RIIO-3 SSMD investor call transcript

July 18, 2024

Akshay Kaul 0:39

Great. Welcome everybody. Good afternoon and welcome to this investor call on the RIIO-3 Sector Specific Methodology Decision. My name is Akshay Kaul, Director General for Infrastructure at Ofgem and I'm joined by my colleagues from the price control team and they will introduce themselves in due course. But just to give you a very quick overview of the call, I'm going to start off with some words of introduction and an overview of the policy framework for the price control as a whole. I'll then hand over to my colleague Mick Watson, who's our Chief Financial Advisor to go through the specific areas that deal with regulatory finance and then we will have a considerable amount of time for questions and answers. And I will go through the instructions for the Q&A just before we begin.

Just to note that this call is being recorded and will be made available with transcripts as usual via our website, so that you can refer to it later on if you need to. A huge thanks to everybody who's made the time this afternoon to be with us. The Sector Specific Methodology document that we published this morning is an important milestone in the process to set the regulatory price controls which will begin from the 1st of April 2026 and will cover the five years of the remainder of this decade and therefore are pivotal in the net zero transition to this new government's ambitions for a clean power system.

We set out our framework decision for these price controls back in October of last year. In December, we published a much more detailed Sector Specific Methodology Consultation document.
And today we have published our Sector Specific Methodology Decision and the suite of business plan guidance and templates that the industry will use to formulate and then submit their spending plans towards the end of the year back to us. We are really grateful for the extensive engagement that we have had to date from a broad range of stakeholders and that has really helped to shape our decisions, I firmly believe for the better.

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So these are some of the main outcomes that we're seeking to achieve with this next forthcoming price review. First of all, we want to put in place infrastructure, energy infrastructure that's fit for a low-cost transition to net zero. The network companies must facilitate a low cost, environmentally sustainable and low carbon energy system that enables the transition to net zero with infrastructure built at pace. This is vital for the rest of this decade because as we all know by now, the scale of network investment that's needed to get to the government's net zero targets is at a rate that has not been seen for decades in this country.

Secondly, we want to ensure that as we go through this transition to net zero, we maintain secure and resilient supplies of energy and so network companies must deliver a safe, secure and resilient network that's efficient, data rich, and is responsive to change. Consumers should have access to gas and electricity supplies that are resilient to physical, financial, climate and cyber shocks.

Thirdly, we want to make sure that consumers get a high quality of service from the regulated utilities in this price review. Network companies must deliver a high quality, reliable service to all consumers and network users, including and importantly those who find themselves in vulnerable situations.

And finally, we want to promote system efficiency and long-term value for money. Network companies must deliver in efficient cost of service, minimise the cost to consumers of the system transformation to net zero and ensure that consumers and network users get a fair deal.
If you can go on to the next slide, please.

I'm now going to go through, very briefly, some of the key points that deal with the electricity transmission sector and then I'll cover off similar set of points to do with the gas sector. So in ET, electricity transmission, our principal focus is acceleration with accountability. Acceleration of the infrastructure that's going to be needed in the right place at the right time while maintaining a good quality of service and good asset health. And accountability for delivery time and budget of the huge spending in CapEx that's going to be needed for net zero.

Secondly, we want to bring greater certainty to transmission owners, to the supply chain and to financial markets by setting out a stable, transparent and very visible pipeline and a stable financial framework for the regulated utilities.

Thirdly, we want a flexible and proportionate regime that allows the acceleration of large capital projects in ET. This will involve some degree of consolidation of the existing bespoke regimes that we've had under RIIO-ET2 to respond to uncertainties, but it will also feature a much more prominent role of centralised planning through the National Energy System Operator that are there's increasingly commissioned to draft special plans that underpin our future price controls. It'll also feature automatic early development funding, so transmission companies can get on as quickly as possible with developing projects that are needed to anticipate demand towards these net zero targets. And it will have protection mechanisms that we will use to hold the transmission companies to account for on time efficient delivery of projects.

Fourthly, we want to really focus on what we can do to secure the capacity to overcome the supply chain challenges that we're seeing in the market at the moment. Obviously, many countries around the world are all trying to transition to a cleaner system at the same time and that is putting a lot of pressure on supply chains and we will play our part in putting in place supply side interventions to simulate long term capacity growth now and we will still expect transmission companies to take the action that they can to mitigate increases in prices and develop capacity and capability in their supply chains, building on the pipeline of work that is going to be highly visible and transparent for everyone.

Fifthly, and very importantly, as you probably know, we have a very major connections review ongoing where the government, the regulator and the system operator are working very closely together on solving the connections problem. And there are two parts to this connections problem. There is a queuing process which is quality and we need to reform that queueing process so that viable projects get to the front of the queue as quickly as possible. But there is also a network capacity challenge to put in place all the enabling works and connection assets that that are going to be needed and that is where we're going to be consulting on incentives to promote faster connections in ET later in 2024.

We want a consistent package of incentives in areas that deliver direct consumer value and we've set that out as part of this SSMD publication across the rest of the ET sector. And all of this is underpinned by a stable and predictable financial package with what we think is an appropriate balance of risk and reward. And my colleagues are going to talk a bit more about that in a minute. If you can go on to the next slide. So a very quick overview of the gas sectors. We tend to focus quite a lot on electricity because of the net zero context. But gas is essentially important as a fuel, as a transition fuel to keeping secure supplies through this transition.

Therefore, we are completely focused, as is the industry, and continuing to have safe, resilient and reliable gas transmission and gas distribution networks that remains a paramount importance for consumers, but we also need to balance the investment that has to be made in these networks to keep them safe, resilient and reliable with the uncertainty, the inevitable uncertainty, that we see around the future of gas, particularly the future of gas demand and the future of the gas networks.

