electricity north west

Bringing energy to your door

Sector Specific Methodology Consultation response

Appendix 2: Response to Finance Annex

March 2024

Contents

1 Introduction

In this annex we set out our response to the questions in the Finance Annex of the Sector Specific Methodology Consultation (SSMC) for RIIO-3.

We have responded to the questions by exception as we have a legitimate interest in the development of RIIO-3 as our consumers, stakeholders and shareholders could be significantly affected by the outcomes of this consultation.

Our response documents should be read cognisant of our key matters set out in our covering letter. The five key matters most important to Electricity North West, which have the biggest effect on our consumers are:

1. Undertaking separate, unfettered consideration of RIIO-ED3 is essential to enable electrification to achieve Net Zero;
2. Maintaining the stability of core regulatory principles in the face of significant change;
3. Ensuring that each sector has a financeable and investable framework calibrated to the requirements of that sector;
4. Protecting consumer interests by incentivising the behaviours consumers prioritise at the levels at which consumers value them; and,
5. Accelerating the levels of innovation and digitisation that will improve the affordability of delivering the Net Zero transition.

It is in this context that our response is limited to the development of RIIO-3 for Gas Transmission, Gas Distribution and Electricity Transmission only. We look forward to the process beginning for the RIIO-ED3 price control in a few months' time on an unfettered basis.

2 Allowed return on debt

Question 1. Do stakeholders consider there to be good reasons to deviate from the overall approach set out under UKRN Recommendation 8?

We have previously set out circumstances and concerns that we consider to constitute good reasons for refinement of the approach set out under UKRN Recommendation 8. We reiterate these points in this response. We consider those circumstances to be equally valid for the current consultation given the broad intention of Ofgem to generally roll forward the RIIO-2 approach. [redacted]

UKRN Recommendation 8 states: *"Regulators should estimate an allowance for an efficient company under the notional financial structure, with actual debt costs suitably benchmarked against other market evidence."*

This is a high-level statement and gives a degree of scope for Ofgem to interpret this, although overall they agree with UKRN. Ofgem though has signalled that they have considered, under FSNR, whether there is evidence and justification for updating their approach in the context of the increasingly differing quantum and pace of investment at network companies[4]. We welcome Ofgem taking a fresh look in this area, and consider each of their proposals below:

1. <u>Indexation weighting and calibrating to sector average</u>

We agree that weighting the trailing average cost of debt index needs to be re-examined for the reasons Ofgem set out in para 2.11. However, we are concerned that the purpose of the weighting exercise is simply to make the comparison to sector average expected debt costs more reflective and accurate (i.e. so there is a technical underpinning to the policy objective to remunerate a notional company based on assuming that sector average expected actual debt costs are efficient). The SSMC notes similarities to the approach adopted for Scottish Hydro Electric Transmission (SHET); however, there is a key difference in that it was applied to a single company with materially different RAV growth to the notional. In those circumstances it was deemed to be appropriate to take a separate course of action. We consider that further refinement to the notional company concept to separately consider a small theoretical company (as also set out in questions FQ10 and FQ13) represents a similar step to the treatment of SHET. Under that circumstance a separate weighting for the small theoretical company will enable the overall basket of notional company modelling to be more representative of the spread in company size within the sector.

It is clear that further information and consideration will be needed before a choice can be made between the possible options set out in paragraph 2.15 of the SSMC and that the Draft or Final Determinations would be an appropriate point to determine this for GD&T. It is also apparent that these choices could be sector specific. More analysis needs to be undertaken to determine the most appropriate weightings, but we are clear in our view that a company specific solution would be the preferred option.

[redacted]

[4] SSMC, para 2.6

2. Additional borrowing costs

NERA[5] have prepared an updated paper re-analysing the components of additional borrowing costs. It is appended to the ENA response, and we fully support its results and conclusions.

3. Infrequent issuer

We welcome Ofgem taking a fresh look at this aspect of cost of debt policy. We have listed below our RIIO-ED2 concerns that we believe need addressing in respect of the infrequent issuer premium.

[redacted] that the current one-size-fits-all notional company is poor at representing the notional company of a singleton DNO that issues benchmark-sized debt relatively infrequently. In particular we have demonstrated:

(i) Ofgem has not identified all of the relevant inherent characteristics of a small notional company that are outside of company control and that give rise to structural differences in cost of debt performance between it and the rest of the sector.
(ii) The Ofgem analysis is focussed at the licensee level and does not take into account singleton networks. Other companies structured as part of groups with multiple networks have markedly different characteristics to a singleton notional network.
(iii) Ofgem has assumed that additional costs and risks faced by a small notional company can be effectively hedged by using CMS which is only applied to the cost of new debt and not to the cost of embedded debt.

We have previously had concerns on the following points that we urge Ofgem to consider when assessing the infrequent issuer premium:

a. Single licensee vs groups: The Ofgem assessment is based on individual licensees despite the fact that some networks are single licensees and do not belong to a Group and cannot therefore benefit from pooled Group facilities and resources. This is an important reason why a single licensee cannot issue as frequently as a Group and another reason to consider a small notional company separately.
b. Threshold for identification of an infrequent issuer: We have previously stated in RIIO-ED2 consultations that the threshold should be £250m. At RIIO-ED2 Draft Determinations this remained at £150m and left ENWL in the irrational situation that it did not qualify for an infrequent issuer premium despite being the only non-Group DNO. This issue was rectified for RIIO-ED2 Final Determinations where the threshold was raised to £250m. We consider this to be an appropriate threshold and expect RIIO-3 will be consistent with this.
c. New vs embedded debt application: The Ofgem 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 as it only provides a partial remuneration for unavoidable additional costs and risks associated with this issuance profile over a short-term window of the current price control. In effect the Ofgem approach:
    - dismisses the impact of all past debt issuance that remains in the portfolio of the small infrequent issuer; and
    - 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 the price control will continue to affect debt costs for years to come.

[5] "Additional Cost of Borrowing for the RIIO-3 Price Control", NERA, February 2024
[redacted]

We have previously submitted a summary report regarding the cost of debt[7] which provides an analysis of the challenges faced by a singleton DNO such as ENWL. The report highlights the RIIO-ED2 infrequent issuer uplift of 6bps was missing a number of relevant costs associated with infrequent issuers such as hedging against interest rate risk, the cost of liquidity facilities, the cost of carry, and the cost associated with RPI/CPIH basis mitigation risk.

4. Calibration

We note Ofgem are intending to continue with their RIIO-2 policy to exclude derivative costs from the calibration exercise. We continue to strongly disagree with this approach for the following reasons:

a. Swaps are a standard tool to mitigate rather than to enhance financial risk.
b. Previous CMA position that:

   "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 framework"[8]

c. Companies' current portfolios include swaps that were entered into during times of illiquidity in the IL bond/debt market 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.
d. 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.
e. 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.

5. Inflation

We address this option in the following three questions.

6. General

   a. Sector average proxy for efficient debt costs is incorrect.

   Ofgem have stated in the SSMC that it intends to continue using the RIIO-2 approach of calibrating the (iBoxx) index using forecast efficient pooled network debt costs[9] and that it intends to continue calibrating the allowance by comparing efficient pooled debt costs of all

[redacted]

[8] CMA (2021), RIIO-2 Final Determinations, Volume 3: Individual Grounds, para 14.219
[9] SSMC, para 2.21

GD&T networks[10], which may be considered further at sector level in the context of diverging capital requirements.

We still have fundamental problems with this approach that we have summarised below[redacted]

- Exposure to differences in timing/frequency of issuance: An allowance based on sector average effectively captures the broader issuance patterns of the entire sector which would be more frequent compared to individual company issuances. Each company faces a point in time risk due to the daily variation in rates which can create material exposure for a company issuing less frequently in the event of material changes to rates.
- Exposure to financing strategies of other companies: An allowance based on sector average costs implies that a company is exposed to the financing strategies of other companies in the sector, particularly those with the largest RAVs, which it cannot control or predict.
- Exposure to differences in the ratio of new debt: Given that market rates are higher now than in the past, issuing a higher quantum of debt over RIIO-ED2 than implied by the sector average would imply a higher cost of debt than the allowance. This is likely to be sensitive to the pace of the transition to Net Zero and associated Capex.

If the RIIO-2 approach is followed, then the efficiency or otherwise of individual debt instruments is not separately assessed. Rather it is assumed that the iBoxx index is a reasonable proxy for regulated company notional debt allowance funding when calibrated against sector average actual/forecast debt costs. By implication, it is further assumed that any costs above this average must be “inefficient”.

A reasonable process to assess efficiency (or otherwise) is to consider, by instrument, whether funding could have been secured at a lower cost at the time of issuance, in the context of the prevailing conditions at the time.

