed in the sector.

²³ RIIO handbook para 12.13, Ofgem (2022), RIIO-ED2 Draft Determinations – Finance Annex, pg 156

²⁴ Bristol PR14, 10.6

²⁵ ED2 DD Finance Annex, page 172

- The sector average cost of debt upon which the allowance is based is RAV weighted. This approach inherently attaches greater weight to the financing strategies of network groups, whose component licensees can act together in concert. The allowance is intended to accommodate the cost of debt of several companies which have different characteristics and circumstances. In this context, the allowance appears biased towards the circumstances of larger groups. This creates a risk differential for individual licensees which needs to be taken into account in setting the debt allowance mechanism.

Ofgem's approach allocates too much risk to companies which they cannot control, the implied risk exposure undermines companies' financeability and creates risks which are inconsistent with allowed returns. Most critically, a licensee is unable to determine at the point of issuance, whether an issuance will be deemed as efficient across its tenor.

Regulatory policy should be consistent with competitive market outcomes

The general principle of Ofgem's approach that energy networks financing long term infrastructure assets should be exposed to these combined risks is contrary to observed market outcomes, where the financing of other infrastructure assets typically depends on the long-term stability of revenue to match debt profiles (for example long term PPAs, CfDs). If Ofgem's approach was imposed in competitive market conditions where investors bid to develop and finance infrastructure assets, there would be no market because the implied risk exposure would be unacceptable to infrastructure investors.

The right approach for the long-term interests of customers is that the networks can invest confident in the knowledge that the costs of efficient financing will be met by customers. Efficiency can only be determined based upon the circumstances at the time of issuance that a licensee can manage. Where companies are exposed to material risks that they cannot control, the design of regulation needs to mitigate exposure to these risks in line with best practice risk management principles, incentive properties and core regulatory tenets.

As Ofgem's starting point of a one-size-fits-all allowance, or its policy of determining "efficiency" does not consider drivers of debt performance outside company control, it is particularly important to make sure that adjustments to capture material differences in risk and/or costs due these factors are robustly captured by regulatory policy.

Part 4B: Risks and costs associated with the infrequent issuer profile

Small, infrequent issuers, as distinct from larger groups acting in concert, are exposed to additional costs and risks (relative to the average issuer) on both embedded and new debt for as long as (1) the issuer remains an infrequent issuer and (2) the debt issued when the issuer was infrequent continues to be in its debt portfolio.

Ofgem recognises that infrequent issuers face additional risks by providing a 6bps premium on the sector-wide allowance but doesn't, for example, recognise that an infrequent issuer's embedded debt would also be affected. It is important to make sure that the overall allowance appropriately captures the additional risks and costs faced by the infrequent issuer.

Small, infrequent issuers have different characteristics relative to the average network group which issues debt on a more frequent basis. In this section, we refer to issuers based upon the size/value of the network group to which they belong. This reflects that they share equity risk and are able to act in concert either separately or through a group treasury, to access debt markets. The larger the group, clearly the more frequently they can economically access the debt market.

Small companies can only issue at benchmark size (£250m) at infrequent intervals (given the small size of their asset base and the smaller implied financing requirement) which exposes them to additional risks and costs relative to the frequently issuing DNO groups.

These risk differentials relate to:

- **Greater exposure to point in time risk:** Issuers which issue infrequently are more likely to raise debt at high (or low) points in the evolution of the yield curve and credit spread i.e., point in time risk. The allowance assumes a daily issuance profile which implies an equal spread of issuance and equal exposure to underlying rates. Hence, infrequent issuers have a higher risk of mismatch with the allowance due to point in time risk.
- **More limited ability to match the sector average:** Small, infrequent issuers have less flexibility to manage factors outside of their control, such as regulatory policy and the macroeconomic environment over time, given they have more limited control over the factors which affect cost of debt. 'Lags' in their responses to such events relative to large issuers could widen variances with the sector average and thus the allowance.
- **More limited ability to influence the sector average:** Issuers with a small RAV have less ability to influence the allowance given it reflects a RAV-weighted average of sector debt costs. Hence, small issuers are more exposed to mismatches with the allowance and underperforming the rest of the sector.

The cost differentials between infrequent and frequent issuers particularly relate to the higher pre-financing costs (**cost of carry**) incurred by the former. Companies can, in theory, mitigate the cost of carry (i.e. the difference between the interest rate on debt raised ahead of requirement and the deposit rate) but this ability is contingent on the availability of committed credit facilities that are not directly employed in the day-to-day liquidity and cash management.

The size of available credit facilities is linked to the size of RAV – 2021 annual reporting indicates that the ratio of committed facilities to RAV increases with the size of the RAV. Furthermore, the scale of

committed facilities for SPEN and SSE further benefits from these networks being part of large conglomerates, noting that the benefits of this are included within the average sector costs.

Smaller, single network companies have materially smaller credit facilities to draw down given their smaller size compared to multi network companies. ENWL, as a relatively small, infrequent issuer, has a low credit facility which would not be sufficient to cover anywhere close to issuance requirements at benchmark size. It is also the case that a significant proportion of these facilities would be required for day-to-day operational cash management of the business.

The result is that ENWL has significantly lower flexibility to mitigate pre-financing requirements for benchmark size issuance than groups, which translates into additional costs.

Ofgem recognises that infrequent issuers face additional risks by providing a 6bps premium on the sector-wide allowance. Given that starting point of a one-size-fits-all allowance does not consider drivers of debt performance outside company control, it is particularly important to make sure that that the overall allowance appropriately captures the additional risks and costs faced by the infrequent issuer.

Notably, infrequent issuers are exposed to the additional risks and costs on both embedded and new debt for as long as (1) the issuer remains infrequent and (2) the debt issued when the issuer was infrequent continues to be in its debt portfolio. Ofgem's approach assumes that any additional costs and risks faced by the issuer apply during ED2 only and does not capture the need for a premium on embedded debt on the basis that there is no evidence of structural underperformance for infrequent issuers (addressed in *Infrequent Issuer analysis part two*)

Ofgem's approach to setting the base allowance (i.e. before any uplifts) recognises that companies are exposed to risks in relation to embedded debt. The result is an inconsistent approach whereby the base allowance considers risks over a long-term horizon covering both past (at least partially) and future issuances, whereas the infrequent issuer uplift only considers risks on future issuances.

CC/CMA precedent supports the need to consider additional costs and risks for the infrequent issuer over a long-term backward-looking window and the size of the issuer at the time of issuance. Ofgem argues that the precedent supports its approach, however, this is because Ofgem's interpretation of the precedent omits important factors and, as a result, is incomplete. Notably:

- The CMA effectively considers that a long-term look-back period, with reference to the instruments that will remain outstanding during the upcoming price control, is relevant to evaluate whether an uplift on the sector-wide allowance is required²⁶.
- The CMA considers that size at the time of issuance is the key determinant of whether size should play a factor in cost of embedded debt allowance²⁷.
- The CMA also highlights the relevance of Bristol's size relative to other water networks, noting that that even using contemporary data Bristol is much smaller than other water companies²⁸
- Consistent with the CMA conclusions at the PR14 appeal, given that the cost of debt allowance for ED2 is calibrated based on the RAV-weighted average of projected debt costs for the

²⁶ The CMA is explicit that its decision on embedded debt largely relates to the impact of long-term historic debt issued nearly two decades ago which will continue to be included in Bristol's portfolio during PR19. (The CMA PR19 FD, para. 9.1031 and 9.992)

²⁷ Ibid.

²⁸ The CMA PR19 FD, para. 9.993

sector, i.e., including both large frequent and small infrequent issuers, without the Small Company Premium (SCP) the allowances for both embedded and new debt will result in a structural funding gap for the small infrequent issuer. In particular, the CMA noted that *“if the cost of debt for both small and large companies were used to decide the cost of debt for all companies then, in the absence of an SCP, smaller companies would tend to face an assumed cost of debt that is lower than their actual financing costs on average, over time. In contrast, larger companies would tend to face an assumed cost of debt that is higher than their actual financing costs on average, over time”*²⁹.

Infrequent Issuer analysis part one - classification criteria and results

Ofgem has also adopted a wrong definition of infrequent issuer and as a result has not identified ENWL an infrequent issuer.

In particular, Ofgem has adopted £150m rather than £250m as the threshold for benchmark issuance, assessed infrequency of issuance at the network rather than at the Group level, and considered only issuances during ED2.

Single licensee vs groups

Ofgem’s assessment of the need for and award of the infrequent issuer uplift is with reference to individual licensees even though all networks, apart from ENWL, belong to a DNO group (or wider) and are therefore able to act in concert, either through central treasury/facilities and intra licensee funding and/or through arranging the pattern of issuances to more closely match the assumed 1/17th debt per annum profile assumed by Ofgem.

Ofgem’s approach to additional borrowing costs recognises there are differences in the financing strategies of DNO groups and of ENWL, noting in particular that DNO groups have in place cash pooling arrangements across networks (or wider) and a shared credit facility for the consolidated group. Ofgem uses group positions to inform its allowance for RCF costs and cost of carry. Ofgem comment that:

- For RCF costs: *“We propose to provide an allowance of 4bps, based on RFPR and group account data about actual RCF holdings.”*³⁰
- For cost of carry: *“In forming our range we have had regard to the different levels at which the calculation could be carried out (e.g. group vs. operating level)”*³¹

Furthermore, Ofgem’s approach to the base allowance does not treat smaller networks on an equal footing as larger networks. A simple average would represent an assessment of sector debt costs based on individual networks.

²⁹ Bristol PR14, para. 10.65

³⁰ Ofgem (2022), RIIO-ED2 Draft Determinations – Finance Annex, para 2.25

³¹ Ibid, para 2.28

In contrast, in its assessment to identify infrequent issuers Ofgem considers individual networks, which results in an internally inconsistent approach for no good reason, which cannot be justified.

Commentary on DNO financing strategies from annual reports and independent commentary from rating agencies³² evidences that DNO groups can and do consider debt issuance on a collective basis. DNO groups issue debt either through central treasury arrangements, or through the coordination of debt issuances between individual licensees within the group, or a combination of the above.

Groups of licensees are able to pool equity and market interest rate risk across a larger asset base, with more frequent debt issuances more able to match a long-term trailing average which assumes even annual debt issuance. They are also able to raise larger short-term facilities in nominal terms, as a bank can assess the credit/liquidity risk against a larger Group RAV.

In contrast, ENWL, as a single licensee, is unable to spread the risk and cost of its treasury activities over the borrowing base created by more than one licence and is disproportionately affected by these factors relative to the rest of the sector. Moody's imply strongly it is unusual that, given these characteristics, ENWL does not qualify for infrequent issuer status: "[ENWL] are the only network not owned by an electricity distribution group with multiple licensees and so unable to issue a larger benchmark size bond and on-lend proceeds to other subsidiaries".³³

The implication of the above is that Ofgem is wrong to consider frequency of issuance at the licensee rather than the group level as financing is managed at this level (or above) for all groups in the sector.

Threshold for identification of an infrequent issuer

Ofgem applies a threshold of £150m average issuance over ED2 to assess whether individual networks are frequent or infrequent issuers. The starting point deriving this threshold is a £250m benchmark size which Ofgem reduces to £150m based on precedent from the social housing sector of issuing at the size qualifying for inclusion in the iBoxx index but retaining some bonds for sale at a later date (tap issuances).

Ofgem's approach appears to conflate determining whether and how a small issuer might approach debt issuance – for example that a small issuer could undertake tap issuance – with the gateway criterion for identification of a small issuer in the first place, i.e. the determination of a risk differential to a large issuer.

Financing techniques in social housing (i.e., tap issues) do not represent a good proxy for how networks would or should be financed in practice due to the differences in characteristics and constraints which governs structuring in financial markets and the type of financing available (asset-based vs cash flow based) to each sector.

Evidence from energy networks financing indicates that tap issues comprise a small proportion of outstanding public debt in the sector. Analysis of investment grade bonds more broadly corroborates the trend observed in energy networks and suggests the trend observed in social housing is specific to the sector. Hence, superimposing financing decisions from social housing on to electricity distribution on an ex post basis is likely to be unrepresentative and distortive.

³² KPMG reference

³³ Moody's Sector Comment (July 2022): Draft decisions for RIIO-ED2 slightly tougher than expected

£250m is the right threshold based on the following evidence:

- Threshold for inclusion in the iBoxx Utilities index - the index applied by Ofgem - is £250m
- Financing strategies recommended by banks for utilities suggest £250m is the minimum efficient size to optimise pricing tension, flexibility and execution risk on public bond issues
- Energy networks most commonly issue at sizes at or above £250m

New vs embedded debt application

Ofgem's proposed approach for estimating the uplift on the sector-wide allowance for small infrequent issuers is not consistent with the recovery of efficiently incurred debt costs – a core tenet in UK regulation – as it provides only a partial remuneration for unavoidable additional costs and risks associated with this issuance profile over a short-term window of the current price control (ED2).

Ofgem's approach effectively:

- dismisses the impact of all past debt issuance that remains in the portfolio of the small infrequent issuer during ED2, even though this debt would have been issued when the company was smaller and had greater exposure to additional risks associated with infrequent issuance.
- assumes that any additional costs and risks faced by the issuer during the current price control no longer apply in the future controls, even though the instruments issued during ED2 will continue to affect debt costs for years to come.

Ofgem's approach to set the base allowance (i.e. before any uplifts) recognises that companies are exposed to risks in relation to embedded debt. The result is an inconsistent approach whereby the base allowance considers risks over a long-term horizon covering both past and future issuances, whereas the infrequent issuer uplift only considers risks on future issuances.

Ofgem's approach implies a structural underfunding of efficient debt costs for the small infrequent issuer given that instruments in its embedded debt portfolio currently and in the future, which drive higher costs relative to the frequent issuer will not be remunerated.

CC/CMA precedent supports the need to consider whether an uplift is warranted over a long-term backward-looking window and the size of the issuer at the time of issuance.

To appropriately price efficient debt costs, arising from the unavoidable characteristics and circumstances of the small infrequent issuer, Ofgem need to apply the assessment of whether a company is a frequent or infrequent issuer over the appropriate investment horizon – both backward and forward-looking – at ED2.

Infrequent Issuer analysis part two – assessment of whether ENWL is an infrequent issuer

Ofgem has also not included an infrequent issuer premium on embedded debt because of apparent lack of evidence that networks which it considers to be infrequent issuers underperform larger networks in relation to the cost of embedded debt. Ofgem's finding – which is based on the performance of issuers that meet its definition for infrequent issuance – is ultimately constrained by the robustness of its criteria for identification of infrequent issuers (see below).

Based on a robust set of criteria for identification of infrequent issuers, there is one clear outlier in the ED sector in terms of frequency of issuance (ENWL) which is under-performing the cost of debt allowance. This indicates that pricing the risk differential for embedded debt is required.

Principles and approach underpinning the infrequent issuer assessment within context of ED2 price control

Robust principles and approach for identifying infrequent issuers are a key first step to facilitate remuneration of efficiently incurred debt costs reflecting the unavoidable additional costs and risks associated with this issuance profile. The evidence presented above implies the following parameters for the assessment:

- time horizon of 22 years in total across the 5 years of the ED2 price control and 17 years of backward-looking data consistent with the trailing average used to set the allowance
- applied at the DNO group level rather than at the individual network level to reflect how DNO financing is managed in practice
- £250m threshold consistent with market data

The assessment also requires a representative and objective measure to assess whether each issuer is frequent or not. We propose the following three measures which allow for assessment on both absolute (for each DNO group) and relative (to other DNO groups) basis:

Measure 1: the implied average annual debt issuance needed for each group DNO to fund RAV growth and refinancing

The average size of issuance (across separately a backward-looking 17-year period and ED2) implied by annual DNO RAV growth and refinancing of existing debt consistent with the notional gearing level³⁴. Where the resultant issuance size is below the £250m threshold, this is indicative of infrequent issuance profile (on an absolute basis).

Measure 2: The implied issuance frequency in years

The implied frequency of issuance, measured as once per n years, to target minimum efficient benchmark issuance size. This allows for assessment of infrequency of issuance on a relative basis, whereby the greater the n, the more infrequent a particular issuer.

³⁴ Group level includes NPg, WPD, UKPN, SPEN and SSE with ENWL as the only singleton network.

Measure 3: Ratio of implied issuance frequency between ENWL and DNO groups

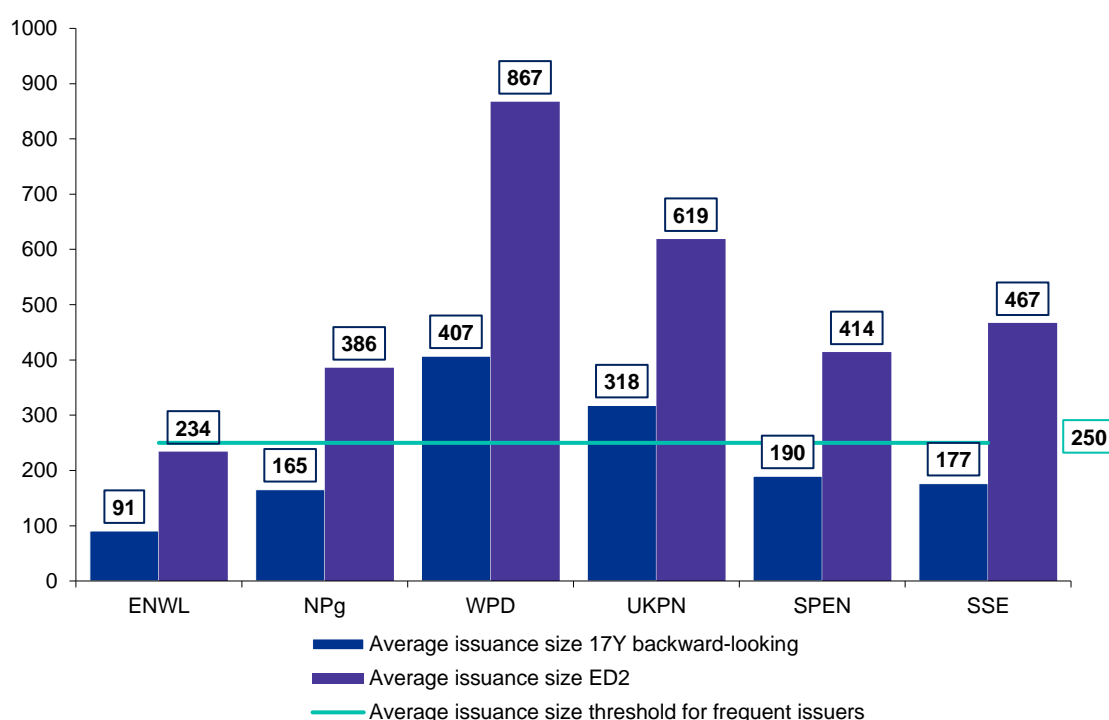
The implied frequency of issuance, measured as once per n years, to target minimum efficient benchmark issuance size for ENWL versus each DNO group. This allows for the quantification of the extent to which ENWL is an outlier relative to the sector.

It is appropriate to cross check the results of this assessment against the outturn frequency of issuance observed from actual DNO portfolios given the reliance on actual company data to calibrate the trailing average and additional costs of borrowing.

Assessment of whether ENWL is an infrequent issuer

In relation to Measure 1, the analysis shows that ENWL's implied average annual issuance size is lower than the minimum benchmark size of £250m over both the historical (17Y) and forward-looking (ED2) period. This suggests that ENWL would not be able to issue debt frequently without incurring material additional costs associated with sub-benchmark issuance size. In order to meet the threshold for benchmark size and avoid higher costs associated with smaller issuances, ENWL, and smaller companies in general, would need to issue debt tranches on an infrequent basis that are larger than would be otherwise considered optimal, given the scale and timing of their capital requirements.

Performance against the Measure 1 to identify infrequent issuers (over 17Y backward-looking period and ED2)



In relation to Measure 2 it is evident from the table below that over the backward-looking period ENWL would have had to issue debt once every three years to reach the benchmark size.

In relation to Measure 3 the evidence presented in the tables clearly indicates that ENWL is an outlier relative to the rest of the sector both on an individual network and RAV-weighted basis based on factors beyond its control – i.e. size.

- ENWL would issue debt 1.8x and 1.7x less frequently than the next smallest DNO group over 17Y backward-looking and ED2 period respectively, and
- ENWL issues debt 2.9x and 2.4x less frequently than the rest of the sector on a RAV-weighted basis over 17Y backward-looking and ED2 period respectively.
- Over the last 17 years ENWL has had a debt requirement of c.£91m per annum (compared to £258m per annum for the average DNO group). On a forward-looking, 5 year only, basis the equivalent numbers are £234m for ENWL and c. £557m for the average DNO group.