We are introducing net zero uncertainty mechanisms that will ensure that our approach to the gas sector is flexible to accommodate government policy changes as we get new government policies in the years ahead and support a low cost transition, including on the question of whether or not to decommission any assets and repurposing them for hydrogen. We will not be providing upfront funding for decommissioning at this stage.

We think that will be pre-emptive and premature. We are instead going to wait for government decisions on the scope, timing and funding sources for something like this, particularly once there is clarity around the government decision on the future of heat. However, we are going to accelerate the speed at which gas network investment is paid back through regulatory depreciation charges on bills to protect both future consumers from paying disproportionate sums of money for the services that they receive and to protect investors from any kind of stranding risk.

We will continue to work with government to ensure that the transition to net zero is fair and at the lowest possible cost to consumers.
If you can go on to the next slide, I think at this point I'm going to hand over to my colleague, Mick Watson, who's going to talk through the financial framework.

Mick Watson 11:05
Thank you, Akshay. Good afternoon. My name is Mick Watson. I am the Chief Financial Advisor at Ofgem and I'll be taking us through the highlights of the decisions we have made following our consultation on the financial framework for RIIO-3.

Before I begin, I would like to thank all the stakeholders who have contributed to the consultation. We have carefully considered this evidence when making our decisions and this input is absolutely vital to ensure that our decisions are fair and appropriate. This breadth of input and evidence is especially important as we enter the pivotal period for the energy networks and where Ofgem has such an important role to play in enabling Great Britain’s transition to net zero.

We are confident that the methodology decisions we have published today give us the flexibility to adapt to evidence and set the financial metrics for RIIO-3 to help to protect consumers, provide sufficiently fair returns to investors updating for any change in risk within the sector, and ultimately support investment in the sector through this price control period and beyond. I would like to stress that these methodology decisions. Final decisions on areas such as allowed revenue will be based on these methodologies and confirmed in draft and final determinations in 2025.

Much of the approach described in RIIO-3 methodology decision document will be familiar to investors in the sector. We think the stability where appropriate is a really valuable feature. We've retained much of the approach used in RIIO-2 and have looked to make a small number of improvements to reflect new evidence and best practise in areas such as calculation cost of capital.
We've also made more structural improvements in areas such as the treatment of inflation and the approach to regulatory depreciation in the gas sector, where we think there is a material benefit to both consumers and investors for doing so. In

today's presentation, we will focus on the key decisions in relations to the cost of capital, treatment of inflation, WACC and financeability, regulatory depreciation and financial resilience.

I will ensure that there will be plenty of time to answer any questions you may have. We will start with equity returns in relation to what we describe as step one of setting allowed returns and equity assessment of the market cost of capital. Our approach remains largely in line with both RIIO-2 and the 2023 UKRN guidance on this area.

So our estimate is based on CAPM. The risk-free rate continues to be based on 20-year index linked gilt yields, with an update to more accurately reflect the upcoming changes to the calculation of RPI. Our TMR approach is updated for best practise to incorporate OMS-back cast CPIH data when calculating historical returns.
We have also updated our approach to also include ex ante analysis in line with the UKRN guidance and the approach used by other regulators including the CMA.
Our beta range reflects modelling across the time horizons, although I would flag that in our final determinations we are likely to focus on the longer horizons.

At this point in the process, we are comfortable with the wider beta range as we continue to evaluate the range of risk and mitigations within the overall package.
We have also flagged the potential to place weight on European comparators to improve accuracy and capture energy network risk factors, which will be subject to assessment of regulatory alignment.

Also, in line with the approach taken in RIIO-2, we will use a step-two element within the allow return on equity setting process to ensure that our cost of equity assessment leads to an allowed return that is appropriate and in line with our duties.
We consider the investability of the sector in all our decisions across the wider regulatory framework and within the financial framework.

Where possible, we've tried to address potential changes in risk exposure at source, be it within the regulatory package itself, by balancing risk between consumers and investors by tools such as uncertainty and topic sharing mechanisms.

We're mitigating supply chain risk by preconstruction funding and advanced procurement mechanisms and more spoke cost assessment approach for CapEx or through the regulatory framework such as by the inclusion of new beta comparators within the cost of equity assessment improvements to the cost of depth methodology to ensure announced sees adapt quickly to market conditions and anticipated spend and through further acceleration of depreciation in the gas sector.

We have explained the specific factors we will consider in RIIO-3 to help ensure that our allowance remains investable, especially considering the likely requirements for additional equity to be raised to support investment in the electricity transmission sector.

Here we consider issues such as any changes to the overall company's risk exposure on a forward-looking basis, cross checks to our allowed return against other market data and assessment of the best way to ensure that equity issuing costs are fairly captured and compensated.

We remain confident that our existing tools and methodologies will lead to a return that's fair to investors. However, we also have the toolkit to adapt to emerging evidence on both the risk space by the networks and the market cost of equity, allowing us to set an appropriate level of compensation for investors in our draft and final determinations.

In terms of Return on Regulatory Equity (RoRE), which is the measure of returns that factors in base allowances and both financial and operational performance, we expect RoRE ranges in the gas sectors to be broadly in line with those in RIIO-2.

For Electricity Transmission, there is the potential for a larger RoRE range, driven by agreed ASTI delivery incentives, while we will seek to maintain a broadly neutral risk profile for totex and non-project delivery incentives.

Return Adjustment Mechanisms (RAMs) are a really important mechanism within the RIIO financial framework. RAMs help to protect consumers from subsequent RoRE outcomes that are too generous to companies and they protect investors from RoRE outcomes that might unreasonably threaten financeability.