An ambiguous benchmark that changes over time inevitably leads to differing “efficiency” conclusions at different points in time and leads to the conclusion that assessment of efficiency or otherwise, is a function of when the index is calibrated which cannot be right.

b. *The basic principle that a licensee should be able to invest confident in the knowledge that its efficiently incurred debt costs will be funded.*

We consider this a fundamental cornerstone of the regulatory framework and one that is increasingly important for forthcoming price controls to retain and attract equity investment. It stands to reason that a well-managed and efficient company will not invest equity if it expects that the allowed equity return is required to subsidise a shortfall in allowances for efficiently incurred debt costs. Given the way “debt efficiency” has been assessed and applied hitherto, this is not an unlikely outcome for a smaller company. This principle is intertwined with the current one-size-fits all definition of a notional company that we believe needs further refinement to adequately capture the circumstances for smaller companies. We have set out our concerns on this particular point in questions FQ10 and FQ13.

[10] SSMC, para 2.22

[redacted]

Question 2. Do stakeholders have evidence in support of, or opposition to, one or more of the updated indexation or inflation remuneration methodologies under consideration?

We agree that is right and proper for the Regulator to review the policies underpinning all elements of the price control, including debt. Such changes target notional financing structures that inevitably have a direct impact on the actual financing structures of licensees. That being so, careful consideration of the context, implication, and impact of the change on actual companies is required. Investors make long-term decisions and investments based on prevailing information in a particular price control. Radically moving a notional goal-post inevitably has consequences on actual financing structures which would have serious implications and costs given that changes made in subsequent price controls were not reasonably anticipated. Under those circumstances it is necessary to evaluate the scale of the change and conduct an impact assessment, with the outcomes of the assessment determining whether such changes warrant compensation in the form of appropriate additional cost allowances. This is particularly important for smaller companies that are not necessarily in a position to react to material financing changes as swiftly as their larger counterparts.

<u>Indexation</u>

We agree that utilising an indexation allowance is still appropriate. We broadly agree that the IBoxx Utilities 10yr+ Index is an appropriate measure for the general notional company however the indices only includes fixed term instruments making it necessary to adjust for inflation.

In question FQ1 we have set out our reservations on why we think the current proposals for a weighted indexation approach do not address the fundamental issue of a one-size-fits-all notional company approach. In our view, this can only be remedied by considering a separate small theoretical company that would apply small-company risk characteristics to a notional company construct. To that end, the weighting approach to the small theoretical company also needs separate consideration to that of the broader notional company, also taking into account the extra risks and costs borne by infrequent issuers (as defined at a group level). [redacted] This raises the importance of the infrequent issuer premium, which, if assessed appropriately, can close the gap caused by the choice of indexation and a one-size-fits-all issue. [redacted]

We broadly support the assumption of refinancing as RAV additions and the use of an even distribution per year. A mechanism that is company specific would be our preference as well as one that is dynamic so takes into account future changes to the RAV such as uncertainty mechanisms (UMs). We have concerns regarding any one proposal that tries to fit all sectors (GD, T and ED). RAV additions should be dealt with for EDs during the RIIO-ED3 process.

<u>Inflation</u>

Regarding options 1 and 2, there remains insufficient detail at this early stage to allow us to consider either option. Any move away from the current RIIO-2 mechanism requires far more work and careful thought if Ofgem is to avoid undermining investor confidence and risk future investment.

[redacted]

The RIIO-2 inflation mechanism importantly ensures the whole asset base is inflation protected, and we believe this key cornerstone of regulatory stability and predictability should be preserved, thereby assisting in retaining and attracting investment.

Option 3 appears to be the same RIIO-2 mechanism but with an alternative source for the long-term forecast. We believe a credible, objective and independent index for the long-term inflation forecast is necessary to support investor confidence, attract new capital and ensure the long-term financeability of companies.

To move away from the current RIIO-2 mechanism Ofgem needs to demonstrate:

1. the case for moving away from OBR as the long-term forecast; and
2. present a viable and superior alternative which satisfies the criteria of objectivity and independence.

Both are necessary to ensure the mechanism is a credible alternative for securing long-term investment capital.

There is no clear-cut case that OBR would be demonstrably inferior to any other long-term forecast. As Frontier explain, Ofgem has not been clear why it is necessary to review the long-run inflation assumption and what is wrong with the long-term OBR forecast currently used at RIIO-2. [13]

For these reasons option 3 as presented is wholly unsatisfactory, and will likely damage confidence, financeability and investability.

To take this important issue forward more work is required to explain the details within options 1 and 2 and how they would operate, and indeed to develop alternative options which satisfy investor and company requirements.

Given the above, we think there is currently no better alternative to the current RIIO-2 mechanism as it stands.

That said, we consider each of the three Ofgem options below in more detail to explain our current position.

Option 1 – Nominal allowance for fixed rate debt

We acknowledge that this could have the desired outcome to remove the “leverage effect” subject to our views on Index Linked Debt (ILD) and transition as set out in FQ3. However, we see that this will also have potential problems in the form of:

(i) complexity of implementation,
(ii) raising customer bills in the short-term; and
(iii) only partial RAV indexation.

We would like to see how this option develops before we comment further.

[13] “Initial consideration of break-even inflation for price control purposes”, Frontier, March 2024

Option 2 – Match indexation of the RAV to the long-run assumption in proportion to the fixed rate debt notional capital structure proportion

Of the two new options, option 2 would appear to be more closely aligned to the current methodology in terms of financeability and future RAV growth albeit the whole RAV is no longer fully protected by uplifting for actual inflation, and there could be greater financeability risk.

This option appears to have the benefit of removing the "leverage" effect without increasing bills materially over the short-run, although we would need to see how this develops before we could comment further. Our views on transition and ILD are set out in FQ3.

Option 3 – Unchanged methodology – review of the long-term assumption

Option 3, which changes the long-run inflation assumption would potentially cause more concerning issues around financeability and financial resilience. Firstly, use of a forward measure of inflation as suggested (eg. 5-year break even inflation) will not solve the leverage effect as outturn inflation can still deviate from the forward assumption. Secondly, careful consideration and analysis should be undertaken to determine the most appropriate method to be used to forecast long term inflation and justify why the current RIIO-2 OBR long-term assumption is inferior in any way to other independent long-term assumptions. We continue to question whether break-even inflation is a valid measure of expected inflation. As long ago as 2012 First Economics demonstrated, in a paper for the DNOs on indexation of the cost of debt and inflation[14], that gilt market breakeven inflation is not a robust or accurate enough measure of expected inflation. There are also separate questions about whether gilt curves reflect the convergence of the RPI measure to CPI by 2030[15]. Frontier have also set out some misgivings in their report on break-even inflation:

> *"…we consider that Ofgem's assessment of potential future reliance on break-even inflation for regulatory purposes is flawed and its analysis of the issue incomplete. In particular, we consider that:*
>
> - *Ofgem has not defined the meaning of an "appropriate" measure of long-term inflation;*
> - *Ofgem has not been clear why it is necessary to review the long-run inflation assumption and what is wrong with the long-term OBR forecast currently used at RIIO-2;*
> - *Ofgem has not considered other potential alternatives for long-term inflation assumptions; and*
> - *Ofgem has not shown evidence to suggest that break-even inflation is a superior measure of long-run inflation when compared to alternatives including OBR forecasts."*[16]

Given these circumstances, it is our view that break-even inflation cannot be used as the forecasting method in the event that Ofgem was minded to move forward with option 3.

As set out above, we do not support option 3 as currently presented, in so far as it is assuming a move away from OBR, given that it does not meaningfully address the principal question on the leverage effect and could damage investor confidence, financeability and investibility. However, if Ofgem were to pursue this option further then it would be essential that Ofgem clearly demonstrated why OBR is inferior, and that any alternative forecast is independently sourced to ensure credibility.

[14] "Indexation of the Cost of Debt and Inflation", First Economics, June 2012
[15] "The Risk-free Rate", section 2.1, First Economics, August 2022
[16] "Initial consideration of break-even inflation for price control purposes", Frontier, March 2024

Question 3. Do stakeholders have views on the potential approaches to implementation of the proposed methodology changes, including assumptions relating to ILD weights?

The answer provided here should be considered in the context of our concerns raised in FQ2.

In principle we agree that for a notional company matching the allowed cost of debt cashflows with the asset growth and reducing the mismatch between total return on debt and the cost of debt caused by deviations in inflation from the long run assumption makes sense.

We have fundamental concerns about the Ofgem approach to implementation, particularly with regard to assuming that the ILD debt percentage for the notional company should be set to zero, and the reasons that are driving that policy consideration. In particular:

1. There should be a clear rationale behind taking away the option to raise ILD in a price control that links RAV to inflation and revenues to inflation.
2. There is a direct impact on how actual companies determine their finance structure which renders prior Ofgem arguments on this matter no longer valid. Ofgem have long upheld a position on actual company financing structures that the company should bear financing risk and have the freedom to determine its own financing structure - the current proposal seems to be at odds with this principle. Ofgem may argue that companies could still operate at the sub-optimal level, but by providing the transition options in the SSMC there is a clear intention for actual structures to follow. This contradicts long-held Ofgem positions and arguments particularly where that same position has been used to disregard funding on an actual company basis.