DNO group	17Y backward-looking			5Y forward-looking (ED2)		
	Average issuance size (£m)	Implied issuance frequency to target £250m benchmark (# years)	Implied issuance frequency to target £250m benchmark (# years) - compared to ENWL	Average issuance size (£m)	Implied issuance frequency to target £250m benchmark (# years)	Implied issuance frequency to target £250m benchmark (# years) - compared to ENWL
ENWL	91	2.76	1.00x	234	1.07	1.00x
NPg	165	1.51	1.83x	386	0.65	1.65x
WPD	407	0.61	4.49x	867	0.29	3.71x
UKPN	318	0.79	3.51x	619	0.40	2.64x
SPEN	190	1.32	2.09x	414	0.60	1.77x
SSE	177	1.42	1.95x	467	0.54	2.00x
Sector excl. ENWL, RAV-weighted basis	258	0.97	2.85x	557	0.45	2.38x

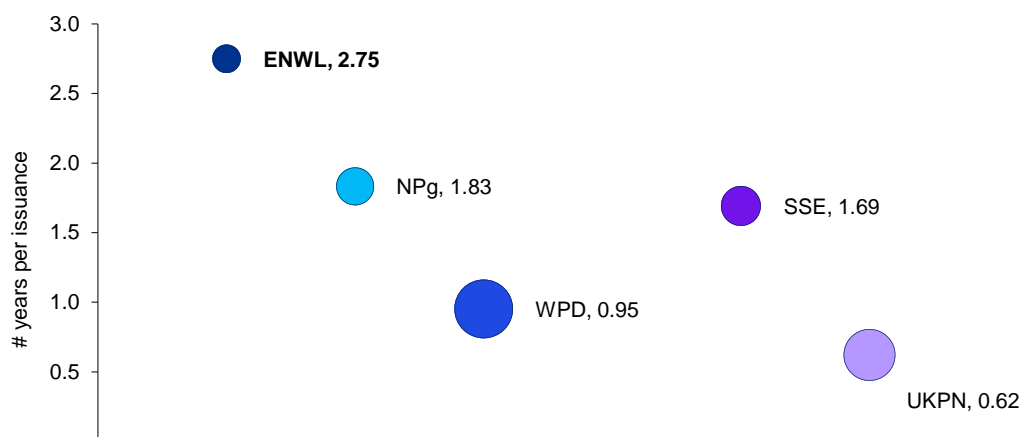
Based on the three measures ENWL is clearly an infrequent issuer in both relative and absolute terms at ED2. The inherent characteristics of small, infrequent issuers result in company specific costs and risks for these issuers which are outside of management control and needs to be taken into account in pricing.

Cross-check against DNO actual issuance data

Analysis of actual DNO issuance profiles corroborates the results from the criteria above i.e., that ENWL is the only small, infrequent issuer.

This is evident from the figure below which translates the analysis into charts where the size of the bubble represents size of the RAV for the DNO. The charts clearly indicate there is a significant negative correlation between a DNO's RAV size and implied issuance frequency, and reaffirms that ENWL, as the smallest DNO, should be classified as a small, infrequent issuer.

Implied issuance frequency and RAV – without intercompany loans



Source: Ofgem November 2021 ED1 PCFM (using 2021 closing RAV), DNO annual reports and KPMG analysis

The implied frequency of issuance for ENWL (2.75-year) is 1.5x longer compared to the next smallest DNO, NPg (1.83-year). All else being equal this supports an assumption that a notional company like ENWL would have issued debt on an infrequent basis once every three years on average.

Evidence of structural underperformance for infrequent issuers

ENWL actual costs represent a robust cross check and indicate that costs and risks priced in the allowance are too low for an infrequent issuer like ENWL.

Ofgem implicitly adopts a cross check relative to actual costs for the infrequent issuer: *We have not found systematic or consistent underperformance of smaller networks' issuance or smaller networks consistently underperforming larger networks in terms of their overall cost of debt to justify a premium being applied on embedded debt.*

We agree that efficiently incurred actual financing costs are relevant for the calibration of market benchmarks as supported by extensive precedent from the CMA:

As part of the Bristol Water (BW) PR14 appeal, the CMA considered³⁵ whether the notional Cost of Debt was reasonable for “a company such as BW” taking into account specific actual embedded financing costs:

- *In establishing the costs of an efficient company, we considered that it was important to have regard to the actual financing costs incurred by water companies. This reflects the reasonable expectation that investors will, on average, be able to recover their efficiently-incurred financing costs. This suggests the need for caution prior to making any assumptions which might imply that, taken in the round, investors in the sector would not be expected to recover their financing costs.*
- *We therefore considered that it was appropriate for us to consider both the notional level... and also the specific actual costs incurred by Bristol Water. The latter provided a cross-check*

³⁵ [Bristol Water plc: A reference under section 12\(3\)\(a\) of the WIA91 - Report \(publishing.service.gov.uk\)](#), section 10

as to whether the notional level derived from industry costs was reasonable for a company such as Bristol Water.

The CMA also considered measures of Bristol's actual costs during the PR19 appeal. *"our updated analysis of actual costs suggests that Bristol has an actual cost of 4.89%³⁶"* and *"In coming to an in the round assessment we give primary regard to WOC costs at the notional structure, but also consider Bristol-specific costs"³⁷.*

Similarly, the CMA set the cost of embedded debt in its Preliminary Findings for NATS with reference to actual observed embedded debt costs. The CMA's approach recognises that long-dated issuances are a key part of a regulated utility's financing and should be reflected where these are efficiently incurred, in the cost of debt allowance.

However, whilst we agree that actual costs of debt are a relevant input into the assessment of whether additional remuneration is required for infrequent issuers, we consider that Ofgem has not employed this evidence in a robust manner. This is because Ofgem's finding that there is not structural underperformance for infrequent issuers is based on analysis at the *licensee* rather than the *group* level. If adjusted to reflect a robust definition of infrequent issuer it is clear that ENWL as the only infrequent issuer in the sector has a materially different cost of debt to the rest of the sector. Furthermore, Ofgem's conclusion is circular because it is contingent on what criteria the regulator uses to identify infrequent issuers i.e. flaws in these criteria mean that Ofgem will not be able to identify structural underperformance for infrequent issuers.

ENWL is the only company – as a singleton network – which can be considered an infrequent issuer (other network groups are at least twice as large and therefore issue twice as frequently), and ENWL is projected to have costs significantly above the allowance implied by the DD, driven primarily by the timing of its past debt issuance.

This has been reflected in Moody's analysis: *"ENWL's debt is materially more expensive than that of other network operators due to the timing of issuance and we expect this differential to persist as a result of inflation swaps that are likely to generate material cash outflows until 2038."*³⁸

ENWL's debt has been efficiently incurred over the long term, with a significant proportion of ENWL's current debt book issued before (and in one case during) the global financial crisis which was the cause of the subsequent step change in interest rates.

A number of ENWL's actual financing decisions were driven by factors outside of its control including *inter alia* entering into RPI-linked swaps as a prelude to an index linked bond, which by necessity were used to create proxy RPI-linked bonds. That this was during the financial crisis at a point when there was a high degree of uncertainty around future lending rates and liquidity, the market expectation being that market rates would rise significantly (i.e. pre-QE) and issuing RPI linked debt before 2015 to manage the inflation risk inherent in the price control and financeability concerns arising from the ED1 approach to debt allowances.³⁹ Moreover counterfactual approaches indicate that alternative

³⁶ PR19 FD, para. 9.1000

³⁷ PR19 FD, para. 9.1004

³⁸ Moody's Credit Opinion May 2021, ENWL

³⁹ The decision to raise 30yr finance at this time was entirely reasonable, minimising future refinancing risk and aligning debt maturity with the long-term nature of our asset base.

financing policy/issuance would not have resulted in a materially lower (or higher) cost for ENWL (as set out in the Centrus⁴⁰ report).

A cross check with ENWL's efficiently incurred actual costs corroborates the under-funding of costs and lack of pricing in of risk differentials for the notional infrequent issuer.

⁴⁰ 'ENWL 2038 Inflation Linked Derivatives and Counterfactual Analysis', Centrus, August 2022

Infrequent Issuer analysis part three – pricing of the risk and costs associated with an infrequent issuer profile

Constant Maturity Swaps (CMS), which are used by Ofgem to calibrate the premium from infrequent issuers, only partially addresses the additional risks and costs borne by the infrequent issuers and hence materially under-states the remuneration required.

An additional allowance is required for the higher costs of carry and basis risk mitigation costs faced by the infrequent issuer. The risks and costs related to the 'base' cost of debt allowance could be mitigated either via a sharing factor (on both new and embedded debt) or a combination of the sharing factor (embedded debt) and CMS adjusted to appropriately price credit spread risk (new debt).

Assessment of Ofgem's approach

Ofgem has recognised that an infrequent issuer profile results in a risk differential that cannot be controlled by management and needs to be priced. Ofgem has priced in costs of hedging interest rate risks associated with infrequent issuance on a forward-looking basis only based on using Constant Maturity Swaps (CMS)⁴¹. The estimate of 26bps on new debt is consistent with GD&T2 and is based on quotes from three of SGN's relationship banks. The estimate cannot be assumed to apply for other issuers as it specifically prices the credit risk of SGN. Furthermore, this estimate assumes a 15Y swap rate tenor, which is not consistent with the 17Y trailing average underpinning the allowance for ED and, all else being equal, understates the costs of hedging the ED2 allowance.

More importantly, Ofgem in error assumes that all relevant costs and risks are priced in for an infrequent issuer based on CMS and has conflated the various additional costs and risks that the infrequent issuer is exposed to. The table below illustrates that CMS only partially addresses the relevant risks and costs for infrequent issuers and hence materially under-states remuneration required:

	Risks			Costs
	Greater exposure to point in time risk on cost of debt	More limited ability to control factors affecting cost of debt	More limited ability to influence the sector average allowance	Higher cost of carry
Embedded	Changes risk exposure but not full hedge	Changes risk exposure but not full hedge	No change	N/A
New	N/A	N/A	N/A	N/A

There are two issues on embedded debt: (1) due to reliance on a flawed definition of the infrequent issuer, Ofgem does not identify that ENWL is a clear outlier whose cost of debt performance provides clear evidence of structural underperformance for infrequent issuers and indicates that remuneration on embedded debt is required, (2) even if Ofgem were providing remuneration on embedded debt CMS would not be the appropriate solution. CMS represents an ex ante solution for hedging the cost of new debt allowance and cannot be assumed to apply on ex post basis. This is because an issuer

⁴¹ CMS allows the issuer to swap (receive) fixed iBoxx and pay a rate that is reset daily based on swap rates to match a given duration of the debt issuance

must enter into the CMS overlay at the same time as issuing the underlying bond and on an ex ante basis in order to secure the hedge.

Even for new debt, CMS provides limited mitigation for the risk differentials between frequent and infrequent issuers:

- **Exposure to point in time risk:** CMS does not remove point in time risk as it does not create a cumulative trailing average of daily yields on the benchmark index as assumed in the allowance. Further, it introduces additional financial exposure of not exactly achieving the daily yields on the benchmark index as it does not reflect the outturn credit spread. On balance, whilst the risk is changed it may be exacerbated through CMS
- **Ability to control factors affecting cost of debt:** CMS does not change the ability of small, infrequent issuers to control frequency of issuance and in turn, the timing of issuance and maturity concentration of the underlying debt book. Further, it effectively removes the choice for these issuers of raising fixed rate debt and in doing so, could result in additional divergence from the sector average position. On balance, the risk is potentially exacerbated through the use of CMS
- **Ability to influence the sector average allowance:** CMS does not counteract the low weight attached to the financing strategies of small issuers in the calibration of the sector average allowance. There is no change in the risk.

Moreover, CMS does not price in additional costs of pre-financing for an infrequent issuer, and hence cannot compensate for additional costs of carry; CMS is an overlay to a benchmark issuance but does not address the need to pre-finance a material issuance.

Appropriate pricing of the risks and costs associated with the infrequent issuer profile

The table below sets out two options for additional remuneration required to compensate an issuer like ENWL for the additional costs and risks it bears due to factors outside its control.

Small, infrequent issuer with:	Option 1: Adjusted Ofgem ED2 DD	Option 2: Sharing factor
Cost of new debt	26bps based on Ofgem's estimate + 7-18bps for credit spread risk	45%/55% (borne customer / company)
Cost of embedded debt	45%/55% (borne customer / company)	
Total cost of carry for an infrequent issuer, on both embedded and new debt	18bps ⁴²	18bps

⁴² Equivalent to 85bps on new debt

Small, infrequent issuer with:	Option 1: Adjusted Ofgem ED2 DD	Option 2: Sharing factor
Basis risk mitigation, appropriate to ENWL for both new and embedded debt, reflecting RPI linked derivative/debt	13bps	13bps

We comment on each component of additional remuneration required in turn:

Sharing factor

The KPMG Sharing Factor Report⁴³ estimates that a sharing rate of 45% is required to mitigate risk exposure for an infrequent issuer **such that it is aligned to that of a frequent issuer**.

The sharing rate for the infrequent issuer has been designed to compensate the incremental risk exposure (i.e., volatility of possible cost of debt outcomes) of an infrequent issuer relative that of a frequent issuer resulting from the inherent characteristics of the former⁴⁴. Put another way, in order to facilitate appropriate allocation and pricing of risks, the application of the sharing factor should reduce the risk exposure of an infrequent issuer to a level consistent with that of a frequent issuer.

The sharing rate represents the proportion of the variance between the cost of debt allowance based on sector average costs (excluding infrequent issuers) and the infrequent issuer debt costs (at notional gearing) that (1) would be provided to the infrequent issuer as additional allowance; and (2) could result in a reduction to the allowance to share costs below the allowance with customers.

A sharing factor represents the most robust methodology for pricing in risks associated with past issuance as it shares with customers costs associated with point in time risk which are not within issuer control. Infrequent issuers have less ability to mitigate this risk than larger network groups, and can only start to mitigate this risk, once the pre-existing debt matures.

Quantitative and qualitative evidence⁴⁵ indicates there is a problem with the existing ED2 cost of debt policy in terms of risk allocation, financeability, incentive properties and consistency with competitive market outcomes. These factors are likely to be heightened for a small, infrequent issuer which – due to its size and frequency of issuance – will be more exposed to financing strategies and changes in interest rates than peers.

A cost of debt sharing factor would provide better protection (depending on the percentage employed) against the risk differential on embedded debt which is fully unpriced under Ofgem's current approach. Qualitative assessment of cost of debt sharing suggests that in principle this mechanism would be appropriate to address the problem with risk allocation as it can meet the high

⁴³ 'An assessment of risk allocation implied by the cost of debt in RIIO ED2', KPMG, August 2022

⁴⁴ The Sharing Factor Report assumes that frequent issuers do not require a sharing factor and hence only considers the risk differential between frequent and infrequent issuers.

⁴⁵ 'An assessment of risk allocation implied by the cost of debt in RIIO ED2', KPMG, August 2022

hurdle for a new mechanism in that it can be targeted, effective and not result in distortions and perverse incentives.

A sharing factor for infrequent issuers – depending on design and calibration – might not expose customers to bearing any more risks including those driven by higher risk debt strategies, given that the mechanism (1) reallocates the risks between companies and (2) can serve to reduce the risk exposure borne by customers which would be most affected by the potential negative impacts (on investment, service quality, financial resilience) of under-funded debt costs for the relevant network.

The current policy takes account of the evolution of sector average debt costs over the price control due to changes in the macroeconomic environment through indexation. Indexation recognises that no issuer can control future interest rates and that passing some of this risk on to customers is appropriate. Cost of debt sharing in general can be considered a further evolution of this policy to reflect the specific, non-controllable characteristics, in this case of small, infrequent issuers. As a result, cost of debt sharing is in line with the current basis for policy i.e., adjusting over time for factors issuers cannot control.

In the DD, Ofgem argues that the sharing factor would have negative impacts on incentive properties for licensees to manage debt prudently and efficiently that setting a sector-wide cost of debt benchmarked to market trailing averages provides. However:

- Ofgem itself acknowledges that the sector average upon which the allowance is based does not necessarily represent an efficient position
- An allowance based on sector-average costs can vary materially from period to period, e.g. due to changes in sector's debt policies. Therefore, the allowance does not provide a clear benchmark for efficiency by design
- To create the right incentives, regulatory policy should expose companies to risks they can control. However, this cannot be the case where material costs and risks that the infrequent issuer bears remain unremunerated
- In setting the price control, noting the single cost of equity allowance being used, Ofgem should be extremely careful to ensure that each licensee is exposed to a similar level of risk. Our arguments above, indicate that this assessment needs to be done at a licensee group level to reflect the shared risk between those licensees. Unless risks are level between licensees, then investment into larger groups would be, by definition, a more attractive proposition than investment into single licensees. The introduction of a sharing factor (varying between groups) could be used to level the risks between licensee groups.

Ofgem also argues that sharing would also move away from well-established regulatory precedent in the debt allowance area (although the sharing factor in Totex was a fundamental tenet of the RIIO regime introduced in 2013). Risk allocation between customers and companies has not been static over the last 20 or so years and will continue to evolve going forwards. Similarly, interest rate environments have not been static over this same period and are required to be taken into account by the Regulator in reviewing the appropriateness of continuing its previous policy at each price control. On balance, the regulatory framework has evolved to increase the revenue at risk (for example, on outputs and costs) whilst the underlying operational environment has become progressively more complex and uncertain (for example, due to Net Zero and climate change). In this context, providing companies with protections around the potential funding shortfall on efficiently incurred debt costs arising due to factors outside their control would allow them to focus on driving

transition to a Net Zero economy and investments in service levels in line with customer expectations, while also reducing the drag on equity financeability.

Ofgem's previous analysis of a sharing factor appears to be incomplete as it does not appear to have considered the specific characteristics and circumstances of small, infrequent issuers and whether the interaction between their inherent exposure on cost of debt and the existing ED2 policy suggests that a sharing factor may be appropriate. Controllability and financeability are particularly important and relevant factors, both of which would suggest that risk sharing is appropriate for small, infrequent issuers, to level the playing field with larger groups.

Additional remuneration (above and beyond 26bps) for credit spread risk

The proposed structure and pricing of CMS assumes a fixed credit spread in the pay leg of the swap, which reflects the mean-expected spread over 15 years at the date of issuance. As a result, the CMS does not hedge risks associated with exposure to outturn credit spreads, which will change daily based on the dynamics of the cost of debt allowance, departing from the mean-expected level set at the initiation of the swap.

Any issuer is exposed to credit spread risk given that debt issuances from comparators bear a risk premium relative to the risk-free asset. However, credit spread risk for a frequent issuer is substantively mitigated as credit spreads in costs are in large part mirrored in the allowance – assuming that a frequent issuer can issue in line with the iBoxx Utilities index. This is not the case for an infrequent issuer which has entered into CMS. As a result, in order to assess the risk differential in relation to credit spread risk for an infrequent issuer, it is important to consider the marginal credit spread risk that an infrequent issuer is exposed to relative to a frequent issuer.

The marginal credit spread risk exposure of an infrequent issuer is defined as the potential change in credit spread from the mean-expected position assumed at CMS initiation. KPMG's Infrequent Issuer Premium estimates a range of 7 bps – 18 bps to price in the risk differential associated with credit spreads on projected new debt issuance for ED2, which is not captured in CMS.

Cost of carry

KPMG's Infrequent Issuer Premium report⁴⁶ estimates cost of carry for an infrequent issuer at c. 18bps, across all debt. The analysis assumes that a notional infrequent issuer like ENWL raises £250m in line with the benchmark size, part of which is financed via the committed facilities and part is pre-financed. The analysis considers a central case for pre-financing of 18 months. The estimate of the cost of carry under each scenario is based on the average difference between the iBoxx index and the 3month overall rate over the last 5 years. KPMG estimates a total cost of carry of 18bps expressed relative to the total cost of debt, which is equivalent to c.80bps in relation to the cost of new debt. Critically we assume that total cost of carry needs to be recovered within ED2, rather than over the life of each instrument, on the basis that Ofgem's approach effectively assumes the same.⁴⁷ This represents a significant additional cost of carry for an infrequent issuer.