We expect to deploy RAMs in a very similar way to RIIO-2, although in electricity transmission we are considering whether it will be beneficial to separate separately account for performance in major projects, so that the underlying business as usual performance does not get swamped.

This is an issue we'll consider further and discuss in draft determinations.
In terms of financial performance, we continue to believe that this should be excluded when calibrating RAMs, as we believe that financing strategy risk should remain with companies and their investors and should not be passed on to consumers. We are, however acting to address important areas of potential financial outperformance in relation to the inflation leverage effect which I will discuss in more detail shortly.

In terms of allowed return on debt, there are two incremental improvements we are making to the methodology, and one more substantial change in relation to the way we factor in inflationary returns. On the incremental improvements, we have decided to split the debt cost cohorts between electricity and gas. It should help us to ensure that allowances remain appropriate if differences in debt issuance patterns between the sectors emerge owing to the transition to net zero.

Similarly, we have decided to broaden the use of RAV weighted allowances in the electricity transmission sector with National Grid and Scottish Power moving towards an approach similar to that already used with within SSE SHET. This should help ensure that the assessed cost of debt can react quickly to market moves and the level of required debt issuance so that out allowed return on debt is as fair and accurate as possible.

Other elements of the allowed return on debt methodology remain in line with RIIO-2, although the assessment process will be conducted and calibrated for the draft and final determinations following the assessment of business plans and other evidence we may request from the companies.

Moving to the treatment of inflation, within the allowed return on debt. Our decision reflects the culmination of extensive piece of work that began with our call for input back in August 2023. As a reminder, this is in relation to the movements of returns based solely on deviations of outturn inflation from the long term CPIH assumptions utilised to deflate the cost of debt allowance.

In the SSMC, we laid out three potential options to address this feature within the financial framework. As a reminder, option one consisted of moving to a nominal allowance for fixed rate debt. Option two, consisted of a fixed deflation and indexation parameter for fixed rate debt and option 3 consisted of maintaining the current methodology, but considering whether there was a better long term inflation assumption.

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After careful consideration of the issues and the evidence we received during the consultation, we have decided to implement option one and move to a nominal allowance for fixed rate debt. This will mean that the network companies will receive the cash element of the fixed rate debt proportion of the allowed revenue in normal terms, and the equivalent proportion of RAV will not be subject to ongoing indexation.

The assumed amount of index linked debt within the national capital structure will remain the same and will continue to be treated broadly in line with RIIO-2, ie. this proportion of the RAV will continue to be indexed to outturn inflation. The impact of this change is that cash allowances in year will be higher and RAV growth overall will be lower than the approach used in RIIO-2, all other things being equal.

Assuming that the long run inflation outcome is 2%, the change is NPV neutral for the network companies, but will help to ensure that cost bound by consumers remain fair in the event of macroeconomic inflationary shocks. While the decision is appropriate and on balance beneficial to both consumers and investors, we understand it represents a more substantial adjustment to the methodology used in RIIO-2 and previously, so we will engage further with the network companies on the implementation of these changes in the coming months.

Just to flag why we have not chosen to implement option three to directly address the inflation affect, we will move to using the Bank of England's 2% CPI target as an ongoing assumption for long run CPIH when considering the residual index linked debt portion of the allowance. We anticipate that the approach to WACC &

financeability will be very similar to RIIO-2. We currently expect to utilise the same notional capital structure used for the sectors in RIIO-2, so 60% for gas and 55% gearing in electricity transmission.

However, we will update this assumption in draft determinations if there is evidence from business plans that would justify change. The overall approach to financeability will be very familiar, although we look to make incremental improvements to our assessment where appropriate, such as using a wider range of credit ratios and extending the horizon of the modelling.

We will also switch the base in the assessment on the analysed cost of debt rather than the allowed return to remove the perverse outcome, where increasing the allowed return on debt actually hardens the financeability assessment.

Now turning to regulatory depreciation. For the electricity transmission sector, we do not currently anticipate a need to change the approach used in RIIO-2 and will continue to use the 45-year asset life assumption. We will check that this continues to match the available evidence following consideration of the information in the network company's business plans. The dynamic in gas is very different and we have carefully considered the potential impact on consumers and companies associated with the government's target to reach net zero emissions by 2050.

This is a complex topic with important potential trade-offs between generations and cohorts of consumers. However, we remain of the view that failure to take action in RIIO-3 is likely to increase the challenge in future periods and may lead to particularly acute burdens on those least able to adapt their situation to the changing energy environment.

We have decided to further accelerate depreciation in the gas sector and target the repayment of investment in the RAV for the gas distribution sector by the government's net zero target date 2050. We may ultimately take a slightly different approach for the gas transmission sector, where we see a potential greater role for asset transfer to alternative uses.

As I mentioned, this is a complex topic and so we will continue to engage with stakeholders during the second half of this year on how we can best implement these decisions. In the SSMD, we lay out the key criteria we will use in this process, focusing on the bill impacts both now and in the future. The potential to mitigate investors' concerns or perceptions around the asset standing risk and the potential impact on financeability of gas network companies.

The final sets of decisions I would like to highlight to you relate to financial resilience. It is vital that however strong our starting point, we remain vigilant and look to make improvements that can help to protect consumers from the harms associated with financial distress.

With this in mind, we have taken forward the three sets of proposals laid out in our consultation. This means that we will require companies to have two investment grade credit ratings, we will require that companies demonstrate the availability of resources over three years or to the end of the price control period of longer, and we will introduce a dividend lock up based on the earlier of reaching a BBB- or equivalent rating with a negative outlook, or a 75% regulatory gearing.