We agree with Ofgem that some licensees have capital structures with significantly higher proportions of inflation linked instruments than that assumed for the notional capital structure and that if policy option 1 or 2 were to be implemented, this would reduce or remove the offsetting inflation sensitivity which corresponds to the inflation linked debt resulting in net inflation sensitivities for certain licensees. We also agree that in these circumstances this could adversely impact financial resilience in a manner which could not have been reasonably anticipated when licensees made these capital structure decisions. The answer appears to be implementation options that includes an option to eliminate ILD from the notional company which is currently 25%. This proposal also suggests an option for licensees to reduce ILD exposure over a number of years to zero during a transition period. ILD is a valuable and effective tool in debt interest covenant management and taking away this financing option can have a negative impact on investment in the network and the ability for companies to choose their own financing structures. We would question whether the “leverage effect" would be exaggerated by utilising options 1 or 2 and eliminating ILD.

If Ofgem is intent on pursuing a transition policy the second ILD transitioning option of renumerating debt to the actual company initially then transitioning to the notional company seems like a more sensible option rather than eliminating ILD altogether in terms of financial resilience. However, it will still reduce the licensee’s options to make financing decisions.

The third option of renumerating debt to the actual company for ILD permanently would be our preferred option and would allow the licensee to scale down ILD appropriately and maintain financeability.

Generally, any deviation from the current mechanic that links the RAV 100% to outturn inflation should involve a high level of engagement and analysis as existing investors to the sector have a preference for the index linked nature of the asset and any amendment from this could impact future investment.

Question 4. Do stakeholders wish to propose any other alternatives that have not been proposed?

We strongly question the rationale behind excluding derivative costs from the cost of debt allowance. We would agree that including derivatives introduces some complexity, but some element of derivative costs can easily be incorporated with analysis of the swap market performance over a period of time, to better reflect the financing arrangements of the sector. This seems inconsistent to the proposal to include derivative generated accretion into the tax clawback mechanism and should be addressed.

One potential alternative is to consider sharing factors such that risk exposure is aligned between a single DNO network and a DNO group, i.e. the risk exposure of a single DNO network is consistent with that of a DNO group following application of appropriate sharing factors which provides for a more consistent and fairer basis to allowances. [redacted]

Question 5. Do stakeholders have any additional evidence for us to consider in our review of the additional borrowing allowances or infrequent issuer premium?

In respect of evidence regarding additional borrowing allowances, we refer Ofgem to the updated report NERA[19] has prepared which is appended to the ENA response. We fully support NERA's results and conclusions.

In respect of the infrequent issuer premium, we do not agree with the Ofgem RIIO-2 approach. Our concerns are outlined in the infrequent issuer section of our response to question FQ1. [redacted]

3 Allowed return on equity

Question 6. Do stakeholders agree with our interpretation and proposed application of UKRN Recommendations 2-7?

We note that the Ofgem general approach to allowed return on equity seems to largely follow that for RIIO-2. We also note that the RIIO-3 world will be very different to RIIO-2 following a step change in interest rates and a requirement to urgently invest in the electricity networks to meet the UK's obligations to decarbonise. We set out below our answers to this question taking a look at each of the UKRN recommendations separately and in the context of these two important real-world events.

The reports accompanying the ENA response from Oxera[20] and Frontier Economics[21] set out the issues in much more detail. They set out clear evidence for appropriate calibration and analysis of

[redacted]

[19] "Additional Cost of Borrowing for the RIIO-3 Price Control", NERA, February 2024

[20] "RIIO-3 cost of equity", Oxera, February 2024

[21] "EQUITY INVESTABILITY IN RIIO-3", Frontier, March 2024

the cost of equity modelling. It is notable that the current evidence supports a higher cost of equity than RIIO-2 as a consequence of significant market changes and the impacts those have had on CAPM components and cross-checks. We fully support the conclusions in these reports.

UKRN recommendation 2

States that the cost of equity should be estimated using a widely acceptable method which they go on to say should be the CAPM.

We accept that this has been the primary model of choice for regulators across numerous price controls and on that basis we are reasonably comfortable with CAPM. However, there are some very important points that need to be considered:

1. The first is appropriate calibration of the component parts of CAPM. Acknowledging that this is not a precise exercise and gives rise to ranges and ultimately choices, RIIO-2 calibration repeatedly erred on the downside pushing down allowed cost of equity at each stage and resulting in an overall cost of equity that is now only marginally above cost of debt. We view this approach as one that was adopted in the context of the relatively low interest rates at the time. Given the economic environment has now materially changed, such a position is unsustainable for RIIO-3 both from an evidential viewpoint on the relative positions for debt and equity, as well as the practical viewpoint in retaining and attracting sufficient equity to fund the de-carbonisation journey.

   For RIIO-3, Ofgem has highlighted the new concept of investability which considers whether the allowed return on equity is sufficient to retain and attract the equity capital the sector requires for de-carbonisation and reaching Net Zero targets. Ofgem accept that this issue is likely to be increasingly important in the coming years as the need for infrastructure investment rises significantly and 'fresh' equity needed[22]. Given this context, it is important that Ofgem strikes a fair balance between cost to customers and attracting investment – appropriate calibration of CAPM is important to address this issue.

2. The second is to use a balanced and fair basket of cross-checks in the toolkit. Too often for RIIO-2 cross-checks proposed by companies that presented valid and equally important evidence were dismissed. At the time this presented a downside skew to allowed equity outcomes, thereby helping to justify the overall downside skew to CAPM calibration. Inclusion of a balanced set of cross-checks on CAPM is essential if ambitions of attracting and retaining significant levels of equity investment are to be realised. We also expect that given the real-world economic changes and future challenges, that cross-checks grounded in market data and evidence will play an increasingly important role in overseeing that the theoretical CAPM model reflects reality.

UKRN Recommendation 3

States that regulators should use recent yields on the index-linked gilts (ILG), with a maturity which matches the assumed investment horizon for their sector to estimate the RFR.

We partially support this approach but consider sole use of ILG's to be too narrow. As we have previously pointed out in prior consultations, sole use of ILGs means it is inherently downwardly biased due to the convenience premium associated with Government bonds. ILGs due to their

[22] SSMC, Section 5.9

special nature create excess market demand that pushes the bond yield below a normal market-clearing price. Our view has been that to overcome this downward bias that 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,

with the latter being the option of choice.

UKRN recommendation 4

States that Regulators should estimate the equity risk premium (ERP) within the CAPM as the difference between total market return (TMR) and the risk-free rate (RFR). We recommend that the TMR should be primarily based on historical ex post and historical ex ante evidence.

UKRN go on to acknowledge that:

> "*There is significant alignment amongst regulators in the overall approach to the TMR/ERP, namely that in recent determinations UK regulators assume greater stability in the TMR and therefore estimate it directly from historical equity returns data. In the interests of maintaining consistency across sectors and also across time, continuing with this approach remains preferable. This approach does not imply that regulators should simply pick the same fixed value for the TMR in each decision for all time, but that the TMR would be relatively less variable than the underlying RFR. This would support greater stability in the cost of equity allowances over time. This policy choice seems appropriate in the wider context of the aspiration for greater predictability and transparency in the regulators' methodologies for estimating the allowed rate of return, and one that is fair to investors and customers over time.*"[23]

From the above it is clear then that UKRN do not expect regulators to have taken a fixed view of the TMR, but instead see the TMR as more stable than ERP thereby allowing regulators the latitude to determine a number in light of the wider market evidence.

It is also clear that regulators have indirectly adopted such an approach, in particular their consideration of the extended low interest rates post the 2008 global financial crisis. The Oxera report expands on this further and in particular demonstrates that regulatory assessed TMR has moved materially between 2010 and 2021:

> "*It is apparent from the figure that Ofgem responded to the decline in gilt yields in the period 2010–21 by reducing the TMR allowance (in RPI-real terms) from 7.25% in 2012 to 6.45% in 2014 and 5.45% in 2020.*[96] *We note an acknowledgment in RIIO-ED1 from Ofgem, that it reduced the cost of equity and TMR due to the changes in the market conditions:*[97]
>
> *[…] we are changing our methodology to give greater weight to the influence of current market conditions in relation to the equity market return, […]*
>
> *Since early 2022, the long-term gilt yields have sharply increased, reaching levels last seen during 2005–11. Given that the TMR was between 7.0% and 7.25% (RPI-real) during that period, a consistent regulatory approach over time implies an increase in the TMR assumption in RIIO-3, to take account of the higher interest rate environment. 7.0% and*

[23] "UKRN guidance for regulators on the methodology for setting the cost of capital", UKRN, March 2022

> *7.25% RPI-real estimates would be equivalent to a TMR between 8.07% and 8.32% in CPIH-real terms."*[24]

Looking at RIIO-3 and adopting the "stable but not fixed" approach for current market conditions where there has been a step-change reversion in interest rates back to the pre-2008 norm, requires regulators to increase TMR in this new-world context to maintain consistency and stability.