⁴⁶ 'Infrequent Issuer Premium for ED2', KPMG, August 2022

⁴⁷ Ofgem's approach in error considers cash on the balance sheet only as a proxy for the scale of pre-financing required by networks. This is unlikely to represent a good proxy for pre-financing costs – in particular for an infrequent issuer. This approach implies that pre-financing costs in any given year of ED2 will be recovered in ED2 only.

RPI-CPIH basis risk mitigation

Ofgem is proposing to include an additional allowance of 5bps to remunerate the costs faced in relation to both embedded and new index-linked debt, resulting from its proposal to switch to CPIH indexation at ED2. This allowance is intended to compensate networks for the additional costs of hedging against what will become CPIH linked assets i.e., companies have raised RPI linked debt and require additional allowance to manage basis risk under the CPIH-based framework.

Ofgem proposes to make an equal award to each licensee that is based upon the sector average impact, rather than on the actual impact on each network to the extent to which that particular network is affected. This is not in accordance with established regulatory principles of fairness (see above).

Ofgem is implicitly recognising that the decision to move from an RPI- to a CPIH-based framework is outside of company control and could not have been predicted at the time debt structures and hedging strategies were put into place. However, its proposal to apply a single award to all licensees – despite the materially different proportions of embedded index-linked debt – creates a benefit for some networks at the expense of others due factors they cannot control. ENWL has a higher level of RPI linked debt (around 60% post-derivatives) compared to the sector average (around 25-30%) therefore would be particularly disadvantaged. This higher level of hedging reflects a greater degree of risk aversion to be expected with a smaller entity than a larger entity which has more flexibility in managing such risk.

The costs arising because of CPIH transition are comparable to business rates and other uncertain costs with a limited or no degree of management control such as licence fees, established pension deficit costs and bad debts, which are remunerated on a pass-through basis by the RIIO framework.

To implement the RPI/CPIH transition in a manner that doesn't penalise and disadvantage (or unnecessarily advantage) certain networks due to exogenous factors outside their control, the size of the uplift for embedded debt should be based on each network's proportion of embedded index-linked debt such that they are no better or worse off than if Ofgem had not implemented the change.

On new debt, the use of sector average proportion to estimate the allowance is reasonable as companies can manage the risk of divergence with the proportion on a forward-looking basis. This approach would not result in any additional costs to the consumer.

2 Allowed return on equity questions

FQ2. Do you have any views on the model to implement equity indexation that is published alongside this document, (the 'WACC Allowance Model - RIIO-ED2 30th April 2022 update Alternative Wedge')?

We have no concerns with the operation of the WACC allowance model. We have concerns around the principles underpinning Ofgem's risk-free rate.

We agree with indexation as a principle. It is logical and necessary that returns should increase/decrease in response to material market changes so that they remain sufficient to attract planned investment, as economic environments change.

That said, we have previously expressed reservations about Ofgem's equity indexation implementation and these concerns remain unaddressed in Ofgem's unaltered policy position.

The risk-free rate is calculated solely using the one-month (October) average of spot yields on long term Index Linked Gilts (ILGs). It is inherently downwardly biased due to the convenience premium associated with such Government bonds, a concept long recognised in academic literature. There is a structural imbalance between those needing to hedge inflation linked liabilities, especially pension/annuity liabilities, and the volume of ILG issuance available. ILGs, due to their special nature, create excess market demand that pushes the bond-yield below a normal market-clearing price.

Recent CMA determinations have recognised this first point in particular:

*"on the balance of evidence presented, we considered there to be evidence of a convenience yield in government debt" (5.45) and "it was our view that ILGs could be marginally improved upon as a proxy for the RFR" (5.174)."*⁴⁸

As noted by the CAA, the CMA stated in its PR19 final report⁴⁹:

*"We note that evidence provided on both the presence of a convenience yield within ILG yields and on market RFRs with different borrowing and lending rates suggest that the appropriate RFR for our CAPM is likely to sit above the ILG yield"*⁵⁰

and concludes to calculate the RFR:

*"... by placing weight on both long-tenor index-linked gilts and AAA-rated non-government bonds (the highest quality commercial debt) and taking into account up-to-date market data"*⁵¹

⁴⁸ Final determination: Volume 2A: Joined Grounds: Cost of equity (publishing.service.gov.uk), CMA (Energy companies); October 2021

⁴⁹ Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations: Final report, CMA, March 2021

⁵⁰ As above, para 9.264

⁵¹ Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations: Summary of Final Determinations, CMA, March 2021, para 85.b

The CAA, in respect of Heathrow airport, supported the use of AAA non-government bond yields in estimating the RFR:

“We have not been able to establish a superior index on which to base an estimate of the risk-free rate. However, as we have previously indicated, we nonetheless consider that ILGs exhibit a “convenience yield”, which means that they are likely to understate the “true” risk-free rate. In the absence of a superior means of estimating this convenience yield, we continue to consider that it is appropriate to place some weight on the iBoxx non-Gilts AAA-rated 10+ years and 10-15 years indices, in line with the CMA’s approach to PR19. While we are aware of drawbacks associated with these indices, we consider their use to be preferable to relying exclusively on ILGs.”⁵²

Our position remains that to overcome the downward bias in the RFR either (i) a value is added to the risk-free rate for the convenience premium or alternatively (ii) AAA-corporate bonds are used instead with appropriate adjustments.

FQ3. In light of the upcoming change to the definition of RPI in 2030, should the RPI- CPIH inflation wedge be based on: a) a single year (as shown in the WACC allowance model when: cell D2 is “year 5 forecast” and cell B5 is “01/04/2022”); or b) should it be based on 20 years of inflation forecasts (as shown in the WACC allowance model when: cell D2 is “20 year geometric” and cell B5 is “01/04/2031”)?

More information is required to make a final decision on which methodology is more appropriate, including Ofgem providing more clarity on the assumptions it proposes to make. We observe that, due to the remaining uncertainty regarding the 2030 change by the Treasury to set RPI equal to CPIH, we consider that the year 5 forecast approach is likely to be preferable. Although the Treasury have indicated their intent to make the change in 2030, there is an ongoing legal challenge brought by three large pension trustees that are seeking to overturn this decision. Furthermore, current market data on yield curves from Bank of England suggest that this change is not currently factored into the pricing of ILGs. Lastly, the calculation of the 20Y geometric average is inherently more uncertain than the 5Y approach used for GD&T2.

FQ4. Is there evidence that suggests we should change our approach to TMR for RIIO- ED2?

We do believe that there is persuasive new evidence available for Ofgem to consider in determining their approach to the TMR. In a report published in May 2022 (“Consumer price inflation, historical data, UK 1950 to 1988”) the ONS have re-examined the historical CPI index and created the CPIH inflation series for the period 1950-1988.

Oxera have conducted an assessment of the effects of these new CPI and CPIH back-casts⁵³ and found that:

- i. The new CPI and CPIH series published by the ONS for the period 1950-1988 are both **lower** than the *previous* CPI back-cast.

⁵² Economic regulation of Heathrow Airport Limited: H7 Initial Proposals (Section 2: Finance issues) Section 9.127, CAA, October 2021

⁵³ Assessing the new ONS CPIH back-cast, Oxera, August 2022

- ii. The revised CPI and CPIH back-casts for 1950-1988 are materially different. On average the revised CPI is 0.22% lower than the old CPI estimate, whilst the revised CPIH is 0.82% lower.

Point (ii) is particularly important because this marked difference demonstrates that adopting CPI as a proxy for CPIH is likely to be introducing downward bias.

This is significant additional evidence that needs to be taken into account by Ofgem in setting cost of equity. To maintain regulatory confidence, Ofgem should always be using the most recent and best evidence. As a minimum, therefore, Ofgem should re-work TMR for the new CPIH estimates. Given this new evidence, and its findings, it should also consider other areas such as the pre-1950 dataset and the geometric averaging method that are also contributing to a downwardly biased representation of TMR in the draft determination.

Extending the historical analysis to cover the full period 1900 – 1921 by adopting Ofgem’s CED data approach for the period 1900-1949, the new CPIH series for 1950-1988, and the current CPIH series for 1989 – 2021, Oxera find that on average the range for the TMR would be increased by 0.25% providing a revised TMR range of 6.50% - 7.00%.

Notwithstanding the material differences between historic CPI and historic CPIH emerging from this new analysis, our previous concerns have centred on the way Ofgem express historical nominal returns in CPI terms (ex post) when CPI as a measure has only been available since 1997. These concerns emphasise even more the need to use the most recent analysis available.

We have also expressed concern regarding the period prior to 1950, which remains relevant. For the pre-1950 period, Ofgem have used CED as a proxy for CPI and CPIH. In Oxera’s back-cast paper⁵⁴ CED is likely considered to be closer to RPI as a measure rather than CPI, and for this reason is likely to have the same upward formula effect bias.

Oxera have previously advocated two solutions to express historical TMR in ex-post CPI/CPIH terms⁵⁵:

1. adding the forecast RPI–CPIH wedge to RPI-real historical returns, restated using today’s RPI methodology; or
2. deflating nominal returns by CPI inflation, adjusted for bias in the historical estimates of CPI.

Ofgem’s preferred approach (2) requires a highly uncertain estimation of a reconstructed CPI dataset back to 1900. It relies on unadjusted estimates of historical CPI creating a series of inflation data that is inconsistent over time. Approach (1) adds a forecast RPI-CPIH adjustment to historical RPI-real return data corrected using today’s RPI methodology.

We consider that adopting the first approach reduces uncertainty in measurement by utilising historical data corrected for known issues, as well as considering the impact of CPIH rather than CPI. We believe this minimises uncertainty and reduces bias and for that reason we strongly advocate option (1) which estimates an RPI-CPIH wedge is applied to the pre-1950 dataset as well.

⁵⁴ Assessing the new ONS CPIH back-cast, Section 2C “Unresolved issue with pre-1950 CPI time series”, Oxera, August 2022

⁵⁵ The cost of equity for RIIO-ED2, Section 4.1, Oxera, June 2021

FQ5. Can stakeholders confirm their view on the trade-off between: the objectivity of using outturn averages (even though the results may be materially higher or lower in future price controls than current TMR expectations); versus the benefits of putting more weight on current expectations (noting the evidence from cross-checks and the associated risk of subjectivity)?

Placing most weight on outturn averages has long been the established approach in UK regulation, with TMR assumed to be stable over time. It is supported by a wealth of financial literature and empirical research.

We do not agree with Ofgem's proposal to consider placing weight on the currently limited evidence presented in step 2 of the draft determination. This is, as widely acknowledged, subjective and not robust⁵⁶ and could result in potential inconsistencies if differing assumptions and step 2 "evidence" were to be used in future price controls. Ofgem themselves state in relation to the TMR that "We accept that outturn averages are objective and stable"⁵⁷

We believe the proposal presented in step 2 of the draft determination would undermine regulatory stability and predictability, introduce downwards bias into the CoE estimate by attaching weight to the least robust evidence, and be detrimental to customers in the long term.

FQ6. Do stakeholders agree with our proposal to apply the same TMR for RIIO-ED2 (a mid-point of 6.5% CPIH) as we did for RIIO-GD&T2?

We do not agree with Ofgem's current proposal of 6.5%. In light of the new ONS evidence as discussed in FQ4 above we believe, as an absolute minimum, that TMR should be uplifted for the ONS revisions to CPIH estimates for the period 1950 – 1988. Overall, this would imply an increase to CPIH-real equity returns of 0.24% to 6.50% - 7.00% with a mid-point of 6.75%.

In addition, we still disagree with Ofgem's overall approach to assessing the TMR range based on:

- i. flawed historical CPIH estimates as noted in FQ4 above; and
- ii. applying geometric rather than arithmetic averaging to arrive at an unbiased estimate of the TMR

⁵⁶ In "Infrastructure fund discount rates" (2019), Introduction, Oxera concluded "A comprehensive review of the infrastructure funds' risk and return characteristics suggests that the funds' discount rates are not an appropriate cross-check to determine the upper bound or the lower bound of the CAPM cost of equity range."

A wider view of cross-checks in "The cost of equity for RIIO-ED2", Appendix A, Oxera, June 2021 evidenced a number of reservations over the validity of many of the cross-checks Ofgem have used.

PR19 CMA FD 9.374 "However, due to the sensitivity of these estimates to assumptions, we place limited weight on the results derived from this approach."

PR19 CMA FD 9.377 investor surveys and practitioner forecasts tend to produce a broad range of estimates, which as a result usually provide limited guidance on a reasonable range for the TMR. The breadth of the range will generally reflect the fact that such surveys / forecasts are subjective; the results may depend on the identity and outlook of the respondents and how they interpret the questions being asked.

⁵⁷ RIIO-ED2 Draft Determinations – Finance Annex, 29 June 2022, Ofgem, Section 3.25

We have discussed and referenced the issues in more depth in our business plan submission⁵⁸ and the associated Oxera report⁵⁹. Both of these issues result in an understatement in the TMR range.

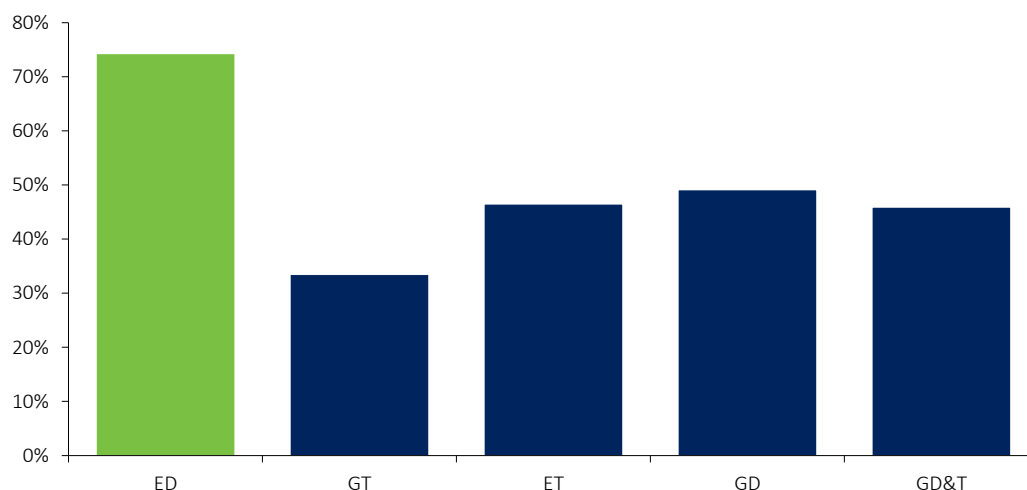
FQ7. Do you believe that DNOs have a higher or lower level of systematic risk than the GD&T companies during their respective RIIO-2 periods?

The interaction between inherent risk exposure and regulation implied by the ED2 DDs – as per the proposed regulatory package – exposes DNOs to greater systematic risk relative to GD&T networks. Therefore, DNOs face a higher level of risk.

The relative risk assessment undertaken by Ofgem is very high level and does not consider systematically risk implied by its Draft Determination for ED2 itself. As a result, it omits important drivers of the risk differential between ED, GD&T2, in particular, Net Zero uncertainty and the value of real options (see below) associated with the significant investment required in the context of this uncertainty.

DNOs have a unique role to play in responding to climate change and the country's Net Zero ambitions. DNOs are expected to undertake significant investments to facilitate the achievement of these ambitions – the ex-ante allowances proposed at the DDs imply an increase up to 20% relative to the projected ED1 spend, although this may be significantly higher again after the application of the UMs. As acknowledged by Ofgem the resulting scale of investment for DNOs is greater than for the other energy sectors, and needs to be taken into account as part of the overall financing requirement as well as the financeability assessment for ED2. The chart below shows that the scale of RIIO2 baseline Totex (before uncertainty mechanisms) relative to RIIO1 closing RAV is significantly greater for ED2 relative to other energy sectors both on individual and aggregated basis.

Scale of RIIO2 baseline Totex relative to RIIO1 closing RAV



Source: GD&T2 FDs (revised), ED2 DD, Regulatory Financial Performance annex to RIIO-1 Annual Reports 2019-20, ED2 DDs PCFM

The significant investment that DNOs have to undertake, and the importance to consumers/Net Zero, is an important risk driver and the uncertainty – around future energy policy, future demand and technologies used to meet this demand – under which this investment will be undertaken represents

⁵⁸ ENWL Final Business Plan, Annex 28C Alternate Cost of Capital, Section 3 – The Equity Return, p26

⁵⁹ The cost of equity for RIIO-ED2, Oxera, June 2021

an additional risk factor. For example, the pace and scale of the uptake of low carbon technologies leads to uncertainty over the investment that DNOs will be required to make in order to satisfy demand. The required level of investment may therefore be significantly higher than provided for in ex ante cost allowances.

The significantly increasing scale and uncertainty of expenditure imply higher variability in expenditure and profit which will increase volatility in absolute terms and, all else being equal, increase volatility relative to the market. This would imply higher risk for DNOs and there will be a systematic component to this higher risk exposure. Furthermore, there is less scope for optimisation of spend over the price control period. The significant difference in the ratio of RIIO2 Totex to the current asset base for ED2 relative to other energy sectors would suggest that the impact of cost volatility on returns would be greater for DNOs and would result in a higher beta to the extent that this volatility is systemic.

There is a greater proportion of expenditure being uncertain at the outset of the price control period and increased uncertainty over the ability to recover fully costs. This creates additional costs for DNOs associated with financing and financial planning as well as exposure to ex post review. The DDs propose a significant number (34) of UMs. Where DNOs have to seek allowances for costs subject to UMs after they have been incurred, there is a risk that the spend may not be subsequently allowed by the regulator (or only partially allowed) or ultimately recovered much later than the expenditure has been incurred. There may also be the risk that the aggregate value of the spend below the trigger points for various UMs creates a material unfunded position. Furthermore, UMs can create cash flow volatility and dividend volatility for the notional company and the actual company.

We have shown that the relative scale of investment required at ED2 far exceeds that for GD&T2 which implies that the value of real options on anticipatory DNO investment is greater. Real options theory finds that for investments whose payoffs depend on the resolution of uncertainty in the future, investors hold 'real options' to e.g., delay investments and adopt a 'wait and see' approach until uncertainty resolves. This option carries value, in the same way that a call option on a stock has value. The greater the uncertainty, the greater the potential downside risk avoided by waiting and the greater the value of the option.

The same analogy applies investing in innovative new projects now (the equivalent of buying the stock now) compared to investing in the future (equivalent to the option to buy the stock in future). For a rational investor to invest in the electricity network now and give up the call option, an allowed CoE that recognises this option value is required.

The Department of Energy & Climate Change (DECC) has previously awarded a 'novelty premium', based on real options theory, in the context of the implementation of the Contract for Difference ('CfD') regime. This novelty premium increased the return for early CfDs by 25bps.⁶⁰ Ofgem has also considered the impact of real options on investment decision-making in the past, focusing on the bias in the Net Present Value framework which does not take into account real options⁶¹.

Firm value is driven by (1) the value of assets already in place and (2) the present value of options to make future investments⁶². For firms with more significant real options the total value and hence the

⁶⁰ See for example, [Annex H - Modelling Assumptions.pdf \(publishing.service.gov.uk\)](#) and NERA (2013), Changes in Hurdle Rates for Low Carbon Generation Technologies due to the Shift from the UK renewables Obligation to a Contracts for Difference Regime, for DECC

⁶¹ [Real Options and Investment Decision Making | Ofgem](#)

⁶² [Determinants of corporate borrowing, Stewart C. Myers, Journal of Financial Economics, 1977, vol. 5, issue 2, p. 150](#)

beta is greater relative to firms with no or limited real to options. As a result, real options translate into a higher beta from ED2 relative to other energy sectors.

FQ8. What are your views on the relative risk comparison shown in Table 10?

We do not think that Ofgem should use this form of analysis in its risk assessment of the ED sector.

We have considered in more detail in FQ7 and FQ15 why we think there are genuine risk differentials between GD&T and the ED sector that Ofgem should consider in more depth, in particular: the relative scale of Totex to RAV, implications of Net Zero; real options associated with the significant investment required; the balance between ex-ante allowances and uncertainty mechanisms and the associated cashflow and dividend volatility; and the new evidence from Oxera⁶³ showing the overall balance of risks in the ED2 price control is asymmetric.

In our view, Table 10 presents a superficial and highly subjective interpretation of the relative risks of DNOs to other energy networks. Although all appear to be relevant risks to a greater or lesser degree, there is no attempt to consider the relative impact of each. We struggle to see how any assessment on risk can be conducted without any consideration of scale or impact. This represents a fundamental flaw to the analysis, or consideration of granular business drivers of risk.