Given the current financial metrics in the sector, we see these measures as bringing in meaningful further protections for consumers, specifically around extreme outcomes at little to no cost to responsible companies and their investors.

So to sum up, I would like to remind everyone that the decision we have published today are methodology decisions not final numbers, however, we do think that these methodologies do give us the tools we need to set those final numbers in 2025 in a way that protects consumers, provide suitable returns to investors and ensure that we are supporting the vital investments that the industry will have to undertake if we are to help Great Britain reach its net zero ambitions.

There are some areas where the implementation of our decisions will be particularly important and where this is the case, we'll be in touch with stakeholders to lay out how we can engage further to ensure that we get the best possible outcomes. We also build on our work and incorporate evidence on companies' business plans wherever this is appropriate.

I will now pass back to Akshay to open up the call for any questions.

Akshay Kaul 28:48
Very good. Thank you, Mick. And yes, so we're into Q&A now. So if you want to ask a question, please use the hand raise function in the chat. If you're joining via phone then please type *5 on your keypad to raise your hand and when it is your turn, your microphone will be activated. You will need to unmute yourself and please type *6 on your keypad to unmute yourself. Before asking a question, it will be really helpful if you could please say your name and your institution.

So I think we're ready to kick off and I think the 1st hand on the call is Deepa Venkateshwaran. Deepa, please go ahead.

VENKATESWARAN Deepa 29:47
Hi, thank you for taking my question, Akshay. I had two questions. I think the first one is on this concept of investability for ET3. So of course you have changed the cost of debt methodology recognising the CapEx. But I think previously when we had a call in December, I think there were also hints that you know you may look at different betas for gas versus electricity transmission.

So I wanted to understand how Ofgem is thinking about aiming up perhaps in the beta for ET. And I know in the document it talks about not necessarily using the midpoint of the range, but I don't know if that was a subtle hint at the possibility of aiming up on the betas for ET specifically. I think that was my first question and the second question a little bit more technical is on the RPI, CPI inflation wedge that's used. It's now 11 basis points and the methodology’s changed.

I think in ED2 it's significantly higher at 70 bps and we saw a different number from Ofwat. So could you maybe explain what's going on with the inflation wedge and how we reconcile that with the OBR forecasts for the current year, but as long as they go, they still have almost a close to 100 bps difference in their forecast of RPI versus CPI. And I know it's going to merge at some point, but at least for the first few years, there's going to be that wedge and how does this 11 bps take that into account? Thank you.

Akshay Kaul 31:23
Yeah, of course, Deepa, thank you so much. And both really, really good questions. Chris, do you want to take both the question on the asset beta and aiming up and the CPI RPI.

Chris Connor 31:38
Yeah, I can take both those. Good afternoon, everyone. Chris Connor and one of the analysts in Mick's team. So on the beta, we have a deliberately wide range at the moment, and I think that gives us the scope and to keep considering the evidence and make sure that we do get to the right number for both sectors. That number might be the same or it might be different. I think there are arguments about higher or lower risk factors in both sectors.

Part of the reason for wanting to bring in European comparators is that it gives us a mixture of ET, GD and GT comparators. I think overall I would prefer to use information like that if we can get comfortable with it rather than making subjective changes to the beta just because, as with all our decisions, we try to make those as evidence based as possible, so no final decisions there. But we think we've got the tools to get to the right beta number for each of the sectors as we approach DDs.

On RPI / CPI. Yes, the approach has changed a little bit over time. If we go back to GD&T2, the approach was based on the 5th year of estimates of RPI and CPI. In ED2, we talked about 2 methodologies. The 5th year approach or the geometric wedge that we've used this time around. I think back then there was maybe still some questions around what would be happening with RPI transition and whether it would go through. I don't think those questions exist now we've had the BT pension court case and I think everybody's pretty settled that that transition will happen in February 2030. So it's a change, but it just reflects we are much closer to that point where the wedge will be 0 and it's a largely mechanical update.

So if you look at the two approaches at the start of the price control, five years from that point, the wedge will be zero. We think that the geometric wedge that we're using is a better indication of how that might be priced into a 20-year instrument that we're using for the risk free rate.

VENKATESWARAN Deepa 33:44
Thanks very much.

Chris Connor 33:45
Does that all make sense?

Akshay Kaul 33:47
Thank you, Chris.
I think our next question comes from Jenny Ping. Jenny, please go ahead.

Ping, Jenny 33:55
Hi, thank you very much. A couple of questions please.

Firstly, just on the investability point. Can you talk a little bit around the fast slow money split that you're thinking about on, specifically looking at electricity transmission, what your latest thought process is there on trying to accelerate some of the cash to ensure investability in the sector.

Second question is with regards to the potential sixty basis points of additional return on equity. Are you going to cap the number of companies who can technically achieve this sort of exceptional plan, or can everybody actually put forward an exceptional plan? And just on that basis is there going to be an explicit reward for having a fully funded plan from an equity basis?
Thank you.

Akshay Kaul 34:59
Chris, I wonder whether you want to take the finance question and then perhaps, Steve, you want to comment on the business plan incentive?

Chris Connor 35:08
Sure, pretty short answer. We don't anticipate the capitalisation rate or the split of fast / slow money being a major driver of investability at this stage. A working

assumption is that will remain largely in line with a sort of natural rate unless we get further down the process and consider the evidence to change that. But at the moment we think the existing tools and getting those allowed returns right are the bulk of the approach to ensuring investability plus the risk mitigation and risk sharing measures we've talked about through the rest of the control.
Steve, on the business plans?