For RIIO-2 the Ofgem choices in assessing the real TMR across extended historical record demonstrated that it is not a straight-forward exercise to conclude on a fixed number and the assumptions made can deliver significant differences in the outcome. Ofgem ultimately adopted the following principles which all served to lower TMR thereby reflecting perceived prevailing market conditions:

(i) Use the CPI historic inflation deflator based on Bank of England rather than the improved CPIH series as provided by ONS;
(ii) Employ geometric averaging with a subjective uplift rather than the arithmetic average; and
(iii) Consider an ex ante historical approach,

On the specifics of the Ofgem RIIO-2 principles listed above we disagree with the subjective nature of the ex-ante approach, and geometric averaging but welcome Ofgem reconsidering its position on the ONS CPIH series.

We also welcome the Ofgem intention to consider alternative averaging techniques as set out in paragraphs 3.54 and 3.55. Evidence has previously been submitted[25, 26] in support of adopting an arithmetic average which provides an unbiased estimate of the TMR and has the following additional benefits:

(i) Avoids embedding a downward bias to the estimate generated by geometric averaging; and
(ii) Eliminates the need to apply a subjective uplift to the geometric average.

Extending RIIO-2 calibration of CAPM components into RIIO-3, we have seen a rise in the RFR due to interest rate increases. If we assume the TMR remains at this downwardly biased level then, following the assumption that it is constant would mean the ERP would move in the opposite direction. The overall outcome would leave equity unchanged, alongside a steep cost of debt increase, thereby closing the gap between the equity and debt return. This runs contrary to risk-based finance theory, and market evidence, that requires a premium for equity investments based on the higher risk equity is taking. Recent market positions, under RIIO-2 calibration, have suggested allowed equity return and allowed cost of debt are almost at parity. This clearly runs contrary to the ambitions of raising significant levels of equity and raises the question why equity would invest at all under these assumptions when it is clearly less risky to invest in debt for the same return. As such, TMR calibration needs to take on board the Oxera recommendations and evidence in the new and prior submissions (see RIIO-ED2 Draft Determinations) in order to calibrate TMR appropriately and thereby provide a realistic allowed return for equity.

[24] "RIIO-3 cost of equity", Section 2.2.4, Oxera, February 2024
[25] "Cost of equity in RIIO-ED2 Draft Determinations", Oxera (August 2022)
[26] "The cost of equity for RIIO-ED2", Oxera (June 2021)

UKRN Recommendation 5 – Equity beta

This states that Regulators should estimate equity beta for the notional company using comparable listed companies and standard regression techniques, and where a comparator has different gearing then regulators should continue to de-lever and re-lever the raw equity beta.

We agree with the principle but disagree with the Ofgem RIIO-2 application and some of the assumptions it adopted in arriving at an equity beta estimate:

(i) Listed comparator set: Placed weight on National Grid and GB water companies. We considered the heavy reliance on water companies as disproportionate given the relatively higher risks the energy sector faces in the decarbonisation journey where the electricity sector is forecast to expand significantly whilst the gas sector faces its own challenges as the UK moves away from gas consumption. A more balanced approach would have been to include the broader set of evidence advanced by the companies to include European comparators. We note that Ofgem have indicated in the SSMC that it is open to attributing different weights to RIIO-2 comparators and/or considering additional comparators which we view as a positive step forward.
(ii) Frequency of data: daily returns: We consider this to be appropriate and note Ofgem may consider a range of frequencies for RIIO-3.
(iii) Estimation period: Ofgem used 2Y, 5Y and 10Y estimation windows using spot rates and 2Y, 5Y and 10Y averages of the rolling beta estimates.
(iv) Gearing and debt beta: Enterprise value of gearing for de-levering raw betas using the Harris–Pringle formula. Ofgem used a debt beta estimate of 0.075.

Equity beta in the CAPM is a measure of how risky an equity investment is compared with the average market portfolio and is a measure of systematic risk. It is a forward-looking concept but, importantly, in practice its estimation requires interpretation of historical market data.

As we have noted elsewhere in our response, RIIO-3 presents a considerably different operational and technical environment to that previously experienced in prior price controls; this inevitably requires a different perspective on what constitutes systematic risk, and why historical betas, even with relatively recent estimation windows, may not be representative of risk going forward. Arguably there is now a potential disconnect between RIIO-2 (and prior) systematic risk and the relative risk faced by network companies in the future. The decarbonisation path requires significant investment and consequently carries significantly higher relative (to the wider market) risk for the following reasons:

(i) **Supply chain risk**: Energy companies are competing for limited resources globally, as is the wider market. However, the criticality of the energy sector, and the asymmetric nature of political demands on the energy sector, requires delivery regardless. Arguably this places far more pressure on energy companies relative to other companies competing for similar resources in the global marketplace. Further, increasing political instability globally may increase issues with supply chain, with a likely greater impact on heavy users of materials, such as the ED sector.
(ii) **Financial investment**: UK energy companies will be competing in world-wide markets with overseas energy companies. The criticality of the energy sector means there’s a heightened risk on securing these resources to deliver decarbonisation.
(iii) **Innovation and technological development**: Changes/uncertainty in how electricity will be used, required and delivered in a rapidly evolving technological landscape. Uncertainty on

the changing shape of how energy delivery evolves by 2050, creates a disproportionate risk on an industry that underpins the rest of the market.

(iv) **Societal and demand expectations**: Major societal, demand and behavioural change will only increase from the implementation and uptake of low carbon technologies. The consequence is electricity demand may go up significantly over future price controls putting ever-growing pressure on meeting and exceeding increasingly demanding service levels. This presents increasing risk pressures on resource acquisition/targeting, planning and implementation strategies/deliverables relative to prior price controls and the wider market.

(v) **Obsolescence** – there is no certainty that particular decarbonisation strategies will remain appropriate; some may be discontinued as particular paths are no longer suitable. In those circumstances, obsolescence could present a major risk to companies making long-term investments, a risk that will be uniquely disproportionate to the wider market.

UKRN Recommendation 6 – CAPM point estimate

We do not disagree with the principle that the component parts of the CAPM should be combined to produce a cost of equity range, from which the mid-point should be used as a central estimate. However, this should not discount any consideration that there are other valid reasons for moving away from this central estimate, not least because of the evidence presented from cross-check information. CAPM has its limitations, especially in its ability to explain systematic risk. Other techniques such as Hybrid debt, ARP-DRP and multi-factor modelling, should play a prominent role as a cross-check in determining the validity or otherwise of the CAPM proposed theoretical range.

The UKRN Recommendations came at a time of low interest rates. Following the unprecedented global upheavals with the pandemic followed by the war in Ukraine there has been a fundamental upward shift in interest rates, back to the 'normal' historic levels seen prior to the 2008 credit crunch.

Approaches to TMR, the risk differential between the cost of debt and equity and equity beta all need to be rethought in light of these macroeconomic changes.

At the same time, significant equity investment into the networks will be paramount given the enormous changes required to meet electricity demand on the road to decarbonisation. Maintaining a broadly RIIO-2 approach that sought to minimise equity returns could jeopardise much needed equity investment on the journey to Net Zero delivery.

UKRN Recommendation 7

As noted above, we consider it is vitally important that returns under the RIIO framework are commensurate with the returns that investors can earn on investments with a similar risk profile. 'Investability' requires that Ofgem cross-checks its CAPM calculations to the observable returns on competing asset types.

The simplest cross-check involves a comparison of the cost of equity and the cost of debt. It is self-evident to us that the RIIO-3 return on equity must be positioned in a meaningful way above the prevailing cost of debt if investors are to be persuaded to take on equity risks. We also commend to Ofgem the more exacting cross-checks set out in the Oxera[27] and Frontier Economics[28] reports. We make further comments about these reports under FQ14.

[27] "RIIO-3 cost of equity", Oxera, February 2024

[28] "EQUITY INVESTABILITY IN RIIO-3", Frontier, March 2024

Question 7. Do stakeholders consider there to be good reasons to deviate from the respective approaches set out under UKRN Recommendations 2-7?

We have set out in our answer to question FQ6 where we think UKRN recommendations can be refined and enhanced by additional considerations. Much more detail has been set out in the consultant reports accompanying the ENA SSMC response.