The unprecedented impact Net Zero is likely to have on Electricity Distribution companies lacks any direct inclusion in the table, despite the tacit reference to “the scale of investment relative to RAV could be larger for DNOs”. This significantly underrepresents the risk that net zero presents to DNOs, and the importance of Net Zero to customers, a risk which should be given far more weight and analysis.

FQ9. Do you have any evidence that suggests the beta for GD&T companies has materially changed since RIIO-GD&T2 Final Determinations in December 2020?

As we have set out in FQ7 and 8 above why we believe there are genuine risk differences between GD&T and ED that Ofgem need to consider in their ED2 assessment of equity beta. In that context we would question the relevance of this question. Ofgem’s starting point for the assessment of beta for ED2 should be a fresh build up, rather than starting from a previous assessment for a different sector.

We also note that the underlying parameters used to set the cost of equity – including beta – should, as far as possible, be estimated in a way that is consistent with the chosen horizon (20Y for Ofgem as per the tenor of the ILGs used for RFR), as otherwise the WACC estimate is not a true expected return over the chosen time horizon. In this context, care is warranted in terms of how short-term market information, particularly in cases of unprecedented volatility and uncertainty given supply chain issues, inflation and rising interest rates following COVID and the Ukraine conflict, is reflected in beta estimates.

⁶³ RIIO-ED2 balance of risks, Oxera, August 2022

FQ10. Do you agree with our interpretation of the cross-check evidence?

There appears to be a material inconsistency between the bar that Ofgem is applying to assess its chosen cross checks (which it, and the CMA, acknowledge have shortcomings⁶⁴) and the evidential bar used to assess the cross-check evidence proposed by companies (i.e. there is a very high hurdle for inclusion if the cross check has been proposed by a company).

Such an approach risks being selective and risks introducing a downward bias in the estimate. To ensure that the approach is balanced, at the very least it is appropriate if the cross-checks proposed by companies – some of which have extensive support in academia – are considered on an equal footing with the cross checks proposed by Ofgem.

The flaws in the cross checks used by Ofgem remain unaddressed limiting the relevance and reliability of this evidence in setting the allowed cost of equity for ED2. Interpretation of cross-check evidence is fraught with uncertainty but Ofgem continues to make selective approaches to their five principal cross-check methods, being:

- MARs
- WACC cross-check
- Investor bids for OFTOs
- Investment managers' forecasts
- Infrastructure funds: discount rates, NAV premiums and implied Internal Rates of Return

Below we discuss further our concerns over each of Ofgem's five cross-checks:

1. MARs

Ofgem maintain that company traded premia to RAV is driven by two factors:

- i. Expected outperformance
- ii. The deviation of required return from allowed returns.

Ofgem's draft determination examines recent MAR transactions and derives conclusions in Table 16 relying on the validity of these assumptions above.

Evidence has previously been provided to caution on the interpretation of cross-checks. Oxera's paper "What explains the equity market valuations of listed water companies? (May 2020) specifically assessed the drivers of equity market valuations for Severn Trent and United Utilities. The analysis concluded that a variety of factors could explain the traded premia including debt overfunding, value from non-regulated businesses, legacy revenue, expected takeover premia, totex outperformance and incentive revenues. The evidence is unclear and cannot be relied on to infer systematic outperformance for the entire sector. As a consequence, Ofgem cannot categorically assume points (i) and (ii) above hold.

Further evidence of other explanatory factors behind MAR premia has been provided by Oxera and Frontier^{65,66}.

⁶⁴ GD&T2 Revised Final Determination Finance Annex, section 3.121, February 2021

⁶⁵ 'Market-to-asset ratios as a cost of equity cross-check', Oxera, August 2022

⁶⁶ 'RIIO-ED2 Cost of Equity Cross-checks', Frontier, August 2022

Oxera's report contends that observed traded premia is symptomatic of long-run "sticky" investor expectations where MAR will remain at current levels without a direct link to outperformance:

*"The premium that investors are prepared to pay is reflective of their long-term expectations about the price at which they will be able to sell the asset. It takes more than one regulatory determination to create a trend that breaks the link between the historical MARs levels and the premium investors pay today. However, once it is broken, the part of the premium that corresponds to this factor could fall sharply as investors revise down their long-term cash flow forecasts."*⁶⁷

Frontier's report considers the appropriateness of Ofgem's MARs assertions from the perspective of market-based valuation metrics. The analysis examines whether regulated company valuations move in line with the market and if they are highly valued compared to the rest of the market. Frontier's conclusions indicate that there is no evidence that the valuation of network companies is out of step with the market in general i.e. that they are uniquely highly valued, and that implicitly there is no reason to adjust equity returns as a consequence.

As set out in our business plan estimates of the cost of equity based on a MAR are forward looking and based on assumptions that are significantly less reliable than the use of historical data.

The detailed information provided in the reports named above have demonstrated significant uncertainty regarding a singular causal link between MARs premia and expected outperformance. A range of plausible conclusions can be drawn which raises significant concerns around the use of MARs to provide an objective cross-check to CAPM outcomes. Given this uncertainty MARs, at best, should only be considered within a wider and more balanced set of cross-checks.

2. WACC cross-check

Ofgem has adopted this cross-check following a UKRN study⁶⁸ that recommended care should be taken in allowing for the impact of leverage when deriving asset beta and in re-gearing for equity beta.

As a result, Ofgem originally turned to market data on two "comparator" companies (UU and Pennon) to cross-check the WACC without "exposure to de-gearing and re-gearing assumptions".⁶⁹ The ED2 analysis has been extended to include five comparators: three water companies and two energy companies, with one of the energy companies (SSE) subsequently excluded for apparently showing a result that was too high.

We do not agree that water companies can be considered as comparator companies. As Oxera have previously noted "the rapid technological change and the investment uncertainties created by an increased focus on decarbonisation suggest that the fundamental risk of energy networks is greater than that faced by water networks."⁷⁰

Ofgem have conducted the above "market" cross-checks as a means to independently cross-check a perceived issue concerning violation of the Modigliani and Miller theory that WACC should be

⁶⁷ 'Market-to-asset ratios as a cost of equity cross-check', Oxera, August 2022

⁶⁸ 'Estimating the cost of capital for implementation of price controls by UK Regulators', Wright, Burns, Mason & Pickford, 2018

⁶⁹ ED2 Draft Determination Finance Annex, Section 3.56, June 2022

⁷⁰ 'The cost of equity for RIIO-ED2', p37, Oxera, June 2021

invariant to gearing levels. Ofgem's original analysis stated: "We find that, given our combined assumptions for risk-free and TMR, common approaches to re-gearing asset betas have the effect of increasing the overall WACC estimate"⁷¹

It has also previously been shown by Oxera⁷² that there are two issues in the market measures used by Ofgem:

- i. The estimate of the cost of debt includes embedded debt; the Modigliani and Miller cross-check should only be used on new debt; and
- ii. Ofgem have set an erroneously low RFR by failing to uplift the spot rate for ILGs to account for the unique characteristics of sovereign bonds and the gap between corporate and sovereign risk-free financing rates

Correcting for both of these issues in the re-gearing of beta goes a substantial way to reinstate accepted finance theory, thereby rendering the need for this cross-check largely unnecessary.

3. Investor bids for OFTOs

Evidence previously presented has highlighted significant concerns with OFTOs as a means of cross-checking allowed returns for regulated DNOs:

- i. OFTO projects are operational assets with a very different risk profile compared to onshore energy networks and little or no ongoing investment requirement due to the age profile of these assets. Any comparison of asset risk is likely to significantly underestimate the cost of capital for a network that undertakes capital and replacement expenditure in addition to operational expenditure. In addition, the debt financing of OFTOs is typically put in place at the commencement of the project with maturity aligned to project length, thereby providing certainty of debt funding costs and little to no risk of equity being asked to subsidise efficient debt underfunding. This is in stark contrast to ENWL's current RIIO2 position where equity is carrying material financeability risk from the systematic under-funding of its efficient debt.
- ii. Ofgem is using OFTO required equity returns as an upper bound comparator for setting the cost of equity. This contradicts the UKRN view that they should represent the lower bound.

Ofgem have acknowledged these risks in the draft determination:

*"We acknowledge that there are risk differences between DNOs and OFTOs. OFTOs are not subject to cyclical price controls (such as RIIO- ED2) that apply to the onshore electricity distribution assets."*⁷³

Ofgem's updated analysis does not address the core issue that the risk profile of OFTOs is significantly different from onshore networks. As a result, it does not imply material improvements in the robustness of the cross check.

⁷¹ GD&T Draft Determinations, Section 3.70, July 2020

⁷² 'Are sovereign yields the risk-free rate for the CAPM?', Oxera, May 2020

⁷³ RIIO-ED2 Draft Determinations – Finance Annex, 29 June 2022, Ofgem, Section 3.71

4. Investment manager forecasts

Ofgem have updated their existing analysis from the same sources drawing similar conclusions to their July 2020 analysis.

Previous Oxera analysis has shown that the TMR forecasts of investment managers have the primary purpose of providing estimates of future returns for clients. These forecasts are produced within an FCA regulated framework to ensure customers are not misled. This framework ensures that there will always be a prudence bias towards the estimates and that deriving meaningful comparison to energy network returns is highly problematic.

Their limited usefulness has been further highlighted by the CMA in the PR19 appeal where the CMA indicate caution should be exercised in interpreting forecasts made by market analysts:

“These estimates may also prove to be no more accurate than our {the CMA’s} own assessment, or may be specifically tailored to particular investors or house views rather than representing the cost of capital demanded by the average or marginal investor in the sector.”⁷⁴

Furthermore, the sample variance between investment managers and across time, and a change to Ofgem’s investment horizon, gives rise to unstable estimates which do not provide for reliable estimates.

5. Infrastructure funds

The methodology to derive the values of this cross-check has not changed relative to GD&T2. An update to existing analysis has concluded no material change between 2019 and 2021. Previous Oxera analysis⁷⁵ revealed a significant weakness in this approach. The asset composition and risk of the diversified portfolios held by the funds cited by Ofgem were shown to differ significantly from those of pure-play energy networks rendering this cross-check unsuitable and unrepresentative of network risk profile and returns.

In conclusion, Ofgem’s current cross-checks are insufficient to provide a balanced check on the CAPM outcomes. It has also been shown on a number of occasions that these cross-checks have significant flaws. We recommend that additional cross-checks are added to Ofgem’s toolkit.

FQ11. Do you agree with our updated MAR and OFTO cross-check techniques, in terms of drawing better inferences for RIIO-ED2?

We remain of the view that significant flaws remain with both cross-check techniques as highlighted in FQ10 above and summarised below:

- Ofgem has failed to provide substantive evidence of the causal link between traded RAV premia, expected outperformance and the deviation of required return from allowed return
- Evidence from Oxera⁷⁶ and Frontier⁷⁷ have shown that MAR premia can be explained by:

⁷⁴ Water Redeterminations 2020: Choosing a point estimate for the Cost of Capital: Working Paper, CMA, Jan 2021, p22

⁷⁵ ‘The cost of equity for RIIO-ED2’, Oxera, June 2021

⁷⁶ ‘Market-to-asset ratios as a cost of equity cross-check’, Oxera, August 2022

⁷⁷ ‘RIIO-ED2 Cost of Equity Cross-checks’, Frontier, August 2022

- Debt overfunding
- Value from non-regulated business
- Legacy revenue
- Expected takeover premia
- Totex outperformance
- Incentive performance
- Stickiness in investor valuation expectations
- Frontier has found no evidence that utility companies are uniquely valued above general market valuations and therefore by implication no reason to assert that this is a consequence of misalignment between expected and allowed equity returns.

FQ12. Do you agree with the cross-checks we have used and are there other cross-checks we should consider?

As covered in FQ10 above, we believe it is critically important for Ofgem to present a balanced cross-check position. All cross-checks are imperfect to a greater or lesser extent. Ofgem's aim should be to capture as many relevant cross-checks as is possible to present a balanced assessment of CAPM outcomes. The current suite does not achieve this. It is missing several checks that have previously been advocated in RIIO2 consultations as well as one new cross-check – the multi-factor model ('MFM'), namely Fama-French five-factor model, which should be considered.

Overall, we believe Ofgem's current suite lacks balance and objectivity, is downwardly biased, and should include the items below:

1. Multi-factor modelling ('MFM')

ENWL, as part of the ENA FWG, have commissioned a review of Multi-factor models by KPMG to ascertain if it is a robust and reliable cross check to setting the Cost of Equity for regulated networks. Multi-factor models are well established in academic research and can be used as an alternative to the CAPM as it is considered to have statistically more explanatory power when explaining returns. It is a complex analysis that requires a range of inputs, quality checks, and reviews for which we have been unable to finalise fully by the end response date. In the spirit of providing new evidence that Ofgem can consider in reaching its Final Determination for RIIO-ED2, we intend to submit this new evidence in sufficient time for it to be considered by Ofgem. At this time, we believe it will be ready towards the end of September 2022 for which it may be highly beneficial for a session to be arranged to explain the review of Multi-factor models with KPMG via the ENA FWG.

2. Differential between the Asset Risk Premium (ARP) and the Debt Risk Premium (DRP)

This check considers the differential between:

- i. the excess return required by investors for investing in risky assets (ARP) and
- ii. the excess return required by investors in return for acquiring risky debt (DRP)

The underlying principle that equity is intrinsically riskier than debt investment and that the cost of equity therefore must be sufficiently higher than debt to reflect this risk premium. This assertion is considered uncontroversial.

The ED2 estimated positive differential is compared to wider market evidence to assess whether allowances and WACC are out of step with empirical evidence.

Evidence presented to date has found that the ED2 differential is too low based on Ofgem's current cost of capital assumptions. In Oxera's August 2022 report "Cost of equity in RIIO-ED2 Draft Determinations" the ARP-DRP differential was calculated for the ED2 DDs at 0.93%, implying a considerable decline since RIIO-ED1. Combined with the evidence set out in its report explaining the sources of parametric uncertainty where Ofgem has erred in the selection of point estimates within the CoE parameters, Oxera finds that this strengthens the conclusion that an upward revision to the allowed CoE is required.

3. Financeability

Ofgem undertakes an "in-the-round" debt financeability analysis and does not treat the results as a binding cross-check on the calibration of cost of equity. Ofgem have stated that "We have previously indicated that "we cannot justify giving investors higher cost of capital allowances to improve a financial metric", and we remain of this view."⁷⁸

We are firmly of the view that financeability is a critical and unique cross-check that should be included in the toolkit. It is important because:

1. it is the only cross check clearly linked to Ofgem's finance duty and
2. considers / reflects:
 - i. the financial position and capital structure;
 - ii. projected cashflows and credit metrics; and
 - iii. financial headroom available for management of risk for the notional company across ED2

As a result, financeability tests can directly assess the impact of the proposed cost of equity and the wider price control package on the financial position of the company and facilitate consistency with Ofgem's financing duty.

Financeability as a cross-check was considered by the CMA in its PR19 Final report. It found that:

"Our analysis of the cost of equity, including the ranges that result from parameter uncertainty, illustrates that the CAPM model could be used to derive a wide range of potential options for the cost of equity.

It is likely that the lower end of this wide range of estimates would ultimately result in ratios which are lower than necessary to support investment-grade credit metrics at the notionally-structured company.

*The overall determination, in the round, needs to include a consideration of whether the WACC assumptions chosen are consistent with the credit rating assumed throughout the determination. We therefore disagree with Ofwat's submission that the need to maintain credit metrics can never be part of the WACC assessment."*⁷⁹

⁷⁸ RIIO-ED2 Draft Determinations – Finance Annex, 29 June 2022, Ofgem, Section 5.25

⁷⁹ Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations: Final report, March 2021, para 9.1387

We agree with the CMA's conclusions on the linkage between financeability analysis and the determination of allowed returns. We expand our commentary on Ofgem's approach to financeability analysis in section 6 where we also illustrate that the notional and actual companies are not financeable under the proposed cost of equity for ED2.

4. Market valuation-based metrics

Frontier has prepared a report for the ENA⁸⁰ that considers alternative cross-checks that could be used by Ofgem in a wider toolkit. They have considered two common market-based valuation ratios:

- i. Dividend growth model
- ii. Long-term profitability

Dividend growth model

The dividend growth model is a well-established forward-looking market-implied discounting methodology used for valuation assessment or to estimate the implied the cost of equity given the market valuation. It is grounded in long established corporate finance principles that values stock at the present value of all its future discounted dividend payments.

DGM is reliant on estimations of dividend growth – a feature that is often highlighted by its detractors. To overcome this issue, Frontier have conducted DGM analysis on five listed companies: Pennon, Severn Trent, UU, NG and SSE that considers a range of potential scenarios for long-term dividend growth set at either no growth, a dividend growth rate or GDP growth. Their conclusions suggest that the DD cost of equity estimates are too low under almost all scenarios and for all companies. In the most conservative scenario considered, which assumes no real dividend growth in the future, the evidence suggests an implied cost of equity of between 4.6%-6.8%, with a mid-point of 5.7%.

This market-based cross-check is an alternative tool to check CAPM outcomes. Its perceived limitations have been overcome by deploying scenario analysis.

Based on Frontier's additional information, it would be unreasonable to exclude it from a cross-check toolkit.

Long-term profitability-based check

Frontier's analysis has also considered evidence on long-term profitability by arguing that Ofgem, by setting the cost of equity allowance, is effectively setting the allowed level of profitability for the regulated business. A valid cross-check would be to compare this allowed equity return with the profitability of comparable businesses or even the market as a whole to see if the steep downward adjustment to equity allowances is matched by similar observable trends in the wider market. The absence of a significant downwards trend in market wide profitability would question the notion that the allowed return should fall.

"Reliance on cross-checks introduces a new form of regulatory discretion into determinations, i.e. how to interpret noisy, volatile and potentially contradictory cross-check evidence. This

⁸⁰ 'RIIO-2 Cost of Equity Cross-checks', Frontier, August 2022

in and of itself would dent investor confidence and make the sector less attractive for investors. This is particularly critical at the current juncture of the UK's decarbonisation journey.”⁸¹

Frontier also performed trend analysis on profitability as a profitability cross-check:

- Analysis compares long-run trend in profitability for the US and UK wider markets and the utility sectors
- The evidence largely shows that profitability has not dramatically trended downwards

Their analysis concludes that “market profitability has not declined with interest rates and benchmark analysis suggests that low end ROE for regulated networks is 6.4%⁸², and recommends that long-term profitability cross checks be considered by Ofgem.

FQ13. Do you consider we should put greater weight on cross-checks or reconsider our CAPM parameters in light of the adjusted cross-check results?

It has been shown in FQ12 above that the current suite of Ofgem cross-checks is insufficient to present a balanced check on the outcome of the CAPM model. Most have questionable arguments with unconvincing theoretical evidence underpinning them. Unsurprisingly, analysis has shown most have a downward bias. Ofgem has acknowledged that its cross checks are not perfect⁸³ so has not directly used the evidence to adjust results from Step 1.

With the concerns outlined above we do not support putting greater weight on these cross-checks or reconsidering CAPM parameters in the event Ofgem’s approach remains unchanged

Unlike Ofgem’s current cross-checks, CAPM is a model that benefits from being grounded in long-established finance theory.

New TMR evidence has been presented to indicate that the overall TMR range should increase (see FQ4). Our expectation is that this should be reflected in an increased cost of equity.

We have argued that a wider toolkit of cross-checks should be adopted by Ofgem to present a more balanced position than those currently used. Were a more balanced position to be adopted, we could support cross-check evidence being used to inform the point estimate for the cost of equity.

FQ14. Do you agree that we should not adjust for expected outperformance when setting baseline allowed returns on equity?

We agree with Ofgem’s ED2 draft determination position to respect the CMA decision in the “RIIO-2 Energy Licence Modification Appeals” issued on the 28 October 2021 that found that GEMA was wrong to impose the outperformance wedge which was poorly justified and targeted.

While removal of the outperformance wedge is welcome, we do have concerns that Ofgem has simply offset this change by significantly increasing the scope and likelihood of incentive penalties and totex under-funding. We do not believe this counter-step was required or appropriate, and in doing so,

⁸¹ ‘RIIO-2 Cost of Equity Cross-checks’, Frontier, August 2022

⁸² ‘RIIO-2 Cost of Equity Cross-checks’, Frontier, August 2022

⁸³ RIIO-ED2 Draft Determinations – Finance Annex, 29 June 2022, Ofgem, Section 3.84

Ofgem has significantly increased the risk in the sector, while also reducing incentives to a level that may no longer justify investment, to the ultimate detriment of customers.