Steven Zhang 35:44
Thanks, Chris. On this business plan incentive, I think just that part of the question around whether there is an opportunity for everyone to be able to go and get the rewards. If you look at the three stages, stages A and C broadly, the same for all sectors and companies. On stage B just where there is some natural differentiation because of the way that we've set up stage B, which is around cost assessment. This is trying to incentivise companies to put forward the most efficient plans upfront and the way that we've designed this is to reflect that some costs are more benchmarkable, and comparative and other cost are more bespoke.

We find very difficult to benchmark those. And in order to protect the different consumer interest implications of the two different buckets of cost, there's a slightly different nuance in how we've set the cap and collar for those two buckets of cost under stage B and that will lead to natural variations in the effective overall strength of the BPI, so it might be slightly less than 60 basis points for companies with a high mix of, say, bespoke costs versus comparable costs.

On the second part of your question around having a fully funded plan. We think something like that should be captured under stage C, which goes partly to assessing the deliverability, credibility of business plans being submitted. And so it is conceivable that having a fully funded plan and robust funding plan with a good amount of financial resilience that that should factor into this kind of deliverability aspect of stage C. And then it will be one of a number of considerations as part of the balanced scorecard approach that we are taking at SSMD.

Ping, Jenny 37:45
Brilliant. Thank you very much.

Akshay Kaul 37:47
Thanks, Jenny, and thanks Chris and Steve for those answers. Our next hand up is from Dominic Nash. Dom, please go ahead.

Nash, Dominic 37:56
Hiya, can you hear me OK?

Akshay Kaul 37:58
Yep, loud and clear.

Nash, Dominic 37:59
Thank you. Can I have a couple of questions for me please as well. The first one is, could you provide some colour on how are meant to look at the risk-free rate in light of the potential inflation numbers? Because I think in your PCFM you're 2.4 / 2.7% for this year / next year as a risk-free number and you've come in at 1.1. And then that implies if you're using a 20-year index linked gilt, I think about 3.5% or so implied RPI, which is of course as an early question as Deepa asked means that's the same CPIH. But then you put 2% CPIH through in your models. And on your cost of debt allowances as you go into nominal. So the first question I've got, can you just talk through is this inconsistent or how do you get those two inflation numbers to work in the models in an NPV neutral way. And then the second question I'm going to ask is on betas on your philosophy of looking at this. Do you think that the cost of equity numbers should be more flexible and more reactive to ongoing sort of market and beta rates, or do you think it should be a more longer term stable sort of beta number taking into account 10-20 years' worth of data? Where do you think your stance is on what sort of timeframes you're looking at? Thank you.

Akshay Kaul 39:46
Thanks, Dom. Again, Chris, do you want to take those two?

Chris Connor 39:51
I'll take a stab at that slightly technical answer to the risk-free rate question. I think it's combination of two things in terms of that 2.7 number and why it's quite different to the number we've got in the early view.

One is around that was probably the peak of rates when we set that ED2 number for 23/24, which is in October 23, so gilt yields were about 1.5% of that point.
And then the fifth year RPI-CPI difference was about 1.2%. And so that's how you get to the 2.7.

It's a slightly cleaner methodology I would say in terms of the RIIO-3 approach. So we've just got the underlying yield plus this geometric assessment of the wedge going forward. And it's just that we have set that on the 11 bps as if we're at the start of the price control just to give less variabilities as we go through the process. If we did that today, it'd be about 35 bps, just reflecting the weight of time where there is any wedge and where there's a zero wedge.

And we can maybe run through the mass of that offline if helpful. I think our approach is very, very similar, if not identical to the official forecast approach that the companies and their consultants have used as well. Just they've based the number on as if you measured it today and we've based it on as if you measured it at the start of the price control.

On beta, we have looked at 2, 5 and 10 years to build the overall range at the moment, but we've flagged we think 10 year is probably where we're most comfortable. That look back helps give a picture of beta through the cycle, but it's not using such historic data that it's bringing in evidence that's maybe not comparable anymore in terms of how companies have changed their composition or how risks may have changed. So that in our view balances those elements appropriately and we said most weight is likely to go in that as we get to draft and final determinations unless less evidence emerges that we shouldn't do that.

Nash, Dominic 42:03
Sorry so I can just follow up on the on the answer to the first question though, which is the implied inflation in your risk free is about 3.5%. Yet, when I look through your data, you're using roughly 2 ish for the next for the next period.
Why are they different?

Chris Connor 42:25
Is this on ED2?

Nash, Dominic 42:29
No, no. RIIO-3. If I look through your CPIH forecast numbers, you're using 2ish% percent into the third review in your documents.

Chris Connor 42:44
Might need to follow up with that offline just to make sure I'm precisely answering your question there and making sure that I'm giving you what you what, if that's OK.

Nash, Dominic 42:54
Yeah. No, no worries. Thank you.

Chris Connor 42:56
Yeah. If you let Jamie know, we'll make sure we follow up on that.

Akshay Kaul 43:01
Great. Thanks, Dom and thanks Chris. Next hand up is Pavan Mahbubani I think. Pavan, please go ahead.