Question 8. Do stakeholders agree with our proposed methodologies where not specifically covered by the UKRN Guidance recommendations or our approach in previous price controls, such as the proposed approach to converting the RPI-real yields to CPIH real inputs in the RFR calculation?

Where something has not been specifically covered by UKRN guidance we are aligned with the recommendations and conclusions presented in the Oxera[29] and Frontier[30] reports.

On the specific question of RPI-CPIH conversion, we expect Ofgem to identify market expectations as regards future inflation rates, particularly around 2030. We further note that in its RIIO-ED2 decision Ofgem explicitly linked its stance on the convenience yield to its approach to the RPI-CPIH wedge. This underscores that the sequence of decisions that Ofgem faces when calibrating a fair return are linked, and that Ofgem must be careful to look holistically at the assumptions it uses and should avoid unwittingly erring systematically towards a series of low-end values.

Question 9. What comparators and/or timeframes are likely to provide the most accurate estimate of beta for the energy network sectors on a forward-looking basis?

As we have stated in question FQ6, there will be a fundamental relative shift in systematic risk for energy networks in the pursuit to fulfil decarbonisation requirements. This area on forward-looking risk will need further technical work as accurate estimates for beta may not be suitable from historical estimates.

4 Allowed WACC

Question 10. Do stakeholders consider there to be good reasons to deviate from the respective approaches set out under UKRN Recommendations 1 and 9?

Ofgem has previously stated that "*notional gearing should be determined as a reference point for the notional company for the purposes of calculating the weighted average cost of capital (WACC) with consideration of the risks network companies face, rating agency views on gearing levels for investment grade regulated networks, balancing an appropriate cost of capital and the impact medium term market conditions have on debt servicing*".[31]

[29] "RIIO-3 cost of equity", Oxera, February 2024
[30] "EQUITY INVESTABILITY IN RIIO-3", Frontier, March 2024
[31] "RIIO-ED2 Sector Specific Methodology Decision", Section 4.3, March 2021

Recommendation 1 of the UKRN guidance states "*Regulators should continue to estimate the allowed rate of return in price controls based on the weighted average cost of capital for a notionally financed firm within their sector.*"

Recommendation 9 of the UKRN Guidance states that the "*notional gearing assumption should reflect the regulator's assessment of the balance of risks facing the regulated company, a wide range of benchmarks on gearing levels and overall regulatory policy objectives" - not just the gearing level of the actual company (or companies) in question. We agree with this recommendation and note that several factors, including the anticipated pace and quantum of investment, market commentary such as from credit rating agencies and the availability of equity versus debt capital, should be taken into account when setting the gearing assumption within the notional capital structure.*"[32]

We broadly agree with the two recommendations above, but with important caveats. On recommendation 1 we acknowledge that application of a notional company construct is a continuation of a regulatory principle established many years ago. As such it is seen as a cornerstone of the stable and predictable regulatory framework investors have come to expect and rely on. That said, there remains an issue with how a notional company is defined, and indeed whether a one-size-fits-all, broad-brush approach, remains fit-for-purpose in a rapidly evolving energy framework. We are firmly of the belief that this needs a fundamental review with consideration of a new "small theoretical company" construct that ensures that all companies (including relatively smaller notional network companies) are appropriately funded for efficiently incurred costs, be they network investment, operational or financing costs. [redacted]

On recommendation 9, we agree that the assessment should be an examination of the overall risks facing the company, noting our views on the current application of the notional company outlined above, taking into account a wide range of benchmarks including those from credit rating agencies. In that way, the underlying business risks have been appropriately considered with a consistent gearing assumption applied.

What is crucially important is that the gearing assessment should not then be subsequently changed to address a financeability issue arising from equity returns and cash flows being too low. The underlying issues need to be addressed separately. Applying a lower notional gearing in this way would be inconsistent with the underlying notional company business risk and would also have practical implications for the time it would take to transition the capital structure. Such a change should not be done lightly, and not in response to an underlying financeability issue. RIIO-2 saw reductions in notional gearing for some of the GD&T sectors following the Ofgem analysis on RoRE, financeability (including stress testing), and a set of sequential logical tests that examined:

(i) Whether there was excessive/sufficient headroom
(ii) Whether the market benchmarks supported a lower assumption; and, if yes, then
(iii) Whether there was sufficient headroom.

The reduction in notional gearing for RIIO-ED2 from 65% to 60% was less clear. At SSMD for RIIO-ED2, the base working assumption was aligned to GD with Ofgem stating that "*Although this represents a 5% reduction from RIIO-ED1 levels, this would be consistent with GD and GT Final Determinations notional gearing levels and is more likely to provide a meaningful starting point for*

[32] SSMC, para 4.9
[redacted]

ED financeability assessment.”[34] Subsequent analysis saw the notional gearing level remain unchanged.

Given we have already seen changes from RIIO-1 to RIIO-2, our views on the reasoning behind notional gearing changes, and the practical issues of the time it takes to transition the capital structure, we are of the view that notional gearing levels should remain unchanged for RIIO-3.

Question 11. Do stakeholders consider there to be good reasons to deviate from the notional gearing assumptions (with respect to the level of gearing and the mix of debt types) applied to GD, GT and ET companies in the RIIO-2 price controls?

We recognise that the path to Net Zero will likely have vastly different outcomes for companies depending on whether they are part of the gas or electricity sector. As such, we think it is appropriate that sectors are managed and considered differently. For electricity it is clear that the sector will play an ever growing and leading role in the transition to Net Zero, and therefore established Ofgem policies towards gearing are likely to be more relevant, although these also need careful consideration in a quickly developing and critical regulatory landscape. Tailoring and refinement of the regulatory framework will be an increasingly important consideration in the forthcoming price control and beyond. This not only applies at the sector level but will likely apply at the company level as well as networks evolve to address the needs and questions raised by local consumers.

Question 12. Do stakeholders agree with the proposal that notional gearing levels should be maintained for each year of the price control? Do stakeholders have a preference for how this assumption is managed within the price control process?

As stated in our response to question FQ11, each sector needs separate consideration with its unique set of circumstances.

5 Financeability

Question 13. What, if any, improvements should Ofgem make to the assessment of financeability in the next price control?

Financeability is the ability of businesses to attract and raise finance. Ofgem has a duty under the Electricity Act to have regard to the need to secure that licence holders are able to finance their obligations. Ensuring financeability gives investors’ confidence which helps keep bills low over the long-term. The regulator delivers financeability by setting fair price controls that allow networks to achieve strong investment grade credit ratings and by providing sufficient shareholder returns to attract investment. This is even more critical over the next few regulatory periods where delivery of Net Zero will require significant levels of investment from both equity and debt investors.

Ofgem has previously assessed financeability based on its interpretation of the financeability duty within the context of its other statutory duties. This has then been applied in practice to a notional company construct for a regulated entity.

[34] ”RIIO-ED2 Sector Specific Methodology Decision”, para 4.38

We would additionally contend that the concept of financeability is a broader issue that requires consideration of the following:

1. Financeability assessment should consider equity as well as debt with companies needing to access equity finance, particularly in RIIO-3 and beyond: This has been acknowledged in SSMC via the newly introduced concept of investability which we discuss a bit more in question FQ14.
2. A re-think of the notional company construct: We have suggested elsewhere in this response that a smaller notional company concept should be separately considered to remove the distortions of the one-size-fits-all existing notional company. Again, we discuss this elsewhere in this response in more detail (see FQ1 and FQ10).
3. Financeability should be considered over the longer term which extends well beyond the current price control to ensure that aggregate revenues over time are sufficient.

In the SSMC Ofgem states that:

"*In order to assess debt financeability we propose to adopt an approach that is similar to that adopted for RIIO-2. We intend to conduct an in-the-round assessment that targets an efficient licensee adopting the notional capital structure broadly achieving comfortable investment grade credit quality. Within this assessment we plan to consider:*

- *financial projections from our financial model(s);*
- *the implied Moody's methodology rating (as this is the most transparent and therefore replicable methodology of the three rating agencies that we currently rely upon);*
- *the strength of quantitative metrics for credit quality, particularly those emphasised by credit rating agencies or that are under pressure;*
- *the strength of other metrics and qualitative factors; and*
- *stress testing results.*"

We believe this is a good starting point, but the RIIO-2 assessment was far from robust with significant limitations and deficiencies in its approach and calibration that need redress for RIIO-3.

Our concerns include:

(i) The notional company is not a good representation for all efficient companies: The definition of the notional company is currently applicable to all companies regardless of size or group structure. We have previously shown[35] that the current one-size-fits-all notional company is poor at representing the notional company of a singleton DNO that issues benchmark-sized debt relatively infrequently.

In particular we have demonstrated:

a. Ofgem has not identified all of the relevant inherent characteristics of a small notional company that are outside of company control and that give rise to structural differences in cost of debt performance between it and the rest of the sector.
b. The Ofgem analysis is focussed at the licensee level and does not take into account singleton networks. Other companies structured as part of groups with multiple networks have markedly different characteristics to a singleton notional network.