FQ15. Do you believe there is new evidence which would support an adjustment downwards (e.g. expected outperformance) or upwards (e.g. aiming up) that we have not yet considered?

Several issues are relevant when selecting the point estimate for the cost of equity. In line with the approach applied by the CMA at PR19, these include investment incentives in light of parameter uncertainty, financeability, and asymmetric risk.

A particular assumption of the CAPM is that the distribution of expected cashflows is symmetric. Where this assumption does not hold, the un-adjusted cost of equity based on CAPM would not provide a 'fair bet' to investors, as, on average, the required returns would not be achieved.

The proposed calibration of the ED2 price control – across a number of regulatory mechanisms set out in the DD – provides new evidence relevant to the selection of the point estimate for cost of equity at ED2 and whether aiming up is required for asymmetry.

ENA have commissioned new analysis from Oxera⁸⁴ (provided alongside this response) that considers the overall risk associated within the ED2 framework to see if it is balanced for both customers and investors or whether it exhibits asymmetry. This shows that there is a reasonable likelihood of a loss in expectation for investors and/or more scope for downside than upside. Oxera's risk assessment for each of the component parts of the ED2 package finds that a greater risk burden now falls on investors. They conclude that "Given that our assessment shows a number of sources of risk asymmetry, and to the extent that this asymmetry cannot be addressed at source, we consider aiming up on the allowed return on equity to be required to restore the balance in the price control risks"

Many of the components of the proposed package imply asymmetric exposure for companies individually and in combination. Highlighted below are some of these key risk areas:

- Totex allowance: In addition to totex allowance cuts as well as a significant shift from ex-ante funding to uncertainty mechanism funding, Ofgem have raised the efficiency benchmark to the 85th percentile (from the 75th percentile at ED1). Together with the unprecedented ongoing efficiency assumption set at 1.2% (more challenging than GD&T2), and a novel (compared to both ED1 and GD&T2) demand-driven post-modelling adjustment for ED2 equivalent to a 3% reduction in Totex for the sector⁸⁵, this presents ever greater challenges and the risk that actual costs may well be underfunded. This in turn leads to questions over the financial viability of important capital investment projects. It is concerning, and unprecedented, that Ofgem's own disaggregated totex approach shows every DNO to be inefficient⁸⁶ which has the effect of setting the efficiency benchmark beyond the frontier.
- ODIs: The structure of the RIIO-2 ODIs suggests that companies are more likely to underperform than out-perform. Of the seven common ODI's four are symmetric and three are asymmetric and skewed to the downside. Material drivers include the Interruptions Incentive Scheme (IIS) and Major Connections. Consumer Vulnerability and DSO Incentives are symmetric but subject to ex post assessment and are likely to involve the application of regulatory discretion and potentially judgement with benefit of hindsight. The overall balance of rewards and penalties is thus skewed downwards, as the maximum allowed penalty (-4.0% of RoRE) is 2.05% of RoRE greater than the maximum allowed reward (+1.95% of RoRE).

⁸⁴ RIIO-ED2 balance of risks, Executive Summary, Oxera, August 2022

⁸⁵ ED2 DDs core document, pg. 222

⁸⁶ Ofgem (2022), 'CostAssessment_File.xlsx', tab 'Cal_Efficiency', rows 545–564

- Network Asset Risk: The NARM model is a penalty only mechanism where Ofgem can apply ex-post adjustments for under-delivery on outputs. Companies will either bear the risk of under-delivery on outputs and thus incur a penalty, or potentially over spend on costs to ensure outputs are delivered. No compensation is provided for over-delivery.
- Cost of debt: Materially lower headroom is implied by the calibration of the cost of debt allowance for ED2, despite the structurally higher cost of debt for the sector compared to GD&T. For an infrequent issuer, efficient costs are not provided for either (1) in terms of the quantum of the adjustment or (2) in terms of the infrequent issuers to which the adjustment is applied – all else being equal this means that there is an expected structural underfunding for infrequent issuers in relation to debt costs.
- Cost of equity: Material reduction in returns have been made from RIIO-1 arising from (1) market movements; and (2) downside-only methodological changes to CoE estimation. Ofgem has not aimed up based on its bottom-up estimate of CoE based on CAPM, at a time when investment demands are more unpredictable yet more important for customers and the delivery of Net Zero.
- Uncertainty Mechanisms: The DDs include no fewer than 34 different UMs, creating significant burden on companies to seek funding throughout the price control. Many of these mechanisms would require the companies to have incurred some costs before seeking additional allowances. Furthermore, some mechanisms would apply an ex-post challenge to the costs incurred for example the annual review and clawback of unjustified spend for the secondary reinforcement volume driver. It should also be noted that Ofgem does not have a good track record on awarding allowances for ED1 re-opener mechanisms, a risk that is accentuated when it can only be triggered by Ofgem. Oxera's⁸⁷ analysis shows that, of the £322m applied for in ED1, only £56m was awarded.

The resulting structure of the regulatory framework heavily constrains outperformance, which – in combination with the findings of GD&T2 appeals – clearly indicates that a downwards adjustment would not be appropriate. In fact, there is a strong case for an upward adjustment, given the implied shortfall below the market CoE that investors expect to earn due to the significant implied asymmetry.

The degree of implied asymmetry in the proposed ED2 package supports the requirement to aim up from the mid-point of the CoE range to compensate investors for the expected loss. There is a strong precedent in telecoms (BT), the SONI CMA appeal and PR19 CMA appeals to price in or address asymmetry in regulatory design to maintain the 'fair bet' principle.

Ofgem has not undertaken analysis to assess the degree of asymmetry or indeed why specific remuneration is not warranted. This means that there is a real risk that the ED2 package will not be a fair bet or otherwise sufficiently attractive for investors. All else equal, this would create further challenges for equity which Ofgem expects to provide significant capital in the short-term whilst not having reasonable prospects of earning required returns.

Aiming up is further warranted to minimise the potential harm to consumers as a result of future underinvestment, or the risk of misaligned incentives in respect of existing investment, due to inadvertently setting an allowed return on equity that is too low given that the parameters are subject to both theoretical debate and statistical uncertainty.

⁸⁷ RIIO-ED2 balance of risks, Table 2.4, Oxera, August 2022

3 Inflation and WACC consultation questions

FQ16. Do you think we should adjust our approach to allowed returns (noting our approach to expected inflation for WACC and outturn inflation for RAV as described above) 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?

Variations in inflation outturn on debt costs reflect a variation beyond the control of the network, although the risk allocation has been very clear since privatisation (both positive and negative). Whilst the impact of this on the network can be mitigated, through the use of index linked debt/proxy debt/derivatives (and has been very significantly by ENWL), this only mitigates the impact on returns to investors rather than the cost to consumers.

We agree that Ofgem should be concerned about the legitimacy of returns to investors and, for this reason, urged Ofgem during ED1 to publish the licensees' full RoRE, i.e. including post financing and tax returns (of which outturn inflation plays a part). We were pleased that Ofgem moved to provide this transparency to stakeholders, as we believe that returns to investors should only arise from incentives and other outperformances, including the result of efficiencies. We continue to stress that luck should not play a part in returns, and highlight that there are other factors such as timing of issuance on debt costs which are also beyond the control of licensees

In the same way that equity should not receive less allowance than its efficiently incurred debt costs, we continue to question the legitimacy of licensees charging customers for more than the efficiently incurred cost of debt in over the long term.

Therefore, we do not think it is appropriate for Ofgem to adjust its approach to allowed returns to remove alone the outturn inflation impact on debt from real equity returns. It is important to consider the interplay between the timing of debt issuances and prevalent interest rates, that also generate real equity returns that are materially higher (or lower) than Ofgem's cost of equity allowance.

Inflation is only one factor on investor returns that is beyond the control of investors, the other very significant such factor being the market interest rates at times of issuance (either past or future) which are referred to in our section on cost of debt allowance, and particularly point in time risk for a small, infrequent issuer like ENWL. We note that the outturn inflation element affected our overall underfunding of debt costs in ED1: increasing the underfunding during periods of low inflation and reducing the underfunding at the end of ED1 with an offsetting period of high inflation.

We would be fundamentally opposed to any approach that tackled inflation outturn. We note the report commissioned by the ENA regarding inflation.⁸⁸ The issues would be exacerbated if any such change worsened debt underfunding either arising from the failure to adjust the notional company properly to the actual circumstances of the actual company, or from the failure to adjust or at least reduce the impact on the networks of the accident of timing of issuance.

⁸⁸ 'Inverse Inflation Exposure', Frontier, August 2022

FQ17. If you believe we should make such an adjustment, what is the best method for making it?

We do not believe that such a fundamental change to the treatment of inflation should be made through the manner proposed, i.e. through an 8-week DD consultation. The method of making any such adjustment should be widely consulted upon, based upon a range of proposals from the regulator, that have the chance to be properly assessed, both by Ofgem's advisers, those from other regulators, and by all the affected UK regulated entities.

Given that there are no proposals, there is insufficient time to consider the complexities involved for RIIO-ED2 of a standalone adjustment. For this reason, any review of the approach should be to inform potential changes across all sectors from RIIO-3, at the earliest, onwards and not before.

We note that should any adjustment be proposed it should be fair, and take into account the actual company circumstances, rather than a sector average approach to the notional company. The existing inflation linked debt and derivative/ index linked proxy debt positions, have been put in place by the actual companies based upon the long term regulatory approach to inflation, and are not changeable without very significant cost and time. The actual company positions need to be factored into any outturn inflation adjustment, whether this is through a reflection of the actual company circumstances into the notional company or otherwise, as these positions unwind over multiple price control periods.

This concern is echoed as a result of Ofgem's approach to embedded basis risk in the ED2 DD proposals, which adjusts for RPI/CPIH basis risk based upon sector average index linked positions, rather than the actual company basis risk, thus under compensating those with higher embedded inflation hedging and over compensating those with lower inflation hedging.

We note that, while Ofgem has not set out detailed proposals, nothing has been written to suggest Ofgem also intends to address any of the other issues and treatments within the price control that leave networks exposed to other risks associated with inflation, or indeed interest rates. These risks include:

- The RPI-CPIH wedge assumed in the cost of debt allowance may differ from the actual RPI-CPIH wedge. Most index linked debt is linked to RPI rather than CPIH. As of May 2022, RPI inflation was 11.7% and CPIH inflation was 7.9% giving a wedge of 3.8%. The wedge assumed by Ofgem is of the order of 300 bps or so lower. This shortfall on the cost of debt allowance partially offsets the leverage effect and, for companies with a high proportion of index linked debt, could cause significant losses to equity investors, resulting from circumstances beyond their control, in the context of regulatory change.
- Ofgem uses forecasts of CPI as a proxy for CPIH but CPI and CPIH can be, and are currently, very different. A report from Frontier Economics shows that the gap between CPI and CPIH has grown markedly in recent years. As mentioned in FQ1, Ofgem's own modelling of the cost of debt index shows that Ofgem expect debt underperformance of 2bps but that this deteriorates by a further 11 bps for a 1% increase in inflation.

FQ18. 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?

We do not believe such an adjustment should be made in respect of inflation for the reasons set out in FQ16 above, particularly through such a consultation process.

We agree with the concept of the question that it is potentially unfair to both investors and consumers when [actual] ex post returns deviate (we would add materially) from ex ante expectations. This applies whether the deviation is caused by a number of factors including basis risks, the interplay between the timing of debt issuance and market rates or other circumstances beyond the control of investors, and inflation.

This concept ties into the comments that we have made in the Cost of Debt allowance section of the business plan that investors should always be able to invest, confident in the knowledge that, provided they are efficient, they will recover their debt costs. Ofgem is recognising with this discussion on inflation, that it is equally unfair to consumers when investors recover more than the efficiently incurred debt cost (in this case as a result of inflation returns being higher than required). The current debt funding policy, of which inflation outturn forms but a part, needs to be looked at in the round.

In respect of our debt underfunding in ED1, this has been slightly mitigated by higher inflation at the end of the period (although worsened by lower inflation during parts of the period). We would be opposed to any adjustment to the debt allowance mechanism that adjusted for one set of beyond-investor/consumer-control circumstances (i.e. inflation) without considering all other similar circumstances, particularly when the outcome of such a change would be to worsen financeability. We note the interplay between inflation rates and market interest rates over time in this regard.

4 Financeability questions

FQ19. Do you agree with our approach to assessing financeability?

Overview

As set out in our final business plan submission in December 2021, we concluded that the plan was not financeable based on Ofgem's working assumptions for the cost of capital.

Using the Draft Determination assumptions, we have not changed our conclusions. Indeed, reflecting the increased financing rates now forecast, we anticipate that under-funding on our efficiently incurred debt costs in ED2 for the actual company has increased from approximately £90m-£95m to approximately £120-£125m⁸⁹

Nominal, £m	FY24	FY25	FY26	FY27	FY28	Total	Average
Debt allowance	68.0	64.4	69.5	71.7	73.3	346.9	69.4
Forecast debt cost	99.5	86.6	100.7	89.7	94.9	471.3	94.3
Under-funding	(31.5)	(22.2)	(31.2)	(18.0)	(21.5)	(124.5)	(24.9)
Allowance rate (%)	4.68 %	4.22 %	4.30 %	4.19 %	4.05 %		4.29 %
Finance cost (%)	6.85 %	5.67 %	6.23 %	5.24 %	5.24 %		5.85 %
Under-funding (%)	(2.17) %	(1.45) %	(1.93) %	(1.05) %	(1.19) %		(1.56) %

⁸⁹ Based on Draft Determination totex allowances, adjusted to reflect proposed overall effective capitalisation rate of 68%, and based upon the inflation and interest rate assumptions provided by Ofgem.

We provided extensive analysis in our Final Business Plan submission to support our financeability conclusions. [REDACTED]

[REDACTED]

[REDACTED]	[REDACTED]		[REDACTED]	
	[REDACTED]		[REDACTED]	
	[REDACTED]		[REDACTED]	
[REDACTED]	[REDACTED]		[REDACTED]	
[REDACTED]	[REDACTED]		[REDACTED]	
[REDACTED]	[REDACTED]		[REDACTED]	
[REDACTED]	[REDACTED]		[REDACTED]	
[REDACTED]	[REDACTED]		[REDACTED]	
[REDACTED]	[REDACTED]		[REDACTED]	

[REDACTED]

There has also been no change in our conclusions with regard to equity financeability - allowed equity return levels have been set at mid-point (rather than at 75% as we recommended), with equity still being asked to subsidise efficiently incurred debt costs, reducing confidence in our ability to raise equity finance when required in ED2.

1. Ofgem's Draft Determination cannot be deemed financeable if a regulated company with either the notional or actual financial structure is unable to raise capital at the equity rates allowed by the regulator

- The regulatory determination must set the allowed rates of return on debt and equity that allows the company to raise and remunerate capital at market cost.
- Ofgem's financeability analysis of ENWL based on its assumed notional financial structure implies a 'financeability constraint' as even the notional company cannot achieve the target investment grade (BBB+/Baa1).
- ENWL notional company (without adjustment) is not rateable Baa1 (projected AICR is below Moody's published minimum threshold of 1.4x for Baa1). The finances of the notional company should be rateable based upon the ratings agencies published metrics at comfortable Baa1 (AICR at least 1.5x on an expected basis).
- For the purpose of the financeability test, the financial parameters used to determine the allowed return (WACC) — specifically, the cost of debt and the cost of equity, as well as the parameters that determine them — must be set at a level consistent with the assumed notional capital structure and take into account the characteristics of the notional company. This means that, for example, the assumed credit rating used to set the allowed cost of debt must be consistent with the credit rating implied by the projected financial position of the company with this allowed level of return under the notional financial structure.
- Given the fact that the set of assumptions about the 'notional company' must be reasonable and achievable, it is important that this notional approach has some regard for the actual financing challenges faced by the regulated company, and its actual circumstances in

⁹⁰ 'Assessment of ENWL risk exposure at ED2', KPMG, November 2021

particular. The assumed notional financial structure must be realistic and achievable in practice and, therefore, must be relevant to the regulated company, rather than relevant only to a theoretical sector average licensee.

- In this context the assumptions about the notional company underlying the DD and hence the allowed return set for ENWL are not appropriate. In particular, they do not reflect that ENWL is a small, infrequent issuer and has inherently higher costs of and risks associated with financing, compared to all others in the sector:
 - **Higher costs.** As a result of being a small infrequent issuer, that is not able to access the benefits of being part of a group of licensees, ENWL will inevitably have a higher cost of debt in real life than the notional company, yet will receive an allowance that does not reflect these circumstances.
 - **Higher risk exposure arising from infrequent issuance.** A notional company like ENWL – which issues debt infrequently – needs to have financial headroom or buffer equivalent to manage its risk differential relative to a frequent issuer. This could be defined as the risk differentials between P50 and P10 levels for a frequent and infrequent issuer. This could be on a notional company basis reflecting stochastic modelling of different scenarios. It is common practice to consider risk exposure at the P10/P90 levels as this reflects plausible but severe level of exposure).
- A notional company which issues debt infrequently needs to be able to expect to achieve the target rating Baa1/BBB+ notwithstanding risk differentials to a frequent issuer and any additional costs. This should be reflected in the DD financeability assessment which needs to consider whether returns are set such that the notional infrequent issuer can achieve Baa1 under a range of cost of debt performance scenarios which reflect risk and cost differentials for an infrequent issuer (risk differentials between P50 and P10 levels for a frequent and infrequent issuer).
- ENWL cannot achieve the Baa1/BBB+ target rating based on rating agency methodologies with Ofgem's notional capital structure and financial assumptions. This problem is exacerbated for an infrequent issuer like ENWL as there is no or negative headroom to the target credit rating. ENWL as a notional infrequent issuer is not financeable as (1) it has no headroom to manage risk differentials relative to a frequent issuer at the target rating (2) Ofgem has not classified ENWL as an infrequent issuer in error and therefore not provided for efficient costs – these unfunded financing costs exert additional pressure on projected metrics and ratings.
- As a result, it cannot be assumed that such an efficiently run company with a notional financial structure will be able to raise debt at the rates assumed in the draft determination. This company will incur higher costs of financing than assumed by Ofgem in its benchmark and have less headroom to manage business and financial risks.
- This could be remedied by an additional return for infrequent issuers (higher WACC) that offsets the higher debt costs at P50. This could be in the form of a higher equity return to price in risk differentials and/or a cost of debt sharing factor to attenuate risk exposure.
- Adjusting projected financing costs to take into account the cost of efficiently incurred embedded debt under the actual financial structure results in a further deterioration in credit metrics, which implies that the actual company is not able to remunerate its debt capital at the rate allowed by Ofgem.
- This means that the company is not financeable based on projected credit metrics under either the notional or actual financial structures.
- We find that ENWL is not financeable under the notional capital structure notwithstanding that Ofgem has made a number of changes to the notional company post ED1 including a reduction in notional gearing, increase in the proportion of index linked debt, full transition to CPIH.

2. Ofgem's Draft Determination is not financeable if the company is not resilient to plausible downside shocks, when exposure to downside risks is not consistent with financial headroom implied by the regulatory determination

- Financial distress can be defined as a range of events where the company cannot access financial resources to meet its obligations, the company is no longer viable from a financial perspective, or the company faces financeability challenges, where it can still access financing, but this access may be limited and increasingly costly, impacting delivery or posing future financeability concerns.
- Ofgem has a duty to have proper regard to the need of a regulated company to be able to secure the finance to meet its obligations. The regulatory determination therefore needs to ensure that the regulated company, acting efficiently, is able to ensure financial resilience.
- The financial resilience of a company can be tested under specific risk scenarios and based on the assumptions about the regulatory regime.
- The company is exposed to material risks over ED2, which can be translated into a set of realistic, potential risk scenarios that could lead to financial difficulty or distress.
- Plausible, realistic downside scenarios would lead to financial difficulty and/or financial distress for ENWL under the notional financial structure given the level of financial headroom available based on the DD. The scale of risk exposure for an infrequent issuer is higher than assumed by Ofgem – as the variance to the allowance on cost of debt can be c.100bps higher than for a frequent issuer.
- Ofgem considers 100bps-200bps to represent a plausible range of downside scenarios to test. This range needs to be c.100bps higher for an infrequent issuer to reflect the risk differentials.
- There is therefore a material inconsistency between the company's exposure to downside risks and the financial headroom available to the company under the DD, which means that the company is not financeable.