Pavan Mahbubani 43:12
Hi, guys. Afternoon. Thank you for the presentation and for taking my questions. I have three please. The first one is again on beta and if you can please talk about how you came to the current asset beta range, and I ask this looking at table 10 in the Finance Annex where your range of 0.3 to 0.4 does sort of capture the bottom end of the range from some of the comparators but doesn't capture the top end in that table. So it feels like it's skewed more toward the bottom end, and I was just wondering if there's any anything we should be reading into that? And just the point of clarification on one of Deepa's questions, is the expectation that we will have a different beta for ET versus the gas price controls. And then hopefully by other two questions are a bit quicker on gearing. If we expect 55% gearing for the ET3 price control, if I recall from T2 you set a vanilla WACC and then even though your gearing changed the allowed cost of equity, the vanilla WACC stayed the same. Do you intend to use that same methodology or are there going to be changes to your thinking on the relationship between gearing and WACC. And then my final question is on investability. The feedback we've gotten from some investors today is there's

still not much clarity on how you're going to reflect that notion of investability in the price control. I guess the question is, are there any decisions you've made today that you would point to investors that should give them that comfort that you are thinking about investability today given it's a few months since you've introduced this, or do you think that's something we're going to see more this time next year?

Akshay Kaul 44:57
Thanks, Pavan. I think I'm going to go back to Chris and then Chris can obviously bring some other colleagues in on some of the gearing related questions as needed. Chris, over to you.

Chris Connor 45:08
Yeah, probably me again, I'm afraid. On beta, there is a lot of judgement that goes into building that beta range. It's got the same midpoint as RIIO-2, but we have extended it from .32 to .37, to from .3 to .4. So I think we're trying to signal that we see the potential for a different position in that range or for a wider range of potential outcomes, but we need to do the work. The low end roughly represents where the water companies might be positioned, the top end closer to where the European comparators would come in in the middle around the National Grid figure, so I think there's lots of work still to do there. I don't see it particularly skewed unless we've placed a lot of weight on those European comparators and we still have some work to do to make sure that the regulatory regimes there are as comparable as we need them to be. We haven't decided on different betas for gas and electricity.
As I mentioned before, different issues in both sectors. I think the network companies would argue on both sides of the coin that they see increasing risks. We need to understand those dynamics. They might go in similar directions, they might not. They might have similar mitigations, they might not. So there's still some work to do there. They will exist in that range I anticipate, but they may be similar, or they may be different figures.

In terms of the approach to WACC, I think that will be done on 1st principles.
So we will regear the asset betas to 55% unless there is evidence to do differently. I know that's a slight difference to RIIO-2. I think this is probably a better approach, but we will consider evidence on that. But as you look through the entirety of the finance annex, we have tried to simplify and stick to first principles wherever we can

and this is another one of those examples.
And then on investability. I think two big things for me. One is that investability is not new as a concept. We've maybe not used the language before, but all of our past price controls were also investable. So in introducing the language, what we've tried to signal is that we are really alive to the challenges that the network companies might face, and that we are ready and willing to look at the evidence around risk and reward and that balance to make sure that we get the number right because we know how important it is as both Mick and Akshay have said to get this right to support investment.

I'd also think about where we are in the process. We talked about the potential need to increase our efforts here in the framework decision. By SSMC we laid out how we might tackle that, and in this methodology decision we've started to layer it through the entire control. So, we've got measures in the regulatory framework itself that help to balance that risk and support supply chains. We've tried to make those efforts in equity in terms of getting the right feed data into that beta calculation to make sure that we're getting the right risk number up front. RAV weighting of debt is an investability measure because it makes sure that the allowance keeps up with the needs of the companies. Regulatory depreciation on the gas side helps to alleviate those pressures and get the cash back to investors quickly. So it's not a gimmick - we're building it through the entire control on each of the individual decisions and we've still got that toolkit at DDs and FDs to say if something's still not quite right, we can make adjustments to make sure that our allowed return is meeting those needs and is meeting the market cost of capital.
I mean, I think people might want something a bit more showy than that, but ultimately over rewarding investors would be an instant fail of our duty to consumers and we're not going to do that. Particularly, stifling investment and not providing the right returns that help that happen is definitely against the interests of consumers as well and so we're really focused on just getting this right.

Akshay Kaul 49:17
Thanks very much, Chris.
And I think our next hand up comes from Harry Wyburd. Harry, please go ahead.

WYBURD Harry 49:26

Hi. Thanks everyone. It's Harry Wyburd from BNPP Exane. This is a very high-level one which is how do you think about or weigh up the complexity of the regulation and how that might impact investor perception. Particularly investors outside of the UK, I know that a lot of us who are here are very familiar for many years with how you guys operate. Particularly given the switch to the nominal allowance on fixed rate debt, you know it's quite a fundamental change. It's going to change quite a lot the way we need to model things especially with if we're trying to keep a relatively simple model that we can explain to our investor clients and we do get pushback in other regions. Companies' other regions are perceived as having complex regulation. So I just wondered, given you know we've now had another quite fundamental change to the way we calculate the RAV growth and inflation and whatnot. Is there a point at which you start to factor the complexity of this regulation into, the investability of the companies because explaining this to investors every time you make a change explain this, gets a little bit more difficult. So interested in your thoughts on that. Thank you.

Commented [JT2]: @Raz Anghel @Dillen Kanjee I can't work out what he says here. Hoping you will be able to work it out from your contact list

Commented [RA3R2]: Ah yes, that was BNPP Exane. I replaced it. Thanks

Akshay Kaul 50:40

Yeah. Thanks, Harry. I think it's a good question and as Chris was saying, in general, it may not seem like it, but for many years now, we've been trying to simplify the price controls, trying to index the values where we can and trying to be parsimonious with the mechanisms trying to make those as automatic as possible. But there are areas where, there is a good case for introducing a more accurate mechanism, which normally comes with some increase in complexity and I think the one you mentioned there, the inflation effect is, is an example of that. Chris, again, do you want to pick up on the relationship between the overall complexity and investability that Harry is alluding to there?