[redacted]

c. Ofgem has assumed that additional costs and risks faced by a small notional company can be effectively hedged by using CMS which is only applied to the cost of new debt and not to the cost of embedded debt.

As such we are concerned that an in-the-round assessment, based on the same RIIO-2 principles, will simply ignore these legitimate differences between companies and therefore put a small theoretical company at greater risk of a financeability challenge within the same regulatory framework, than a larger peer group. The assumed financial structure of this small theoretical company should be realistic and achievable in practice, be resilient to realistic downside shocks and must be relevant to the regulated company in question.

(ii) Ofgem has stated that it is its intention to follow a similar approach to RIIO-2 for financeability. At RIIO-ED2 Final Determinations Ofgem stated that it had concerns with basing price control review financeability assessments on individual metrics, or on particular thresholds for these metrics that the rating agencies themselves may choose to apply for their own rating assessments[36]. We agree that the in-the-round assessment is a good starting point, but only a starting point, and it should be supplemented by a more nuanced approach to the components. In particular, the assessment must consider relative weightings of the components with certain metrics such as AICR weighted much more highly than others as achievement of this metric underpins the entire rating. A proper financeability assessment cannot be done without paying due attention to those elements of the framework that are most important to ratings agencies, and in particular Moody's.

The RIIO-2 in-the-round-assessment has previously targeted AICR credit ratings at 1.40x for the average notional company. This caused some concern because of the importance of AICR and its calibration. Ofgem had used a sector average approach, disregarding actual company financing and capital structures. By design therefore, the approach would likely lead to a range of actual ratings in the sector and as a minimum, would be across the rating bands either side of the threshold, being Baa2 and Baa1. Considering this was for the base company assumptions, it was also apparent that under stress scenarios (e.g. high inflation, high interest rates) a higher level of Totex spend implied a rating of Baa3/Baa2. It is clear for RIIO-ED2 that there was insufficient headroom in the Ofgem assessment of one of the most important metrics in the financeability assessment.

Understandably at this early stage, Ofgem has not been able to provide more detail on proposed calibration approaches to AICR (and other credit metrics). That said, we would like to once again highlight at this early stage our concerns with the Ofgem RIIO-2/RIIO-ED2 approach and hope that a more objective view is taken for RIIO-3.

Our key recommendations:

1. [redacted] it is our view that in order to deliver a fair and financeable settlement to all companies based on the regulated notional approach, a more nuanced and scientific approach is necessary for a small theoretical company. We have set out our concerns

[36] ED2 Final Determinations, paragraph 5.30.

[redacted]

regarding calibration to the sector average for debt allowances calculation in question FQ1. It follows that a sector average calibration will have an adverse impact on a small theoretical company. There is precedent for a separate assessment of a notional position where circumstances have differed significantly to the existing notional position. Such considerations have previously been given without major issue for SHETL, the CAA and CMA price controls in the aviation industry and the NI Utility Regulators' price controls for the electricity and gas networks. We are happy to sit down with Ofgem to explore this idea further.

2. Due consideration and weight need to be given to what the rating agencies consider important in their financeability assessment, as a notional company needs to be grounded in the real world. In the SSMC Ofgem has focused on Moody's methodology rating, stating that it is the most transparent and replicable of the three ratings agencies. We would suggest that greater analysis and consideration is also placed on S&P and Fitch methodologies to provide additional assurance/balance on the overall outcomes.
3. Appropriately calibrated and realistic stress-testing needs to be in place, especially in light of the recent economic shocks. It is clear that the calibration of stress-testing for RIIO-ED2 fell short of what was needed.
4. Retaining the need to maintain a strong investment credit rating.

We welcome some of the Ofgem suggestions to consider incremental adjustments[39] such as looking at longer term analysis (i.e. beyond the current price control) and assessing broader indicators of equity cost. More detailed proposals would be necessary before we could provide Ofgem with our views. However, we see our four key recommendations as being critical in determining a financeable outcome for all companies in RIIO-3.

Question 14. What evidence, if any, should Ofgem consider in relation to expanding its assessment of financeability to account for 'investability'?

Ofgem acknowledges in section 5.9 that the concept of investability (the sufficiency of allowed return on equity to retain and attract equity capital) will become increasingly important in the coming years as the need to invest in infrastructure rises significantly (for energy networks across the UK and globally) and companies are required to seek 'fresh' equity from their investors over and above what they would be able to fund via retained earnings. In particular, we see this concept having particular significance in the electricity sector to meet the growing needs and legal deadlines of decarbonisation. It is important to point out here that these are real-world needs applying to actual companies and that sufficiency of equity resource will be a requirement for **all** companies to meet these important obligations, be they large or small. It is more important than ever to ground the approach to a notional company in the real-world financing environment in which the licensees operate.

It should not be taken for granted that the regulated energy sector will be such an attractive investment opportunity that limited changes to the existing allowance framework is all that's needed to satisfy future needs for equity investment. We agree that Ofgem needs to look at a broader assessment of investability in addition to the traditional assessment of financeability that could include metrics such as dividend yield expectations and equity issuance costs. This though is not necessarily about looking at relatively small changes. This should be part of a fundamental review of how the industry will retain and attract the significant amount of equity investment needed in the face of stiff domestic and international competition.

[39] SSMC, para 5.14

One key test that Ofgem should perform is whether the return on equity is sufficient given the return on debt, by comparing the differential between allowed equity and debt arising from the modelling in comparison to "real world" evidence. It has been shown by Oxera's ARP-DRP[40] and Frontier's Hybrid Debt[41] analysis that market data is demonstrating that the gap between the RIIO-2 equity allowance and debt cost is simply too small and is therefore no longer representative of the extra risk that equity holders have to bear compared to debt holders. A further test is to consider whether the return on equity is sufficient versus the equity return on offer from competing investment opportunity, and other wider cost of equity cross-checks, including those used by Ofgem at RIIO-2 (more is said on this in the Frontier report)[42]. The implication for financeability is clear: insufficient equity allowances will put strain on key credit metrics. The implication for investment is concerning; if the equity allowance is too low, decarbonisation investment will be difficult to raise.

It is also clear that rating agencies and the investment industry should be widely consulted to understand any barriers to investment and how to overcome these.

With the current need for equity investment, it is unhelpful to see in the SSMC considerations and comment that there may be no explicit in-year cash costs that would threaten equity financeability. Equity investors should be remunerated in a fair and balanced way taking into account the risks they bear and prevailing/expected market conditions. Appropriate risk differentials over debt should be reflected in allowances for equity investors running a well-managed efficient business, something that all equity investors would expect, especially in an environment where there is a pressing need to retain and attract equity investment.

Similarly, we do not see that potentially signalling a reduction in dividend assumptions is an appropriate way to attract equity investment into the sector. To any rational market participant, this is likely to have the opposite effect.

6 Financial Resilience

Question 15. What is your view on the proposed financial resilience measures? Are these appropriate and/or are there any other measures that you would propose?

<u>Measure 1:</u> *"Amend the licence condition to "require" licensees to maintain more than one investment grade rating rather than "use reasonable endeavours" or "all appropriate steps"."*

We are supportive of this measure.

<u>Measure 2:</u> "*Amend the dividend lock-up trigger to be the earlier of reaching BBB- with a negative watch/outlook and 80% regulatory gearing.*"

We think that this provides the right balance between customer protection and freedom for the companies to manage the risk of financing.

[40] "RIIO-3 cost of equity", Oxera, February 2024
[41] "EQUITY INVESTABILITY IN RIIO-3", Frontier, March 2024
[42] "EQUITY INVESTABILITY IN RIIO-3", Frontier, March 2024

Measure 3: “*Amend the Availability of Resources requirement for board certification to require that the licensee states that, based on agreed assumptions, it has sufficient financial resources to cover the entire price control period or a minimum of three years ahead.*”

We need additional information from Ofgem on this measure before we can comment further. Providing such board assurance could be problematic as we approach the end of a price control period when the conditions set for the next price control have not been settled. Further clarification and assurances will have to be provided by Ofgem to make this workable particularly in the transition between price controls.

Question 16. Are there better ways to protect against excessive leverage and financial risks, in particular leverage via acquisition finance, by utilising existing powers rather than imposing new requirements in the licence?

We believe that the existing measures plus the enhancements proposed in Table 3 should provide the right balance in assessing a company’s financial resilience position without undue regulatory burden.

Question 17. For the SSMC we have not proposed dividend controls or dividend policy requirements. How should we think about protections to ensure that leverage at MidCo and/or HoldCo does not become disproportionately influential in decision making at the licensee with the potential for negative outcomes for consumers?