Ofgem's consultation positions

As set out in our final business plan submission and expanded on further below, we do not agree with Ofgem's approach to assessing financeability. We believe there are fundamental issues both with its overall consultation positions and also with how the financeability checks have been conducted.

In respect of Ofgem's two Draft Determination consultation positions, we highlight the following issues:

- **Financeability check.** Ofgem's approach is to consider whether all networks are financeable on the basis of the notional capital structure, taking account of the proposed allowed costs, cost recovery and allowed returns in these Draft Determinations.

We agree this is a sensible starting point for the financeability check, but we do not believe it is in the long-term interests of customers to restrict the check to this analysis only. Importantly, we believe Ofgem must extend the check to include the following:

- **Scenario analysis:** Ofgem must consider whether the settlement is sufficient to ensure financeability of networks in a range of plausible macro-economic environments – including reasonable changes to both interest rates and inflation. The inadequacy of the +/- 1% interest rate and inflation scenarios is laid bare when considered against movements witnessed in both these measures over the last 12 months. We believe that Ofgem needs to both include scenarios with more acute movements in interest rates and inflation; and consider reasonable combination scenarios, including operational

performance. It is critical that the allowed return is consistent with risk exposure implied by the ED2 framework.

- **Actual company cross-check:** Ofgem must also consider the financeability positions of networks using actual financing costs, excluding any costs found to be inefficient, and actual capital structures. This step is necessary for Ofgem to confirm that its policy and approach to setting cost of capital remains appropriate for notionally geared, efficient networks in the current economic climate. In essence, where a licensee is forecasting, on an actual basis rather than a notional basis, any risk of a financeability issue, Ofgem should check to ensure that this is solely as a result of proven inefficiency on the part of the individual licensee. The financeability of the networks is a matter of significant impact to customers' interests, and it therefore should be assessed on the actual company. To define the sector average cost as "efficient" in terms of application of any individual licensee, is intellectually weak. Ofgem should investigate whether the circumstances of the individual licensee are different from the sector average, including concluding whether the timing of debt issuance, rather than any true inefficiency, is to blame.
- **Notional Gearing.** Ofgem is proposing a notional gearing level at 60% for networks in RIIO-ED2. We do not believe that Ofgem has, so far, provided sufficient positive justification for this change, including evidence to support that a lower gearing level better reflects the optimal capital structure for networks and is in the long-term interest of customers. We are concerned that the networks have been asked to show then that this move is not in consumers' interest, with Ofgem concluding that there is insufficient proof that it was wrong, in effect providing a differential evidential standard to that applied to the initial proposal.

This is an example of the shifting evidential bar – Ofgem can impose or propose changes to the regulatory framework with minimal justification, requiring networks to prove it is wrong. Recommendations for change by the networks are often submitted with evidence and justification, yet Ofgem simply declares that it is not convinced, or, if it is different from GD&T2, requiring that a higher evidential bar is required. We believe that the lower notional gearing target has been proposed by Ofgem in order to deliver an improved AICR, as it was clear that under a 65% gearing assumption the proposed equity return could at best deliver a Baa2/BBB rating for the notional companies at ED. This is not the correct way to create policy.

As a result, we do not feel that the Draft Determination financeability assessment delivers what is required - a fair and objective 'checks and balances' test that the ED2 cost of capital proposals will allow the sector to attract and retain the equity and debt financing it needs over the five-year price control, without detriment to customers over the longer-term. We expand on these concerns in the section below.

Specific concerns on the financeability checks included in the Draft Determinations

In respect of how the financeability checks have been conducted for the Draft Determinations, we raise the following observations and concerns:

- **Rating simulator.** We raised significant concerns with Ofgem's Rating simulator as part of our Business Plan submission. These do not appear to have been addressed. In particular, we believe that Ofgem has incorrectly applied the Moody's rating methodology and as a result, formed incorrect conclusions. This is evident in Table 20, where Ofgem has stated ENWL AICR at 1.30x but has then concluded this AICR is commensurate with a credit rating of Baa1/BBB+. This finding is in direct contradiction with how Moody's states that it applies its rating methodology in practice (which attaches significant weight to AICR as a core metric – where this metric is below threshold it overrides ratings implied by the rating scorecard) and has not

been properly justified other than through an opinion by Ofgem that Moody's have underestimated the benefit of the regulatory environment.

As outlined in 5.23, Ofgem considers that it is conducted an 'in-the-round' assessment and that it has not considered it a hard requirement to always meet guidance levels, "*recognising the discretion that rating agencies have in applying those levels to their eventual ratings*".

We believe that Ofgem's conclusion that a company with a 1.30x **average** AICR ratio **over 5 years** would still be rated Baa1/BBB+ by Moody's is an error. While qualitative aspects are inputs into the Moody's methodology, they act to inform the threshold levels for each credit metric (i.e. used by Moody's to arrive at 1.40x for Baa1). They do not act as anchors, allowing networks to fall under thresholds **for an extended period without mitigating factors** with no rating impact. Given that Ofgem is pitching the WACC at a level to generate the minimum AICR of 1.40x to maintain a Baa1/BBB+ rating, we would strongly advise Ofgem to engage with the ratings agencies to ensure that the ratings agencies endorse any Ofgem findings that contradict the agencies' public guidance for the sector.

As this is such an important component of the financeability check, we are strongly of the opinion that it is in customers' interests for Ofgem, and indeed any regulator, to request the Credit Rating Agencies to provide formal implied rating guidance for the notional companies under baseline, high totex and plausible stress scenarios, more so when Ofgem is contradicting the agencies' own guidance.

- **Long-term financeability.** We consider that Ofgem's long-term financeability assessment is cursory, with severe limitations, not least that it relates to a different sector. It completely fails to address the importance of the need for networks to maintain their financeability over the long term. We are particularly concerned that the long-term analysis in the DD is not that of the ED sector, but of a completely different sector (GD&T) with the conclusions being presented as if they were based upon the ED sector. This approach reflects to too great an extent a short term thinking approach to financeability of networks where investment is based upon a very long-term return of capital:
 - Lacks depth – The discussion of longer-term trends in financeability is restricted to three paragraphs in the consultation document, focused on AICR only, for a different sector.
 - Narrow focus – no apparent evaluation of other important metrics over the longer-term, including FFO/net debt, which would show significant pressure for the sector in ED3. This has a direct read across into the ability of the licensees to raise finance during ED2, particularly to support debt issuances towards the end of ED2 when ED3 trends become important to the ratings agencies.
 - Simplistic analysis – Ofgem's evaluation of AICR shows an improving trend not only for the baseline position, but also in the scenarios where implied rates go up as well as those where rates go down. We do not understand how this analysis can be credible, and appears to reflect an intellectually weak approach to the analysis.
 - Inter-generational fairness – There appears to be little consideration given to the potential impact of a failure to deliver financeability for the sector, particularly the impact of failure on future customers. We believe this provides useful context for the regulator that should frame the approach and rigour adopted across the financeability assessment

- **Actual company financing costs and capital structures.** Ofgem notes *“We have considered actual company debt positions and structures to inform the notional structure. However, consistent with our RIIO-ED2 SSMD and our Final Determinations for RIIO-GD&T2, we treat actual company financing decisions as matters for companies themselves.”* (5.10)

Ofgem’s assertion that financing decisions are matters for companies themselves only is incorrect and a fundamental disregard of the financing duty in the Act. There are numerous examples of how the regulatory price control restricts company financial policy, not least in the gearing threshold trigger test for the calculation of the tax clawback.

It is not appropriate for Ofgem to simply set policy and tests only around the sector average position without further consideration of how well this policy fits the wider sector, or includes the relevant characteristics of individual networks, or how the average compares to actual, efficient costs.

ENWL is an efficient, notionally geared network. The fact that we are reporting a significant under-funding position on debt should be the ‘canary in the coal-mine’ for a regulator to consider whether its policy remains appropriate.

- **Rating headroom.** We believe that Ofgem has calibrated the whole financing package to deliver an **average** notional company AICR very close to 1.40x, under the baseline assumptions, believing that is the threshold required to deliver a Baa1 rating from Moody’s (<1.40x = Baa2). This has been delivered through a reduction in the notional gearing level to 60%.

Taking into account the sector average approach and Ofgem’s disregard of actual financing and capital structures, this would likely lead to a range of actual ratings in the sector which, by design, and as a minimum, would be across the rating bands either side of the threshold, being Baa2 and Baa1.

This conclusion is present under the baseline assumptions, and Ofgem has acknowledged that positions will deteriorate by ~1 notch in a high-totex environment (Table 20 of Draft Determination).

As such, ignoring any movement in interest rates, inflation or operational performance, Ofgem is implicitly accepting that the sector would likely be rated across Baa3/Baa2 under a high totex scenario – i.e. requiring half the sector to submit financial resilience reports to the regulator.

We note that in 5.55 and 5.56, Ofgem references Moody’s rating migration statistics to show a 1-in-16 chance for a Baa rated entity to move to sub-investment grade in 5-years. This appears to suggest that Ofgem is comfortable with calibrating the financeability check such that it would be comfortable with 1 of 14 DNOs moving to sub-investment grade, and thereby losing its licence to operate, **each and every price control period**.

We believe this is a serious mis-calibration by Ofgem that cannot be in the best interests of customers. We contend that this level of risk is not priced into current betas of public utility companies and that if this were to be so reflected, then it would result in higher equity returns and higher bills for customers.

- **Equity.** The focus for Ofgem’s financeability check is on debt, and specifically credit ratings. We believe it is critical that financeability is also considered fully from an equity perspective. We accept that the cross-checks performed when setting cost of equity (notwithstanding our concerns noted later in this response) should provide some assurance that returns are theoretically sufficient to attract and retain equity for the notional company under the base scenario. However theoretical returns are not the only characteristic that is important for

investment decisions. We believe the following components should be evaluated for equity financeability, including:

- Change in returns between periods. A change in the level of returns (or dividends) available in the sector between price controls will undoubtedly lead to investors re-evaluating portfolios and prioritising the direction of new funds. It should be recognised that the large reduction in equity returns as proposed in ED2 and driven by methodological changes, carries a greater risk to financeability than gradual changes.
- Change in risk between periods. As with returns, large changes in risk will also carry a greater risk to financeability. We believe that ED2 carries a substantially greater potential for variability in returns (and dividends) than ED1, which is a core measure of investment risk, despite the additional uncertainty mechanisms introduced. This is underpinned by the de-powered and asymmetric incentive opportunities, together with challenging efficiency benchmarks for cost efficiencies. The implied asymmetry and unfunded debt costs suggest that equity cannot reasonably expect to earn the allowed return, and hence the DD is not financeable from an equity perspective.

This lack of risk analysis can be juxtaposed with Ofwat concerns regarding financial resilience, the recent collapse of the energy supplier market, and the requirement for financial resilience plans to be produced by licensees if their ratings reach Baa2 negative outlook.

- Dividends and cash. As the sector leads on the transition to net-zero, there is a step change in the level of investment required. There is potential for this to increase significantly above the ex-ante baseline position through uncertainty mechanisms relating to Net Zero and Access SCR changes. The resulting RAV growth will require significant investment from equity, thereby changing the investment proposition from a stable dividend paying utility, to a capital growth investment. In itself, this represents a further material change for ED2 compared to previous price controls and other utilities.

This dynamic has been compounded by other facets of the ED2 price control including the change in notional gearing to 60%, significant under-funding of debt for some companies (including ENWL) and regulatory capitalisation rates for uncertainty mechanisms at close to 100%.

- **Notional company construct, including gearing.** As noted above, we do not believe the move to 60% gearing has been appropriately justified by Ofgem and we have serious concerns over this change. To expand further:
 - Logical sequencing: it is not right to reverse the logical sequencing of the financeability analysis and to use reduced notional gearing to justify proposed WACC (and the rest of the ED2 package).
 - Signalling: where financeability analysis using the 65% notional gearing assumption indicates problems, this suggests that the equity returns and cash flows are too low and not commensurate with business risk, and signals the wider deterioration in financeability across the sector.
 - Shift to equity risk: assuming a lower notional gearing cannot improve a company's overall financial position with the same level of business risk—it simply shifts risk exposure from debt to equity and this should be considered and compensated.

- Practical concerns: Financeability cannot be contingent on changes in notional gearing. Changes in capital structures take time to implement and are not achievable overnight.
- **Dividend yields.** Ofgem states *“We have used a notional dividend yield of 3.0% ... and assessed the implied dividend cover ratios in financeability modelling. We consider the dividend yields and cover ratios to be adequate, in line with our views on allowed equity returns”* (5.8).

As per our final Business Plan submission, the ENWL actual company model did not forecast any dividends in ED2 post actual efficient debt costs, but still showed rising gearing levels. Equity injections were needed to maintain gearing at the revised notional level. Ofgem has disregarded the ability of networks to pay dividends in ED2, instead focusing only on the notional company. However, the notional company can only pay a notional dividend yield of 2% in the Final Business Plan submission, out of line with Ofgem's implied dividend cover ratio, even before the impact of any uncertainty mechanisms are taken into account.

- **Financeable in all circumstances.** Ofgem outlines that *“we do not believe we are required to ensure that actual licensees are financeable in any and all circumstances (whatever risks they have taken or however inefficient they may be)”* (5.11).

We agree with this position and it could not be in the interests of customers for this assertion to be true. While so, the converse is also not true – that the regulator can disregard financeability concerns being raised by companies without ensuring that these concerns are solely the result of inefficiencies.

- **BBB+ Target.** We agree with Ofgem's conclusion that *“we are comfortable with the BBB+/Baa1 credit rating target adopted by most networks.”* (5.18), but believe that all networks should have the same chance of achieving this rating, both at notional company, and at actual company levels (noting always the need to be efficient).

FQ20. Do you have any evidence that would enable us to improve our calibration of stress test scenarios?

Stress tests need to be significantly more robust

We believe that, given the importance of the ability of the networks to deliver the investment required to support net zero, we believe that more robust stress testing was required both in the context of ED2 financeability and also to ensure that the policies adopted for ED2 did not create problems for networks or stakeholders over future price control periods.

The sector is entering a period of potentially rapidly rising interest rates, high inflation and a consequential higher requirement for equity and debt investment returns, making the necessity of longer term thinking and what-if / risk management scenarios more important.

Modelling also needs to take into account high investment scenarios, to ensure that the networks are financeable at the point that they will most need it. This assessment should also take into account the risk of significant economic dislocation, given the importance of the interests of customers in ensuring that the networks continue to be able to invest to meet a fixed net zero timetable. Rate reversion scenarios of 3 or more percentage points are plausible outcomes, given inflation of over 10%, as are scenarios where interest rates spike and then fall quickly again. All should be considered.

For ED2, Ofgem should model the impact of a spike of interest rates followed by a decline of rates, on the networks. The risk of under funding of future issuances is key in this regard. As Ofgem stressed on the establishment of RIIO, the confidence of equity to invest, confident in the knowledge that

efficiently incurred debt costs will be funded, remains as important as ever to the long-term interests of consumers⁹¹. The proposed policy does not instil this confidence at the point that this policy actually matters, i.e. for the individual company, rather than the notional company, as this is the point that real equity investment takes place.

Ofgem has highlighted how its proposed ED2 approach to cost of capital and financeability checks is consistent with past price controls. To maintain this approach, it should also consider both its present relevance (with the history of interest rate declining to recent dates) and its continuing current and future relevance (both in ED2 and beyond, with the risk of, for example, significant rate changes in the future). Ofgem took this approach at the end of DPCR5 and it should take this approach again ahead of ED2, in similarly unpredictable economic circumstances.

Investor confidence is important to customers, is hard won, and easily lost, and this is a major consideration that Ofgem should take into account in its modelling and allowance setting. Modelling should take into the account of a range of risks coinciding and their long-term impacts.

Operational performance and combination scenarios

As part of our Business Plan submission, we submitted an external report from KPMG that demonstrated that the Ofgem required scenarios of +/- 200bps RoRE were plausible.

We are disappointed that Ofgem has instead rowed back on its own downside scenario of 200bps as above, to a range of 100-200bps RoRE, without any real justification and in spite of the evidence provided to it. It has then compared this to an investment grade tipping point of 200-300bps RoRE and, given that these don't overlap, has concluded that the risk in the sector is no greater than investors' expectations for a business with similar rating.

We find this analysis and conclusion extraordinary - it is a single variant analysis, with no evaluation of error margins or of the impact of failure.

Ofgem has accepted through separate analysis that the a higher totex scenario or higher interest rates would also independently result in a worsening credit profile. It should not be the role of the regulator to ensure financeability in all circumstances, but Ofgem must conduct analysis to understand how the sector would perform in a reasonable combination scenario – for example, a high totex scenario with 1% interest rates and 100bps RoRE under-performance. Failure to do so could result in a repeat of the Energy Supplier failures that occurred in 2021, but on a significantly larger scale and, given the Net Zero backdrop, with far greater consequences.

Calibration of the stress tests and interpreting the results

In relation to interpreting the results of scenario modelling, we are concerned by Ofgem's reference to published credit rating migration risks⁹². Whilst Ofgem state that it does not use these mechanistically, we are concerned about the use of these statistics in the context of financeability checks, particularly if Ofgem is implying that it would be acceptable for one-of-fourteen DNOs to move to sub-investment grade each price control., thereby losing its licence. Ofgem should not be calibrating a price control with this level of financial risk, given the regional economic dislocation that this might result in, the likely disruption to net zero investment, and the future pricing of risk across the sector to the long-term detriment of customers.

⁹¹ RIIO-ED1 DDs: Finance Annex , Ofgem, July 2014, para 2.31

⁹² Finance Annex 5.55

Need to extend checks beyond ED2

Given the forward-looking nature of ratings agencies, we believe that Ofgem should have reviewed and published a full range of credit metrics across ED3 and ED4, based upon the proposed cost of capital allowance approach. In particular, we highlight material structural deterioration in the FFO/Net Debt credit metric over this time horizon. It is necessary for the regulator to consider financeability over this extended horizon to ensure that policy adopted today does not create inter-generational problems for customers in the future. While the regulator may insist that future problems can be addressed by future policy, this cannot be appropriate when future customers end up paying for mistakes that are avoidable or where future policy has to differ markedly from current policy to correct issues.

Given the forward-looking approach of ratings agencies, any deterioration in ED3 metrics will have an impact in ED2. Hence this matter is not just of ED3 concern.

As noted in FQ19, we note that Ofgem's analysis of financeability over the longer-term appears restricted to AICR over the period to 2033, and relates to a different sector. We have requested more information on the underlying assumptions and calculations. We have highlighted the inconsistency between Table 20, which indicates an average base case totex AICR of around 1.40 across the sector, and the modelling in Figure 7, which, at no point in ED2, shows AICR below 1.40 with the sector average finishing at 1.50 or higher. We are informed by Ofgem that this is the result of Figure 7 being based upon data for the GD&T sector.

Requirement to understand the position of individual networks

We have not reiterated our previous comments regarding the application of the Financing Duty in general and in particular regarding Ofgem's need to consider the financeability of individual licensees and not just the Notional Company, although our position remains unchanged in these regards. Based upon Ofgem's position of looking at the notional company, at the very least Ofgem should ensure that the Notional Company's circumstances match the actual company's and that the notional company is financeable for the long term (i.e. beyond the regulatory period), in more extreme scenarios, and from the full range of ratings agencies' perspectives.

FQ21. Do you agree with the requirement to provide the Financial Resilience Report within 60 days?

We recognise – particularly following the recent crisis for energy retail – the importance of financial resilience. Whilst we have no objection in principle to additional financial resilience measures, we are concerned about the context in which these proposed changes take place – as well as with the impact of plausible downsides on financial resilience of the notional company. It is important that Ofgem continues to consider financial resilience in the round and takes account of all relevant factors in conducting any financial resilience assessment.

Firstly, as noted in FQ19, as a consequence of Ofgem's calibration of the cost of capital proposals to provide an average AICR of 1.40x (i.e. at the Baa1/BBB+ boundary), and through the imposition of 'one-size-fits-all' policy, ***by design*** Ofgem is expecting half of the notional DNOs to be rated Baa2. Thereby, the requirement for additional financial resilience measures is triggered by simply a negative outlook for these companies (i.e. less than one notch of headroom to cash lockup). ***We highlight that this is the case for notional companies (ignoring real-life debt funding positions) under the baseline scenario for totex, performance and macro-economic factors.***

With reference to paragraph 6.5, the context is referred to as “if networks either operate inefficiently or choose not to bolster their financial resilience”. This puts all the onus for financial resilience on the network, regardless of the regulator’s actions. We do not believe that this meets adequately Ofgem’s duties to have a proper regard to the need to secure that licence holders are able to finance their activities. In particular, as we have pointed out before, it cannot be considered inefficient to have issued past debt during a period of high interest rates in the past, just as it cannot be considered inefficient to issue future debt following a future spike in interest rates.