Chris Connor 51:24

Yeah. Agree a great question. I think these things do compete a little bit and we're trying to get the balance right. So you know the fact that we index the cost of equity and the cost of debt I think is a big support to investability for example. It means that allowed returns are always in line with the market cost of capital. But it's more complicated than if we just said a number upfront and simply, any adjustments that people might want us to make for investability would be additional adjustments and would make things more complicated. So we're aware of this. We try and simplify where we can, but where we see fundamental issues like we did in the inflation leverage effect, we’re duty bound to go and fix those on behalf of consumers.

Akshay Kaul 52:07
Thanks Chris.
I think that's the end of the hands and the moment.
Is there anyone?
Pavan did you want to come back?

Pavan Mahbubani 52:21
Yes, please. Thank you for taking my follow up question. I had one more on part 1, part 2 spend or last time you called it baseline uncertainty mechanism and this is a question geared more toward ET. How much do you expect to actually utilise this difference between baseline and uncertainty mechanism? I'm thinking of it from a context of it feels like in ET lot of the spend is well underpinned by ASTI and similar concepts. So do you see a need to have Part 2 expenditure in
RIIO-3 at all? Do you expect that you'll be using it much? It would be great to hear your thoughts based on what we know so far.

Steven Zhang 53:01
Yeah, sure. Thanks, I'll take that.
Good question. I think high level compared to RIIO-2, there'll be much more of a mix towards uncertainty mechanisms being used and triggered in period than the next ante. Part of that or big part of that, is owing to the future investment requirements that are tied to the ET build up needs going beyond ASTI.
ASTI covers a period up to about the early 2030s, but then we're expecting the transitional CSNP and then the full CSNP from 2026 onwards to come online fairly quickly, to give that clarity around that pipeline of projects going through to 2035-2040 and potentially beyond as well. And so what we've tried to do, I guess through the policy framework under T3 is to create a very adaptable and flexible regime that allows some level of baseline funding for projects that are well known, well established as well as BAU replacement, refurbishing stand, but then have those

uncertainty mechanisms that can be triggered when those investment cases or investment needs are established later on the process and that might be after the business plans are submitted at the end of the year, but before we issue final determinations or it might be, you know welding into the T3 period as well. So taking a step back we think companies will be submitting a much more a much bigger part of their business plan that that doesn't sit in the baseline ex-ante funding but actually sits in period.

Akshay Kaul
Thanks, Steve. I think for the next question, we're going to go back to Dom. Dom, please go ahead.

Nash, Dominic 54:57
Hi there. Yeah. Thank you very much. Couple of questions for me again.
Firstly, could you just give us some colour on the nominal cost of debt, I think you're saying that it's still got to go through some consultation. What has been your feedback from stakeholders on choosing I think option one on a nominal cost of debt and also push back you've got.

And the second question I've got is: this SSMD was delayed, I believe because you wanted to meet with the new minister. What's been the response or what was his thoughts on regulation and your approach into RII0-3? Thank you.

Akshay Kaul 55:44
Yeah. Thanks, Dom. I think maybe I'll turn to Stefan to take the question on debt and then I can come back and pick up the one on the new government. Stefan.

Stefan Blanchard 55:56
Hi, good afternoon everyone. I work in Mick's team, specifically on the cost of debt and it's great to talk to with you all today.
Just on the remaining steps of the consultation, so option one is our decision, but the way we implement that decision, particularly in reference to different companies capital structures is still to be determined and we'll be working with stakeholders for the draft determination and the final determination to really get to the fundamentals

of how we implement it and bring it to life.

I think when we went through the consultation approach and evaluating the different options, it was fair to say that most of the network companies didn't support option three, which was to continue with the existing methodology, but review the long run assumption. Many wanted to retain the status quo and I think that was the majority opinion. However, I think some expressed the view knowing that we saw this feature and was likely to include that this the inflation leverage effect or the inflation effect that we've called in SSMD was detrimental for consumers that we would want to take action. And when they looked at the different options from option one and option two, it was split.

Some preferred option one and some preferred option two. We evaluated all of that feedback. There's lots of different reasons to support one over the other and even a difference of opinion of whether option one is more consistent with the current methodology or option two is, and different licensees go through those different views in detail. But we've summarised those views within the document, so I would point you to that in the first instance, but if you have any follow up questions, I'm happy to take them.

Akshay Kaul 57:50
Thanks Stefan, and Dom on your second question. So as you say we did delay the publication of the SSMD, originally that was scheduled for June, to today, to give ourselves a little bit of time to brief the incoming administration.
The short answer to your question is that I think the government remains very supportive of independent regulation and we make our decisions obviously within the overall policy framework that is set by the government and the framework for this new one is still in in development. We've seen quite a lot of action in the first couple of weeks, but we'll continue to work closely with them to ensure that the regulatory framework supports their ambitions on net zero and consumer protection.

I think there's a range of areas where I should stress that we, the regulator, will need to work very closely with the government and the system operator, including on the spatial planning of the energy system, to meet these net zero targets, and on taking firm, indecisive action to speed up good connections, and we continue to look

forward to doing that in the months and years ahead.
Thank you. And the next question, I think we're going back for a follow up to Deepa. Please go ahead.

VENKATESWARAN Deepa 59:20
Thank you. I think I had two more follow up questions again on the cost of debt. So firstly, I think in your document last year you talked about also considering refinancing when you're doing the adjustments for the new cost of debt, not just RAV weighting, I didn't see any referencing to refinancing. So maybe if you can clarify that is this going to be similar to the current SSMC methodology or will you take refinancing? And secondly just to clarify how the indexation will work practically in the future on the debt. So you've said on the nominal part, there'll be no inflation, so that would work out to 41.25% of the RAV will get no inflation based on 75% nominal debt assumption and 55% gearing. On the equity 45%, you'll get the actual inflation. And then on the on the index link portion of the debt, is it a fixed 2% inflation or will it be based on the outturn in the RAV? So just wanted to clarify how mechanically the RAV will get inflated in this new methodology.