It has long been understood that regulators regulate licensed businesses. Ofgem already has very stringent ring-fencing requirements that require licensed entities to act independently from parent companies. Ofgem has not presented any evidence to suggest that these arrangements are inadequate, hence we are unclear why Ofgem is contemplating a possible extension of regulation up to MidCo/HoldCo companies.

In our view, any perception that Ofgem is seeking to regulate beyond the boundary of the licensee risks having a chilling effect on equity investment.

For the avoidance of doubt, we believe that there are adequate controls in place to protect the operating company from decisions made for non-regulated companies and that there is no need to examine MidCo and Holdco companies as the proposed rating obligations in the SSMC for the regulated company should cover any issues of financial resilience at MidCo and HoldCo as their ratings are directly linked to the OpCo rating.

As was noted in the ENA response[43] to the Ofgem Call for input on the impact of inflation, the current Ofgem arrangements and obligations on networks regarding dividends and reporting are comprehensive. These include obligations and mechanisms to manage financing, financial resilience and dividend distribution which include board level obligations and key roles for companies’ auditors. The current arrangements include financial resilience reporting requirements that impose additional requirements on any companies that fail to meet certain resilience criteria. A list of those obligations is provided in the table below:

[43] ”Energy Networks Association response Ofgem Call For Input - Impact of high inflation on the network price control operation”, ENA, September 2023

Obligation	Overview of requirement*	Relevant licence condition		
		RIIO-GD2 / GT2 licence	RIIO-ED2 licence	RIIO-ET2 licence
Credit Rating	Licensee must take all appropriate steps to ensure that it maintains an investment grade credit rating. Includes financial resilience reporting for some sectors.	SSC A38	SLC 40	SLC B10
Availability of Resources	Board of directors evaluates any proposed dividend payment and certify that the making of that payment itself, or when it is taken with other reasonably foreseeable circumstances, will not cause the licensee to be in material breach of the specified licence conditions; and Certify that the licensee's directors have a reasonable expectation that the licensee will have sufficient financial resources and financial facilities and operational resources respectively to enable the licensee to carry on the Distribution/ Transmission Business for a period of 12 months from the date of the relevant certificate.	SSC A37	SLC 30	SLC B7
Pre dividend certificate of compliance	Directors formally certify that the licensee is compliant with a wide range of relevant obligations and that the making of a distribution would not cause it to become non-compliant.	SSC A37	SLC 30	SLC B7
Restriction of Activity and Financial Ring Fencing	Restricts the activities that the licensee can undertake, including investment activities. Requires that a licensee has in force a system of treasury management operations internal controls that complies with best corporate governance practice.	SSC A36	SLC 29	SLC B6
Indebtedness	Restricts the type of financial transactions and arrangements that licensees can enter into.	SSC A39	SLC 41	SLC B9
Prohibition of Cross Subsidies	Prohibits any cross subsidy between the licensee and any other activity or company in the same ownership group.	SSC A35	SLC 4	SLC B5

Undertaking from the Ultimate Controller	Requires commitment from the holding company that owns a licensee that it and other companies in the same ownership group will refrain from action that would be likely to cause the licensee to breach any of its obligations under the Act or this licence.	SSC A26	SLC 31	SLC B8
Regulatory financial performance reporting (RFPR)	RFPR requires considerable reporting related to dividends and dividend decisions including: the level of any dividends; a reconciliation to statutory accounts; a split of regulated and non-regulated business dividends; an explanation of approach to dividends; details of where decisions reside for dividend policy; and an explanation of dividend policies and consideration of long term financial sustainability	SSC A 40	SLC 46	SLC B15

We believe that if Ofgem were to propose dividend control or dividend policy requirements then that would represent Ofgem intervention within actual company financing decisions and would therefore have implications and expectations for other areas of financing.

Ofgem rightly points out that this is a complex area, but one that it is considering nonetheless. We see no difference between this complex area and other complex areas (such as inclusion of derivatives in debt financing) and as such would not want to see discrimination between the two based on a “complex grounds” argument.

Question 18. Is there merit in amending the RFPR RIGs to include requirements for Licensees to undertake stress-testing, and to provide the results to Ofgem, as in the Retail sector and as the Prudential Regulatory Authority/Bank of England does for banks, to test for financial resilience?

We are of the view that this is an unnecessary intervention given that:

1. The retail sector faces a significantly different risk profile to the networks. As such regulated network companies should not need to carry the extra costs and significant regulatory reporting burden that will arise as a result of this proposal.
2. Extensive and adequate stress testing should form part of the business planning process giving rise to an appropriately calibrated price control. There should be no need to subsequently perform any further and unnecessary stress testing on network companies that face far less risk.
3. Boards have the responsibility to assess going concern which invariably already includes stress testing.

7 Corporation Tax

Question 19. Do you agree with our proposal to align the RIIO-3 tax approach with RIIO-2 and RIIO-ED2 including; to maintain Option A - notional allowance with added protections; the approach to capital allowances, and "glide path"?

We agree with a consistent approach across all energy network companies.

Question 20. Do you agree with the proposed revision to tax clawback methodology?

The Ofgem proposal to include cumulative accretion in the regulatory definition of net debt is not necessarily something we would immediately disagree with. However, we fundamentally disagree with the suggestion that this is not inconsistent with the existing Ofgem approach to exclude derivatives from the cost of debt allowance.

Hitherto, for its calibration exercise for the cost of debt allowance, Ofgem has excluded derivatives on the basis that:

- The debt allowance can reasonably be achieved using standard debt instruments and derivatives are not a necessary feature for the notionally efficient operator.
- Derivative use varies between licensees and is likely to reflect company-specific risk management decisions.
- Assessing derivatives at a single point in time creates complications where derivatives are used to profile cash inflows and outflows.
- The exercise to assess the overall value of derivatives over the full term would add significant complexity and amplify the time and resource burden of the calibration exercise.

The reality of the situation is that the index for the debt **allowance** is calibrated based on expected **actual** sector debt costs **excluding** derivatives.

It is now suggested that the net debt position within the tax clawback assessment should be based on **actual** costs **including** derivatives. It is also noteworthy that other areas such as performance assessment on the debt allowance within the Regulatory Financial Performance Report (RFPR) also contains this inconsistency.

The above highlights that calibration of the **allowance** and **assessment of the actual** company are both based on **actual** costs, but that bizarrely one excludes derivatives and the other does not.

This is a fundamentally inconsistent approach, and one that can be rectified by Ofgem despite its reservations listed above.

We remain unconvinced by the Ofgem assertions that analysis of actual company derivatives is too complicated. It seems that in other proposed areas in this SSMC (e.g. Financial resilience - the proposal to potentially look at Midco and Holdco debt) that Ofgem recognise that this is also a complex area (para 6.25) but do not conclude that it is therefore too complicated to look at.

Our position on this tax clawback question is that it needs to be set in the context of setting a consistent and fair framework across all aspects of finance policy. Ofgem need to land on a view to include or exclude derivatives within the wider framework and apply this consistently.

For the avoidance of doubt, our preferred position is to include derivatives within all the relevant policy and reporting areas, including cost of debt allowance calibration.

8 Regulatory depreciation and economic asset lives

Question 21. GD & GT: assuming re-openers are available and there is no adjustment to the allowed WACC, how should regulatory depreciation be used to address the uncertainty around the future path for gas and perceived asset stranding risk?

We broadly 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. We believe this remains the best approach for the electricity sector albeit with additional limited refinement for separate consideration of discrete groups of RAV additions.

Separately, we also recognise the challenges the gas sector faces and within this unique context we consider regulatory depreciation could be considered as a way to manage the appropriate return of value to investors for gas networks. Therefore, asset lives should be reviewed for this coming round of gas price controls in that context. Such a review could also consider the merits of any profiling to ensure the correct cost recovery between current and future consumers.

Question 22. GD & GT: what long-term path should regulatory depreciation aim to follow between 2026 and the assumed de-energisation point to promote fairness for current and future consumers? What unit metrics should this be based on? Is this resilient to the various scenarios under FES 2023?

We do not have any views on this question.

Question 23. GD & GT: assuming there is a relevant gas reopener for government policy, is there a need to reopen regulatory depreciation policy intra-period?

We do not have any views on this question.

Question 24. GD & GT: what considerations are raised by asset repurposing and how might these affect the decisions to be made on regulatory depreciation policy? What guidance is sought for the SSMD so that licensees have sufficient clarity for their business plans?

We do not have any views on this question.

Question 25. ET: do stakeholders consider there to be a need for amending the existing RIIOET2 asset life and/or profile assumptions, on either a company-specific or sector basis? If so, please set out your evidence base and potential consumer benefits and costs of changing the existing methodology.

We broadly 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.