Ofgem, in the draft determination, assume that, in the event of circumstances beyond the network’s control, such as past or future market interest rates, there should be imposed an obligation on the network’s owners to bolster the financial resilience of the network, for no economic return on such investment. Where this is as a result of true inefficiency, this would not be unreasonable. However, imposing this duty on investors where it is the result of a pure accident of timing, is not reasonable and indicates insufficient regard to the need of the network to be able to finance its activities.

We note the footnote on page 78, that Ofgem would consider notional company financeability constraints and potential remedies as the price control progresses. As the notional company assumes that it will always have debt costs equal to allowances, this implies that, were there to be financeability constraints as a result of future interest rate changes, which are beyond the network’s control, Ofgem would not factor these into any thinking about financial constraints or remedies. We consider that this puts far too much risk on to the networks’ ability to finance themselves in all economic scenarios, to the potential detriment of customer interests and net zero investments.

We have no disagreement with the threshold itself (being Baa2 with negative outlook), rather we have significant concern with the regulator’s approach to calibrating the financeability of the sector without sufficient headroom to the trigger, and without regard to actual positions, and then putting the onus onto networks to solve the problem. Ofgem is showing insufficient regard to the need of licensees to be able to secure funding for the investment required, instead indicating equity should be injected to solve the problem, such equity being unremunerated.

5 Corporation Tax questions

FQ22. Do you agree with our proposals to make allocation and allowance rates variable values in the RIIO-ED2 PCFM?

In principle, we agree with the proposal to make allocation and allowance rates ‘Variable Values’ as it will allow for rates to be amended throughout RIIO-ED2 in order to reflect the changing circumstances of the network and its tax position.

Whilst we agree in principle, a number of questions that we have raised previously, broadly relating to the practical application of the proposal, remain unanswered, namely:

- In relation to the change in allocation percentages, could the allocations be different for the individual years and would the onus be on the company to calculate and revise the allocations on an annual basis? It is our view that the allocations should be altered on an annual basis in order to afford businesses an appropriate level of flexibility, and that it should be for businesses to set the allocation percentages in line with the expenditure profile of their business during any given year.

- What methodology would be put in place to ensure a consistent approach is taken across the network operators? It is our view that a methodology should be sought in order to ensure a consistent approach amongst the network operators.

Furthermore, how does Ofgem anticipate the calculation of rates will feed into the tax reconciliation and review process? How much autonomy will network operators have when it comes to setting the rates and what course of action do Ofgem propose to undertake if they do not agree with the rates used?

Finally, whilst we welcome the proposal to allow for variability in this area, the proposal raises another question in relation to the capitalisation rates currently proposed within the draft determination. In recognising the need to allow for variability in this area, it feels somewhat contradictory to not allow for capitalisation rate variances in respect of such a large proportion of the network's capital expenditure. We would appreciate sight of Ofgem's justification for seeking to impose what, *prima facie*, appears to be a contradictory position in respect of capitalisation rates.

FQ23. Do you agree with the proposed additional protections? In particular:

Ofgem is proposing to include a number of protections in place for RIIO-ED2. We have included comments in relation to specific aspects of these protections in response to FQ24-FQ26 below, but in relation to these measures more broadly, we make the following observations.

Tax Reconciliation – We appreciate that Ofgem wishes to acquire a clearer understanding of the differences that arise between the tax allowance and the actual tax liability that is declared on a DNO's CT600. The proposal is for DNO's to submit a tax reconciliation which effectively bridges any gaps between the tax allowance and ultimate liability.

We have a general concern about the form that this reconciliation may take. Para 7.27 of the 'Draft determination – Finance Annex', notes that Ofgem will provide a template for the reconciliation. It is not yet clear exactly how much detail and commentary the template will require as part of the reconciliation, the materiality levels involved, and what additional resource pressures it will place on DNOs.

We welcome the fact that Ofgem have committed to publishing guidance which will make clear the fact that some differences are expected between the tax allowances and final liability and that those differences will not require detailed commentary. However, at this juncture, it is difficult to assess whether the additional clarification that Ofgem is seeking pertaining to the residual differences is appropriate or proportionate, until we have seen the final guidance.

Tax Review – We acknowledge that Ofgem has engaged the DNOs in relation to this matter, and work is ongoing in relation to the drafting of the relevant licence condition and Handbook. We note that we still have significant concerns around the potential reach of a prospective tax review. It remains unclear what specific circumstances might give rise to a tax review, as well as who would conduct said tax review, and the administrative burdens involved.

Any such review would inevitably incur significant additional costs, and as such, we believe that the licence condition needs wording in such a way as to make clear that tax reviews will only be conducted in the most serious and exceptional cases.

Board Assurance – We acknowledge that work is ongoing in order to agree on a mutually agreeable statement that Ofgem can expect from the respective DNO boards. However, we have some general concerns in relation to the board assurance statement.

The purpose of the board assurance statement appears to be to provide assurance to Ofgem that information provided by networks in the tax reconciliation represents a true and fair view of the network's position. We don't believe a separate statement is warranted in this area. The tax reconciliation will provide significant additional detail and will be subject to the usual collective DAG control procedures with Director level sign-off.

When added to the additional existing documentation and procedures that support the legitimacy of the network's tax affairs, including the SAO certification, Fair Tax Mark and the published Tax Strategy, we do not believe an additional statement is required.

Fair Tax Mark - We note that Ofgem has decided not to make the Fair Tax Mark a requirement for RIIO-ED2 on the grounds it would not provide consumer value or ensure tax legitimacy. We take an opposing view and believe that the additional disclosure requirements drive businesses to provide more transparency about their tax position. This provides external stakeholders, and the end consumer, with a greater level of comfort that the business is operating in a reputable manner in relation to its tax affairs, which of itself must be viewed as providing value.

It is our view that the Fair Tax Mark accreditation should be a mandatory requirement for all DNO's in order to provide consumers with additional transparency, at a time where additional focus is being placed on the sector.

FQ24. Do you have any views on a materiality threshold for the tax reconciliation?

Point 7.29 of the draft determination finance annex, explains that networks have expressed a desire for a materiality threshold to be set for the tax reconciliation, in order to ensure that only *material* unexplained variances will be reviewed. We share this desire in order to remove the need for unnecessary investigations into items that are either immaterial or adequately explained.

Ofgem's proposal is to use the 'deadband' level set in RIIO-1. We have included our thoughts on using the 'deadband' as a materiality threshold at FQ25 immediately below.

FQ25. Do you think that the "deadband" used in RIIO-ED1 is an appropriate threshold to use? If not, what would be a more appropriate alternative?

The deadband used in RIIO-1 affects allowances, and we do not think that it is a tool that could be used to make an assessment of materiality for the purposes of conducting a tax reconciliation.

We believe that significant work is still required in order to agree a suitable materiality threshold in relation to the tax reconciliation.

FQ26. Do you have any views on our proposals relating to the Tax Trigger and Tax Clawback mechanisms? In particular, do you have any views on a proposed “glide path” for the notional gearing levels used in the tax clawback calculation?

We agree with the principle of a tax clawback mechanism, however, we oppose both the proposal to reduce the notional gearing rate from 65% to 60% and also the proposal to move the tax clawback trigger threshold level.

The legitimacy of the mechanism is to protect customers from paying tax allowances to networks where these tax allowances are not required because the company has opted to take on additional amounts of debt finance, increasing gearing and exposing customers to additional risk.

For ED1, Ofgem considered that the threshold for the tax trigger should be 65% in-line with the notional gearing level. As set out in FQ19, we do not believe Ofgem has justified the move in notional gearing to 60%, nor do we believe it is necessarily appropriate to force companies to comply with such a change if Ofgem did not believe 65% represented significant risk to customers and companies during ED1.

We note that if the gearing trigger is met, then the penalty relates to the full amount of any additional interest deductions in the network’s corporation tax computations. As such, a company that is under-funded on its debt allowance, such as ENWL, will face significant penalties if gearing is just 0.1% above threshold. In contrast, a company that is over-funded on its debt costs has no such restriction and could theoretically have gearing well above 60% or even 65%.

This hard cap for those licensees that are under-funded against their efficiently incurred debt costs creates significant challenges and financial risk in the context of high totex scenarios and 98% capitalisation rates on volume drivers and re-openers. As ENWL is disadvantaged by the proposed debt allowance by virtue of its size, assessing the clawback based upon actual debt costs, rather than notional debt costs imposes a further disadvantage. Assessing the clawback on actual debt costs is an inconsistency by Ofgem, given those underlying debt costs are not fully funded.

At the margin, the tax clawback mechanism may prevent companies from funding any investment fully through additional debt, even in the short-term, for example pending equity raisings – at the margin providing a disincentive to investment, which is not in customers’ interests. As noted, we already have concerns over the attractiveness of the sector from an equity perspective, and if new equity cannot be injected in a timely manner, the tax clawback will likely restrict the ability of companies to invest in-line with customer needs.

Overall, we believe it is appropriate for Ofgem to retain a 5ppt deadband above the notional gearing level for the tax clawback trigger, to mitigate against these risks. This would help avoid the undesirable outcomes noted above. Failing that, we believe it would be appropriate for Ofgem to consider other protectionary measures, including averaging of gearing positions across years and/or a third trigger, to remove companies that have not paid any dividends (thereby actively managing gearing to the maximum extent possible without external capital injection) are not captured by the clawback.

6 Returns Adjustment Mechanism questions

FQ27. Do you agree with our proposals for the RAM thresholds and adjustment rates?

At a fundamental level, we do not believe a RAM is necessary for a well calibrated price control framework. A RAM mechanism is likely to distort the working and effect of incentives, if the RAM is

seen to curtail output incentives at the margins. We see this moving the regulatory framework towards rate of return regulation.

However, as we have noted throughout this response, we continue to have concerns over the calibration of the price control as set out in the draft determinations. In this context, we would not object to the introduction of a RAM provided it is structured so that it does not disincentivise networks from continuing to strive for innovation and further efficiency. Notwithstanding our overall position on the RAM as a concept, we believe Ofgem's upper calibration is broadly acceptable.

One of our key concerns with the RAM proposal is the exclusion of financing and tax performance.

The RAM is clearly structured to protect customers from excessive equity returns, with adjustments triggered as those returns deviate materially from the baseline.

We do not see how it can be justified to base the RAMs assessment on an incomplete view of equity returns. Equity returns have to fund the shortfalls from financing and tax and it therefore seems logical and essential for the legitimacy of the RAM to include them. Similarly, where licensees are overfunded for debt costs, which would include the net impact after inflation, the amount that they are charging their customers represents an additional return and should be included within the mechanism. Needless to say, this should be on an actual company basis, rather than on a notional company basis.

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

7 Indexation of Regulatory Asset Value

FQ28. What are your views on the technical implementation of the switch to CPIH as set out in the attached PCFM?

Adopting RPI-linked financing, either directly as index linked bonds or through the use of derivatives, has helped manage inflation risk in networks for many years. Much of this RPI-linked financing is structural and long-term, it cannot be restructured easily without cost. CPIH adoption could not have been foreseen by networks and debt allowances should be adjusted to include the cost of removing any resulting basis risk, based upon actual licensee positions rather than sector averages.

That said, Ofgem's approach in the ED2 PCFM which uses monthly inflation indices and calculates the April 2023 value of the price index with half RPI and half CPIH, with subsequent months growing by CPIH seems sensible and practical.

As noted in FQ1, we do not believe the way that Ofgem is proposing to remunerate networks for existing RPI exposure is fair or appropriate. Given that this is an unforeseeable regulatory change, networks should receive an appropriate level of compensation for basis risk based upon their actual embedded positions, and not a sector average.

8 Regulatory Depreciation and economic asset lives

FQ29. Do you agree with our proposal to set depreciation policy on RAV additions in the RIIO-ED2 period to 45-years straight line, based on the average economic life of the assets?

We agree with the proposal to set ED2 depreciation policy at 45 years straight line and have no evidence to support a change to this approach. We agree with the principle that the depreciation policy of the RAV should align with the average economic life of the assets it is associated with. This maintains the economic principle of intergenerational fairness.

However, Ofgem should be mindful of the impact of such a policy beyond the ED2 price control. Deferment of customer funding over a longer period of time stores up long-term problems for certain credit metrics such as FFO/net debt further, compounding the ED2 financeability problem. Ofgem should recognise and act on the additional financeability problems being stored up for future stakeholders as a consequence of decisions made now. Ofgem's modelling on long term financeability should specifically address this point, as we note above, in the response on financeability.

9 Capitalisation rate questions

FQ30. Do you agree with our proposal that we should set different capitalisation rates for ex ante allowances and re-openers and volume drivers?

At a fundamental level, if the natural capitalisation rate for volume drivers and re-openers is materially different from the natural capitalisation rate for other areas, we would support a different capitalisation rate. We believe this is in the best interests of customers.

At present, we have strong concerns that the current proposals for volume drivers and re-openers do not include any indirect opex costs. We believe this is a material oversight and strongly recommend that this decision is revisited for Final Determination. As a simple answer, it is unreasonable to expect material additional network investment to take place without indirect design costs or other volume related overhead costs.

We also believe it is appropriate for Ofgem to consider the implications of having different capitalisation rates when calibrating other components of the price control – in particular, the impact of credit ratings and financeability, and also the need to align rates with tax pool allocations.

On the latter point, we note that Ofgem is proposing that tax pool allocations are variable and updated over the course of ED2. This would be likely to result in an undesirable disjoint between these two aspects over time.

The use of different capitalisation rates for volume drivers and re-openers should not be considered as a purely financial issue, and the impact on how uncertainty mechanisms will be able to operate and facilitate investment in period should not be under-estimated.

As noted in our response to FQ31 below, we strongly disagree with the capitalisation rates set at Draft Determination. We have re-analysed them in Appendix 1 and recommend our proposed rates are implemented for Final Determination, subject to the totex composition remaining unchanged. If totex undergoes further adjustment another the capitalisation analysis will have to be updated accordingly. This issue is discussed in more depth in our response to FQ31 below.

FQ31. Do you have any evidence that would enable us to improve our estimates of regulatory capitalisation rates?

We do have further evidence, and this is presented in Appendix 1. We disagree with the Draft Determination capitalisation outcome that provided for an overall rate of 75.3%.

Our final business plan submission proposed ex-ante capitalisation rates at 68% (consistent with our calculation of natural capitalisation rates), with an additional proposal of a reduced 65% rate to address cash flow and financeability concerns.

Ofgem has instead proposed an overall capitalisation of 75.3% - consisting of (i) "Bucket 1" representing non-variant allowances and variant allowances (excluding re-openers and volume drivers) at 73.2% and (iii) "Bucket 2" representing variant allowances for re-openers and volume drivers at 98%.

It is important to note that Ofgem has applied some significant changes to ENWL's submitted business plan for totex work mix and non-variant/variant balance. These Ofgem changes inevitably require the original rates within the business plan to be updated. We note that, despite Ofgem removing spend categories with a high level of capex from the non-variant category, it has not then updated the resultant capitalisation rate for this category to compensate for this movement.

With this in mind, we have revisited our capitalisation rate analysis in light of Ofgem's totex changes to our business plan. The details can be found in Appendix 1, but in summary the overall rate based on Ofgem's split of spend categories would be 70.4% (down from 75.3%) with "bucket 1" rates (including the non-variant ex-ante costs) at 67.7%.

However, we also disagree with the cost splits that Ofgem have applied to the different categories. We believe that, to deliver the business plan outputs, we require a greater proportion of our allowances within the controllable opex category in order to support the capital programmes. As a consequence, we believe our natural capitalisation rate to deliver the draft determination would still be approximately 68%, in line with the natural capitalisation rate proposed in our business plan submission.

We would recommend that in the Final Determination Ofgem apply one blanket rate capitalisation rate to non variant costs (being 58%) and then use separate rates for the variant costs. The overall rate should then equate to our natural capitalisation rate of 68%. The calculation will need to be revisited for Final Determination if the split between variant and non variant spend is again changed, to ensure it still equates to our overall natural capitalisation rate.

	Ofgem Proposed Capitalisation Rates	ENWL Proposed Capitalisation Rate
Non Variant Capitalisation Rate	68%	58%
Variant Bucket One Capitalisation Rate	93%	93%
Variant Bucket Two Capitalisation Rate	98%	100%
Overall Capitalisation Rate	75%	68%

In the absence of an Ofgem re-evaluation of our capitalisation rate we are likely to see further and unnecessary strain on ENWL's credit metrics and financeability. Analysis by PA Consulting has shown that higher capitalisation rates can have a material and negative impact on DNO financial ratios.⁹³

On a related point, we have raised a Draft Determination supplementary question with Ofgem relating to the consequential impact on tax pool allocation rates. These will need updating in light of any revision to capitalisation rates. We note from Ofgem's response that these rates will be updated for Final Determination and annually through ED2 to align to natural capitalisation. There remains a concern that, as Ofgem has chosen to deviate from the natural capitalisation rate advised in our business plan, the use of natural capitalisation rates in the regulatory tax pools could still lead to a mismatch between the regulatory capitalisation rate and the rate used to calculate tax pools for the tax allowance.

10 RAV opening balances questions

FQ32. Do you have any views on the use of forecast RAV opening balances for the start of RIIO-ED2, which will be trued-up following RIIO-ED1 closeout?

We are comfortable with Ofgem's proposal to use forecast closing RIIO-1 RAV balances as opening balances for RIIO-2. This maintains regulatory consistency and underpins long-term financial planning. We agree that these should be trued-up for any closing ED1 changes and recommend:

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

11 Transparency through RIIO-ED2 reporting questions

FQ33. Do you agree that additional corporate governance reporting described (including on executive director remuneration and dividend policies), will help to improve the legitimacy and transparency of a company's performance under the price control? If not, please outline your views in relation to the rationale provided for these additional requirements, including consumer protection.

We support governance reporting and disclosure that conforms to recognised FCA guidance and standards as determined by an appropriate expert regulator in this area. Statutory accounts disclosure has long been the appropriate benchmark in this area adhering to a long-established, well-understood and independently verified set of guidelines. Change control in this area has always been subject to a rigorous independent process with extensive consultation. We are happy to disclose information that conforms to our Statutory reporting obligation.

⁹³ 'Assessment of capitalisation rate applied to uncertainty mechanisms in the RIIO-ED2 Draft Determinations', PA Consulting, August 2022

In light of the recent BEIS decision on Restoring trust in audit and corporate governance, we anticipate further developments will be required in corporate governance reporting during the ED2 period. We recommend Ofgem reviews these proposals prior to introducing any further requirements on companies.⁹⁴

On the two specific Governance areas covered by this consultation we note the following:

- Dividends – we are happy to continue reporting actual dividends as required under current reporting rules. We agree with the statement that it is not appropriate to forecast dividends given that some companies are part of listed entities, and the impact that this could have on their Listing Responsibilities.
- Executive Directors’ Remuneration – We do not support the current proposal to include narrative around executive remuneration within the RFPR commentary or Excel reporting of information outside of that reported in the Statutory Accounts. If disclosure is required, it should be entirely aligned to the published Statutory Accounts for the company in question. Moving away from this risks conflicts with requirements in respect of good corporate governance and the disclosure of directors’ remuneration set by Parliament, the FCA or any exchange on which a company’s securities are listed.

12 Consolidated reporting and calculation of allowed revenue questions

FQ34. What are your views on the proposed consolidation of the revenue RRP and PCFM, or applying a fully dynamic concept of allowed revenue?

We support Ofgem’s approach to integrate the PCFM and revenue RRP. Clarity, consistency and accessibility should all be improved to the benefit of all stakeholders.

We also support Ofgem’s move towards a fully dynamic model that integrates forecasting into the one model. We anticipate this will provide further flexibility as well as simplify the licence for all stakeholders.

Whilst we are supportive of forecasting we have concerns regarding risk which is outlined in questions FQ37 to FQ40 below.

13 Licensee self-publication of allowed revenue questions

FQ35. What are your views on allowing licensees to self-publish the PCFM with their charging statements, rather than relying on an Ofgem publication or direction to determine allowed revenue?

We have no concerns about licensees taking responsibility for ownership of the numbers and process for the PCFM, and welcome simplification of approaches wherever that can add value.