Akshay Kaul 1:00:25
OK. Thanks, Deepa. I think is that back to Stefan?

Stefan Blanchard 1:00:30
Yes, yes, I think so. And thanks those are great questions. So just on the refinancing, there will be a refinancing assumption within the weighting methodology and refinancing does feature in two different places for clarity. So one is the calibration approach which is separate but because your questions in respect to the indexation, I'll just focus on that for a second.

There'll be an assumption around refinancing of what we call legacy RAV or prehistoric RAV, so debt raised before a cut-off point would assume to be refinanced in equal increments and then when we look at debt raised which is incorporating the weighting methodology, we would make a refinancing section, but it's unlikely to affect this price control unless we made an assumption that was very, very short term, which I don't think we would do, the refinancing of those increments would happen after this price control period if that makes sense? But refinancing will be incorporated and hopefully when you see the models, it will come to life a bit more but also, I can take detailed modelling questions offline once those models have been published.

Just in terms of the indexing that portion, your second part of the question. The RAV related to that part of the capital structure would remain indexed to outturn inflation. The 2% assumption is just how we set the real allowance for that element, what it's deflated by and how we model it. So if we computed the nominal cost of debt was 6%, we would then deflate it by the 2% assumption to provide that index link debt real allowance, but then the outturn RAV would remain indexed to inflation. So if inflation picked up in line with that debt, the RAV will index. And then the reason why we would still do that is because it eliminates the effect of the notional capital structure because as that cost of debt rises, as the principle of that index linked debt rises, it offsets the RAV growth and so it's one for one, whereas with fixed rate debt that doesn't happen, which results in the effect, which is why we've had to change the approach. But I hope that answers your question.

VENKATESWARAN Deepa
Yeah. Thank you.

Akshay Kaul 1:03:10
Our next question comes from Rob Pulleyn. Rob, please go ahead.

Pulleyn, Rob 1:03:25
Ah, hi. Sorry about that. I was going to say thanks for all the colour so far. Obviously, a lot to digest for all of us. Two super high-level questions if we may. The first one in light of Ofgem's new duties around enabling the energy transition, how much does the longer-term lens of investment over decades influence the next five-year frame? And I was wondering why very simply you think 55% notional gearing is the right level given its higher for ED and also indicated higher for gas.
Thank you.

Akshay Kaul 1:04:02
Thanks a lot, Rob. Steve, do you want to take the first question and then maybe we'll go to Chris for the 2nd.

Steven Zhang
Yeah, in, in terms of that longer term view on investment, that is certainly consistent with the approach that we are trying to take.
As I mentioned earlier the pipeline of investments that are coming through the NESO central system planning are that they are not part of the investment projects. ASTI is an example where already that's starting to span multiple price controls and therefore, we are certainly looking through that longer term lens with respect to a few factors. One is the actual design of the what we call the load capex regime, the funding regime itself where we're designing that so that it is an enduring regime.

It's not something that hopefully needs change every five years but can span multiple price controls. Obviously, we'll keep it under review, make sure it's working effectively, but the intent is that it becomes an enduring regime. The 2nd aspect is that when it comes to the actual scrutiny around investment cases and investment appraisal that we are encouraging companies to take that longer term approach and when it comes to delivering low cost in terms of whole life cost, that means asking companies to think about whether a particular project needs to build in more optionality around the design of that project in respect of requirements and the actual surrounding infrastructure, so that companies can hopefully avoid that kind of expensive retrofitting scenario and actually think further ahead around those future requirements. That's just against that backdrop of that kind of high electricity demand and the large connections. Chris

Chris Connor 1:06:12
Yeah, I think the 55% reflects the view that we've had for since the RIIO-2 of just recognising the scale of investment that's coming in ET and the requirement to have the financial flexibility to match that. It's something we can keep considering and we'll take evidence through business plans as to whether that remains appropriate but at the moment, we think the evidence is that it does.

Pulleyn, Rob 1:06:38
Thank you.

Akshay Kaul 1:06:40

Thanks very much, Rob.
Once again, I think we've come to the end of the hands.
And just give it another minute. In case attendees do have further questions and if not then I'll try and sum up and then look forward to the next steps in the process.

OK, I think we can start to sum up and wind up the call. So thanks everybody for attending and for all your questions and for your continued engagement, during this RIIO-3 process. I can't overstate just how important and beneficial it is for us to be able to talk openly and candidly about the various issues that we deal with as a regulator and your feedback is always phenomenally important in helping us get to the right outcome for consumers.

In terms of where we go from here. We have published the methodology decision today alongside the business plan guidance that sets out the rules for formulating and submitting the spending plans which the industry will put back to us towards the end of this year. We'll then launch a brief call for evidence on those spending plans early in 2025 and then that will take us through to draft determinations in the second quarter of 2025 and alongside those or shortly after then, we will start our licence consultation for RIIO-3.

Once the consultation and the draft determinations is concluded then towards the end of 2025, we will publish our final determinations and start the statutory consultation process for modifying the network company licences which will take us through to early February and then RIIO-3 will begin on time from the 1st of April 2026.

That's the remainder of the process. I think there's still quite a lot of discussion to have before we get to final values for these price controls. And once again, I'd just like to say a big thank you to everybody for joining in today and for all your continued engagement with the price review process. Thank you so much and look forward to continuing working with you on this. Thank you.