In RIIO-ED2 the number of uncertainty mechanisms increased significantly with 33% of Totex allowances (pre-TIM) now subject to potential future funding[44]. This compares to RIIO-1 where uncertainty mechanisms accounted for 10% of Totex allowances[45]. Although Ofgem sees this as a risk mitigation measure, it can also be seen as increasing risk for companies as future funding remains uncertain which will inevitably have knock-on impacts for resource planning and procurement. With this in mind it seems sensible to look at complementary depreciation options with potential risks of stranding, particularly with technological investments, a real risk on an uncertain path to Net Zero. It makes sense to revisit new asset additions to the RAV and consider them in discrete groupings that have similar characteristics e.g. capitalised items that have short asset lives e.g. technology-related assets. Increased use of uncertainty mechanisms with potentially differing risk profiles lends itself to separate limited consideration of other depreciation options. Cyber is a prime example of this where there will be a material amount of discrete capitalised expenditure that will have a much shorter asset life than most other assets. Treatment of subsets of new RAV additions, on suitably discrete asset sub-classifications could be different to reflect the risk faced to each.

Ofgem should be mindful of the impact of a one-size-fits-all policy beyond a single 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 RIIO-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 and should be seen as part of the development of the PCFM raised in question FQ38. We also note from paragraph 5.14 that Ofgem is considering incremental improvements relating to financeability which is something we support.

Question 26. If a 'semi-nominal' cost of debt and WACC approach were to be adopted which results in an acceleration of cashflows, would this impact your responses to any of the Questions above?

Application of depreciation policy should reflect the risk of asset stranding and should be calibrated to avoid this risk. Companies expect to receive RAV back in full which is a well understood and long-standing regulatory cornerstone. Other policy choices that appear to accelerate cashflows should not be used to mask risk issues here.

[44] ED2 PCFM (December 2023)
[45] ED1 PCFM, November 2021

9 Return Adjustment Mechanisms (RAMs)

Question 27. Do stakeholders have views or evidence as to why RAMs should or should not continue?

At RIIO-2 we set out our concerns about the introduction of a RAM mechanism, which, under a properly calibrated price control, we saw as unnecessary. We also set out why we believed that its partial application that ignored financing and tax, effectively skewed it as a mechanism to protect customers from perceived excessive equity returns, but did not consider the effect of financing and tax on those equity returns.

We still 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 also be included within the mechanism.

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.

Question 28. Do stakeholders have views or evidence as to whether the RAMs methodology should be amended, such as recalibrating the threshold or rates or including financial performance?

As outlined in question FQ27, we believe RAMs should include financing and tax, as equity has to pick up the impact of financing and tax performance and therefore assessment of equity is incomplete without them. Therefore, we would advocate for a change in this, but given RAMs has only just been introduced for RIIO-2, there is no evidence to suggest that recalibration of the threshold is necessary or justified.

Question 29. Do stakeholders have views or evidence as to whether there should be separate RAMs for 'BAU' parts of the business and specific programmes, such as ASTI?

Component parts of the price control should be appropriately calibrated. A RAM takes a holistic view, and should remain as such, if this type of mechanism is to remain in place. It makes no sense to start applying RAM-type adjustments to individual policy components.

10 Other finance issues

Question 30. Is there a case for altering the capitalisation rate modelling approach between sectors (eg removing the multiple bucket approach for GD)?

Yes, capitalisation rates should reflect natural rates based on accounting distinctions as assessed ex-ante. As we have previously stated at RIIO-ED2 we could also support well understood moderate adjustments deviating from the natural rate where justified and agreed between networks and Ofgem.

We have concerns about:

(i) Excessive deviation from the natural rate: Ratings agencies may see it as an artificial construct thereby rendering any limited financeability actions ineffective.
(ii) Using ex-post rates to reflect reported outturn proportions for Capex and Opex: Ofgem moved to ex-ante rates for RIIO following concerns about distorted decision making. Use of ex-ante rates provide predictability and certainty, and the scope for a material ex-post true-up of RAV could undermine this, especially when financial covenants are dependent on RAV. In the extreme this could lead to breaches in those covenants, so should be avoided.

Question 31. What are your views on retaining an ex-ante capitalisation rate for allowed totex, but reporting an outturn capitalisation rate for the purpose of calculating the totex incentive mechanism?

Please see our response to FQ30.

Question 32. Are there any reasons why the RIIO-3 approach to directly remunerated services should differ from RIIO-2?

At this stage we do not believe there is a need for the approach to differ from RIIO-2. This view could change as policies evolve over the RIIO-3 process. Ofgem consolidated all DRS's into a common approach for RIIO-ED2, but for the avoidance of doubt we have taken this question **not** to relate to ED sector specific DRS's.

Question 33. Do stakeholders have any reasons or evidence to suggest more directly remunerated service categories are necessary?

See our response to question FQ32.

Question 34. Do stakeholders have views or evidence in support of or objection to treating all asset disposals as fast money? Would the existing or alternative approaches have greater merit?

We have no evidence to support treating all asset disposals as fast money. In the absence of evidence one way or another, our preference would be to retain the current approach thereby maintaining predictability and stability. A move away from the current approach might also raise concerns that the treatment would not be consistent with the assumptions embedded into the original allowances.

Question 35. Do stakeholders have views or evidence as to what reporting information should be provided to Ofgem (under the RPFRs or other forms) to ensure objective identifiability of repurposed assets and cost data remains appropriately like-for-like?

We do not have any views on this question.

Question 36. Do you consider that the existing reporting requirements on executive pay/remuneration, dividends and corporate governance previously introduced for RIIO-2 price controls remain appropriate in helping demonstrate the legitimacy and transparency of company performance?

We have previously supported 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 sets of guidelines. Change control in this area has always been subject to a rigorous independent process with extensive consultation.

On whether the RIIO-2 price controls remain appropriate we note the following:

(i) Dividends: We are happy to continue reporting actual dividends as required under current reporting rules. We agree 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.
(ii) Executive Directors' Remuneration: We continue to support disclosure that aligns with statutory reporting requirements. 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.
(iii) We agree that transparency is important but that there is no need to examine MidCo and Holdco companies as the proposed rating obligations in the SSMC for the regulated company should cover any issues of financial resilience at MidCo and HoldCo as their ratings are directly linked to the OpCo rating. Please also refer to question FQ17 for further detail.

Question 37. Do you have any other suggestions for clarifying or strengthening the reporting requirements with regard to executive pay/remuneration, dividends or corporate governance?

As discussed in FQ36, we have reservations about those policy areas that go beyond Statutory requirements. We view going beyond these requirements as unnecessary and adds to Regulatory burden.

Question 38. Do you have any suggestions on how to improve and future-proof the price control financial model, or use cases it could better support?

There is a tricky balance that needs to be addressed in that future-proofing a model requires longer-term regulatory framework policies to be in place such that regulatory changes from price control to price control are an evolution rather than a revolution. Radical changes to policy inevitably require significant changes to the model underpinning them. Therefore, we see consistent long-term policies are a prerequisite for future-proofing the PCFM.

Further to consistency, we also support removal of unnecessary complexity where it does not have an adverse effect on outcomes. Simplicity for simplicity sake is not a fundamental principle that should be adopted. Therefore, in areas that demand extra complexity to deliver accurate and fair outcomes, investment in making the model representative should be made. An example of this is capitalisation and depreciation where there are good arguments to retain/develop the modelling to deliver a fair outcome.

Our third recommendation would be to use the prior price control's model as a starting point to build the business plan financial model for the next price control. Naturally this is dependent on the first point we raised (i.e. the extent to which the regulatory framework is changing) but significant time and resource is applied in developing and implementing a model, so it is worthwhile utilising this as a starting point if it can be.

It is also unnecessary to retain two business plan models: one that contains a suite of extra financeability information and the other used for the subsequent ongoing price control. Ways should be sought to rationalise these down to one model, with the more detailed and "extra" information being available to networks on an ongoing basis. If there's a need to exclude information due to confidentiality, then structuring the master model such that information can easily be deleted should be the way forward.

Financeability testing is an important part of the model. The time horizon for conducting such an important exercise is currently restricted to the price control period in question. This needs to be extended such that the financial effects of current policy changes can be seen on the future company. Further to this, and as set out elsewhere in this response, it is important that all companies are dealt with fairly so that they can deliver the challenges of Net Zero. Notional company considerations should be grounded in real-world expected outcomes for actual companies.

Question 39. 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 had no concerns about licensees taking responsibility for ownership of the numbers and process for the PCFM, and on this particular policy point see no reason why this should not be consistent across sectors.

Question 40. What are your views on applying a single time value of money in the financial model to all prior year adjustments, based on nominal WACC?

We set out in our RIIO-ED2 response our considerations of the differing circumstances in which a time value of money adjustment would be needed and what the appropriate rates might be for each. We concluded that if Ofgem wanted to pursue a single rate across all prior year adjustments then we believe this should be WACC. We remain aligned to this view, and see no reason why sectors should be treated any differently in this respect.