We welcome Ofgem’s decision to also publish a consolidated PCFM post annual iteration process each year. This will serve as an essential single point of reference for all stakeholders.

⁹⁴ BEIS, ‘Restoring trust in audit and corporate governance,’ May 2022

In the event that there is a material change in forecast positions, we would highlight that it would be necessary for Ofgem to re-publish the PCFM in order for changes to be reflected in financial covenants. If this is not performed, it may restrict the ability of networks to respond appropriately rapidly to changing totex requirements.

14 Best vs reasonable endeavours in charge setting

FQ36. What are your views on having a best endeavours obligation for charge setting: "The licensee must, when setting Network Charges, use its best endeavours to ensure that Recovered Revenue equals Allowed Revenue"?

We disagree with Ofgem's proposal to require DNOs to deploy best endeavours when setting network charges. We have shared our concerns previously in submissions dated December 2021⁹⁵ and March 2022⁹⁶, which came from the ENA on our behalf.

Ofgem made a conscious decision to require DNOs to use reasonable endeavours when setting network charges for RIIO-ED1 and has not adequately justified its proposal to impose a more onerous obligation. There has been no evidence of any abuse or poor performance in this area.

Ofgem's argument for making this change seems to rely on three pieces of logic:

- That the obligation is arguably "the most fundamental obligation" in the price control;
- That greater responsibility is appropriate given the expectation that licensees will self-publish the value of allowed revenue; and
- That making the change would bring ED into line with other sectors.

These arguments are not sufficient, individually or collectively, to justify the proposed change. Furthermore, Ofgem has failed to recognise that it would be unfair to increase this obligation at the same time as making multiple other changes to the price control package which flow through to Allowed Revenues, such as removing the two-year lag or the significantly increased usage of uncertainty mechanisms.

Additionally, while Ofgem has recognised that the introduction of such an obligation would cause DNOs to incur additional costs in meeting a more stringent obligation, Ofgem has failed to fund DNOs to undertake those activities.

We consider each of Ofgem's arguments in summary below:

1. Ofgem's argument that a change is required to reflect "the most fundamental obligation in the price control" fails to recognise (a) the increasing costs to be funded by consumers without additional benefit or (b) the safeguards that are already incorporated into the price control to protect customers from any deviation between Allowed Revenue and Recovered Revenue

Ofgem has failed to provide examples that justify increasing the obligation, and has not answered the examples provided by DNOs that demonstrate the additional costs that would be incurred in chasing very marginal improvements in accuracy of network charges

⁹⁵ ENA Note to Ofgem on SpC2.1, 16 December 2021

⁹⁶ Best endeavours follow up note, ENA, 30 March 2022

2. Ofgem's suggestion that the proposed move to self-publishing the Allowed Revenue justifies the change in obligation misrepresents the extent to which this change will improve DNOs' ability to forecast Allowed Revenue more accurately
3. The change in standard for DNOs cannot be justified by reference to the standard applied in other sectors
4. Ofgem's proposed change to the level of obligation is internally inconsistent with its proposal to remove the current lag on many aspects of economic condition or performance flowing through to Allowed Revenue
5. Ofgem's proposal is also inconsistent with its assumptions in other aspects of price control package
6. A "best endeavours" obligation may be used to penalise any over collection of revenues. As a consequence, the mitigation of such risk would be to deliberately aim to under collect. This further exacerbates financeability issues and creates a tendency towards under investment, such tendency not being in customers' interests.

Furthermore, we note the requirement to set prices 15 months in advance creates risk outside of the licensees' control, that changes in market conditions, customer behaviour, or new requirements to vary totex spend in uncertainty mechanisms, can lead to fluctuations in collected revenue. For example, the Covid-19 pandemic caused reduced electricity usage and therefore collected revenue, that had not been forecast when FY21 prices were set long in advance of the pandemic. Increasing the obligation on licensees to align collected and allowed revenues, while prices are set 15 months in advance, risks penalties being applied due to events post-price-setting that were unforeseeable at the time prices were set.

Ofgem recognised that some fluctuations in collected vs allowed revenue could be outside the licensees' control in ED1, in setting a 6% over/under-recovery band before penalties were applied. Notwithstanding our standpoint that the "reasonable endeavours" obligation should remain and the 15 month notice period should be reviewed and shortened, the greater risk of deviation between allowed and collected revenues in ED2, for example from uncertainty mechanisms, means the 6% dead band should be increased appropriately, and exceptions allowed for variances outside the control of the licensee.

15 Appropriate time value of money questions

FQ37. What are your views on applying a single time value of money to all prior year adjustments, based on nominal WACC?

We think this needs careful consideration, as set out below.

TVOM adjustments are used in three main areas of the financial model:

1. Expenditure/revenue adjustment in calculating the MOD (ADJ) term (currently at WACC).
2. Adjustment to the Interruptions-related quality of service incentive (currently at WACC).
3. Historic revenue under/over collection (currently at BoE plus a margin plus a penalty rate of interest if applicable).

1. We are strongly of the opinion that a time value of money at WACC, reflecting the company's cost of capital, should apply for investment-related adjustments (impacting MOD/ADJ terms). Investors

are required to provide upfront finance for expenditure which may only later be recovered from customers as the associated allowances are determined. Increased use and size of uncertainty mechanisms are likely to exacerbate the uncertainty and risk in this regard. Forecasting allowances, if licensees are in a position to determine this, may help to offset some of the risk, but there will remain a requirement on both equity and debt financing to cover any mismatch between costs and revenues.

Additionally, if there is no headroom for borrowing - a realistic scenario given the transition from 65% to 60% notional gearing - then the burden will fall entirely on equity. The alternative, using debt financing, in such a scenario could lead to tax trigger adjustments.

2. As the incentive framework has changed from ED1, TVOM application in this area should be reviewed. Where it is appropriate for TVOM to apply, then it is appropriate to set this at WACC.

3. We think a key question to ask is how material is the under/over recovery? In the event under/over recoveries are relatively small (and within the thresholds at which a penalty is applied) the current situation of a bank interest rate plus a margin would still be appropriate. In the event under recoveries are large (the frequency of which may be increased by extended use of uncertainty mechanisms), and outside the company's control, then borrowing capacities to finance a gap could become constrained and equity would have to step in, in the absence of any Ofgem intervention. Under this scenario the WACC would be an appropriate TVOM. For K factor TVOM adjustments Ofgem should consider a materiality threshold at which the adjustment switches from (i) a bank interest rate plus margin to (ii) a WACC TVOM.

We disagree with CEPA's conclusion that the cost of debt, in all circumstances, is an appropriate proxy for the marginal cost of capital for prior year adjustments as it assumes additional borrowing capacity is available. If Ofgem want to pursue a single rate across all prior year adjustments then we believe this should be the WACC, based on our conclusions above.

16 Forecasting and forecasting penalty questions

FQ38. What are your views on our proposed approach to using forecasts within RIIO- ED2?

Overall, we agree that inclusion of forecasts is likely to assist a company to recover its allowed revenue on a more timely basis. This is particularly important in the marked shift towards the use of uncertainty mechanisms. However, as noted in FQ 39 below, greater use of uncertainty mechanisms brings with it greater risk of forecasting error. We note that totex is still deemed as within management control, and by implication, uncertainty mechanisms. Our view is that UMs carry significantly extra forecasting risk and that penalty bands should be reconsidered as a consequence.

FQ39. What are your views on the proposed charging penalty mechanism?

We note from the Ofgem's September 2021 decision following DNOs request to temporarily disapply the current DuoS charges notification periods that Ofgem will not apply penalty interest rates on any excess over/under recovery for regulatory years 2023/24 and 2024/25.

From a recovered revenue/volume perspective, there are increased risks associated with the uncertain timing of the electrification of transport/heat. Adding this additional uncertainty to a

requirement to set prices 15 months in advance will likely result in higher volatility in K factors driven by factors outside management control.

FQ40. What are your views on the proposed revenue forecasting penalty mechanism?

From an allowed revenue perspective, forecasting risk and uncertainty is greater in ED2 as a result of proposed ED2 policy changes that (i) require us to use best (rather than reasonable) endeavours to ensure recovered revenue equals allowed revenue and (ii) employs a significant increase in the use of uncertainty mechanisms. At the same time the general economic outlook is subject to significant volatility given recent national and international events.

We note and support Ofgem's draft determination position that penalty mechanisms be framed to focus on those components that are under the control of licensees. Licensees should not be penalised for things out of their control, e.g. inflation forecasts, impacts of weather events. However, we still remain of the view that the extra forecasting risk that the ED2 price control brings should be reflected in wide penalty bands that remain unaltered from ED1.

17 Incentive lags and incentive rates questions

FQ41. What are your views on removing lags from incentives?

We agree with the proposal to remove the lag between performance and revenue entitlement although by the time ED2 starts, FY24 and FY25 prices will have already been set so the cashflow associated with the first two years of ED2 will only be realised later in the period. Without the lag, suppliers still get an advanced view of charges through the 15 month notice period. We agree that it should promote greater consistency between the PCFM and incentives as well as make reporting and understanding easier.

FQ42. What is your view on using RoRE as a general baseline for describing ODI caps, rather than base revenue?

We support any move that simplifies and clarifies caps, collars and other thresholds. Measuring these in terms of RoRE is appropriate as the yardstick against which companies are measured. We also agree that RAV will generally be more stable than revenue. Using one RoRE benchmark rather than a variety within and across sectors helps to support accountability through simplification and consistency.

We broadly agree with Ofgem's approach in translating base revenue incentives to RoRE. One important caveat is to ensure fair treatment for each ED licensee. We note that Ofgem's translation using sector average involves winners and losers.

FQ43. What is your view on fixing the potential £m 20/21 value of incentives using one number for all years, based on a forecast of RIIO-ED2 at Final Determinations (an approach similar to RIIO-ED1)?

Given the step up in totex between RIIO-ED2 and RIIO-ED1, we do not agree that a fixed £m figure is appropriate for each year, calibrated based on 20/21 RoRE. In order to retain the desired incentive properties, we believe it is necessary to scale the potential incentive values in-line with RAV (or regulated equity) growth.

FQ44. What is your view on the method of calibrating incentive caps in RoRE terms, or the overall proposed incentive caps?

Subject to our response to FQ43 above, we have no objection to the calibration in RoRE terms in principle.

18 Bad debt questions

FQ45. What are your views on our proposal to remove the Bad Debt terms from the pass-through licence condition?

DNOs do not have discretion over the Supplier businesses to whom they extend credit. Furthermore, the level of security required is set out in DCUSA and hence cannot be determined by a DNO based on an individual assessment of the credit risk. This situation means DNOs cannot either control or mitigate this risk, and so it is correct that DNOs should not bear the costs of bad debt arising from Supplier failure.

We believe that the consultation position on bad debt would result in a clearer outcome than the treatment of bad debt under RIIO-ED1. Recording Recovered Revenue on the basis described ensures the reported amount reflects the value actually collected.

The draft determination moves from a model where bad debt costs are identified distinctly and explicitly included as a pass-through term, to a situation where these costs are included within a calculation of Recovered Revenue. Following such a change it is important that the uncontrollable nature of these costs is not overlooked in other areas. One area where this consideration is relevant is the calculation of the penalty rate of interest. Bad debt events are (i) of sufficient regularity, (ii) of sufficient size and (iii) are clearly outside of the control of the DNOs, to warrant exclusion from any penalty rate of interest calculations. This would be markedly the case if/when a major supplier/ a number of smaller suppliers all go into bad debt scenarios in quick succession.

19 Revenue profiling questions

FQ46. Should Ofgem allow proposals to re-allocate or re-profile revenue throughout the RIIO-ED2 period and what profiles could be considered in the customers' interest?

Ofgem should allow the option for revenue to be able to be re-profiled, but only use it in limited and special circumstances. One such example that would be in customers' interests, is to alleviate financeability stress of a licensee in a particular year. However, given the financeability straits of ED2, and the ability to tune up or dial down network investment to match revenue, it should not be used without appropriate notice.

Appendix 1

Accounting Paper- Natural Capitalisation Rate for ED2

Executive Summary

This paper calculates the natural capitalisation rate based on the total Price Control Financial Model (PCFM) spend of £1640m awarded in the Draft Determination in June 2022.

In the Draft Determination, Ofgem has proposed an overall capitalisation rate of 75.3% for ENWL. Ofgem has requested feedback on this capitalisation rate as part of our Draft Determination response.

The calculations in this paper show that our overall natural capitalisation rate would be around 70%, based on the Draft Determination and *Ofgem's allocation of allowances*, including non-variant expenditure and Ofgem's split of spend categories. The reason for the difference in overall capitalisation rates is principally due the non-variant allowances category, where an adjustment is needed to reflect the fact that projects with a high level of capital spend have now been moved into specific variant categories.

However, we do not agree with the allocation of allowances in the Draft Determination. We strongly believe that to deliver the capital programme and outputs, we would need a greater proportion of our allowed spend allocated to operating expenditure categories.

Based on the Draft Determination allowances of £1640m, we recommend that the following capitalisation rates be used:

	Ofgem DD Capitalisation Rates	ENWL Proposed Capitalisation Rates
Non Variant Allowances Capitalisation Rate	68%	58%
Variant Bucket One Capitalisation Rate^	93%	93%
Variant Bucket Two Capitalisation Rate^	98%	100%
Overall Capitalisation Rate based on ex-Ante allowances	75%	68%

[^]Splits for these categories shown later in this paper

We note that our proposal for the overall capitalisation rate is 68%, being in-line with the figure presented in our Final Business Plan.

We note that the tax pool allocations proposed in our Final Business Plan were aligned with an overall capitalisation rate of 68%. To the extent that the capitalisation rate is not 68% on Final Determination, we request that Ofgem allows networks to update the tax pool allocations to align with capitalisation rates.

Analysis

For the Final Business Plan Submission, we calculated the natural capitalisation rate for ENWL based on the amount and classifications of spend in our plan and provided this information to Ofgem.

This analysis showed a natural capitalisation rate of 68%, which we proposed was allocated to all categories, in-line with ED1.

We have updated this analysis to reflect the following:

- latest statutory accounts capitalisation rates (year ended 31 March 2022); and
- proposed PCFM allowances of £1640m for ED2 included in the Draft Determination.

A detailed list of our proposals is included in Appendix 1A at the end of this paper.

Non-Variant Allowances

Category of Spend	Capitalisation Rate	Justification
Load related capex and Non-Load related capex- asset replacements	100%	Capital expenditure cost categories.
Non-load related capex – other	85%	While the majority of spend in this category is statutory capex, as accounting rules are changing and as IT cloud-based investment in particular becomes prominent, the natural capitalisation rate is expected to be around 85%. This has been estimated based on the proportion of our ED2 IT capital programme that invests in Cloud based infrastructure and services and therefore cannot now be capitalised.
Faults	58%	Rate aligns with our actual capitalisation rate in the 21/22 Statutory accounts.
Tree Cutting	0%	Rate aligns with our actual capitalisation rate in the 21/22 Statutory accounts.
100% revenue pool expenditure	55%	Rate aligns with our actual capitalisation rate for people costs in the 21/22 Statutory accounts.
Controllable opex	33%	This has been calculated by translating the Draft Determination allowances into a statutory view and then using our 2022 capitalisation rates for the different operational expenditure areas to give a weighted average capitalisation rate. These 21/22 rates have been updated in a couple of areas such as DSO/Vulnerable Customers where the work programme and mix of expenditure will materially change in ED2 and therefore the 21/22 capitalisation rate needs to be adjusted accordingly.
Non-variant capitalisation rate	58%	This is based on our estimate of spend levels in each category to deliver the capital programme and outputs set out in the Draft Determination. Figure would be 61% based on Ofgem's allocation

We would recommend that a blanket rate of 58% be applied to all non-variant categories, to provide flexibility in delivery and remaining consistent with Ofgem's approach for the draft determination.

Variant Allowances

The table below sets out areas where we believe that the capitalisation rate should be different than that proposed by Ofgem, with justification.

Category of Spend	Capitalisation Rate	Justification
RPE's (non-variant allowances)	58%	Aligned with the proposed capitalisation rate for all non-variant spend.
RPE's (variant allowances)	100%	Rate is in line with average variant allowances capitalisation rate in the calculation excluding the RPE allowances.
NARM asset replacement, NARM asset refurbishment, Visual amenity, Worst served customers, Load volume drivers, Smart Street	100%	Capital expenditure cost categories.
Cyber UIOLI Op IT	85%	Rate of 85% due to reclassification of some Cloud based spend in line with non-variant rate.
Cyber PCD: BS IT&T	28%	Rate applied in line with 21/22 Statutory accounts IT support costs capitalisation rate.

Conclusion

Based on the Draft Determination allowances of £1640m, we recommend that the following capitalisation rates be used:

	Ofgem DD Capitalisation Rates	ENWL Proposed Capitalisation Rates
Non Variant Allowances Capitalisation Rate	68%	58%
Variant Bucket One Capitalisation Rate [^]	93%	93%
Variant Bucket Two Capitalisation Rate [^]	98%	100%
Overall Capitalisation Rate based on ex-Ante allowances	75%	68%

[^]Splits for these categories shown later in this paper

To the extent that allowances are updated for Final Determination, the information provided in this paper should allow Ofgem to calculate appropriate capitalisation rates that are aligned with the Final Determination.

We highlight that, under Ofgem proposals, spend included in 'Variant Bucket Two' includes capital items only. We believe it is critical for Ofgem to amend these uncertainty mechanisms to include an additional allowance for operating items, including closely associated indirects. While there are

differing mechanisms to achieving this, the introduction of allowances for these items in Variant Bucket Two would need to be reflected in a decrease in the capitalisation rate.

We note that the tax pool allocations proposed in our Final Business Plan were aligned with an overall capitalisation rate of 68%. To the extent that the capitalisation rate is not 68% on Final Determination, we request that Ofgem allows networks to update the tax pool allocations to align with capitalisation rates.

Appendix 1A: Proposal for ED2 Capitalisation Rates

£'m 20.21 prices	Ofgem Allowances £'m	Ofgem Capitalisation rate	Ofgem Calculated Slow Money £'m	ENWL Proposed Allowances £m	ENWL Proposed Capitalisation rate	ENWL Calculated Slow Money £'m
Bucket 1						
Non Variant Allowances						
Load related capex	79.9	68%	54.3	79.9	58%	46.3
Non load related - asset replacement	255.3	68%	173.6	255.3	58%	148.1
Non load related capex other	148.7	68%	101.1	148.7	58%	86.2
Faults	128.7	68%	87.5	128.7	58%	74.6
Tree cutting	35.3	68%	24.0	35.3	58%	20.5
100% revenue pool expenditure	69.3	68%	47.1	69.3	58%	40.2
Controllable opex	473.2	68%	321.8	473.2	58%	274.5
Total	1190.4		809.5	1190.4		690.4
Non Variant Capitalisation Rate			68.0%			58.0%
Variant Allowances						
RPEs (non variant allowances)	56.5	73%	41.2	56.5	58%	32.8
NARM asset replacement	134.1	100%	134.1	134.1	100%	134.1
NARM asset refurbishment	23.9	100%	23.9	23.9	100%	23.9
Visual amenity	5.4	100%	5.4	5.4	100%	5.4
Cyber UIOLI Op IT&T	0.7	100%	0.7	0.7	85%	0.6
Smart Street	71.6	100%	71.6	71.6	100%	71.6
Worst Served customers	18.3	68%	12.4	18.3	100%	18.3
Cyber PCD : BS IT&T	1	68%	0.7	1.0	28%	0.3
Cyber PCD : Non Op IT&T	0.8	100%	0.8	0.8	85%	0.7
Total	312.3		290.9	312.3		287.6
Variant Allowances Bucket 1 Rate			93.1%			92.1%
Total Bucket 1 Rate (Variant & Non Variant)			73.2%			65.1%
Bucket 2						
Variant Allowances						
RPE's (variant allowances)	17.6	87%	15.3	17.6	100%	17.6
Load: Transformers volume driver	28.7	100%	28.7	28.7	100%	28.7
Load: Circuits volume driver	73.4	100%	73.4	73.4	100%	73.4
Load: Unlooping volume driver	17.4	100%	17.4	17.4	100%	17.4
Total	137.1		134.8	137.1		137.1
Bucket 2 Capitalisation rate			98.3%			100.0%
Total Bucket 1 and Bucket 2	1639.8		1235.2	1639.8		1115.1
Overall Capitalisation rate			75.3%			68.0%