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RIIO-3 Gas Distribution & Gas and Electricity Transmission
Sector Specific Methodology Decision (SSMD)
Investor Call

14:30-16:00 – London time (GMT)

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OFG1161

Order of proceedings

Akshay Kaul
Director General for Infrastructure

- **Welcome & RIIO-3 SSMD Overview**
  – Akshay Kaul, Director General for Infrastructure
- **Regulatory Finance Overview**
  – Mick Watson, Chief Financial Advisor
- **Q&A, Timeline / next steps & Close**
  – Akshay Kaul, Director General for Infrastructure

Introduction

- The next set of price controls (RIIO-3) for the transmission and gas distribution networks begin on 1 April 2026 and will run for 5 years to 31 March 2031.
- In October we set out our **Framework Decision** for the price controls.
- In December we published our more detailed **Sector Specific Methodology Consultation (SSMC)**.
- Today we have published our **Sector Specific Methodology Decision (SSMD)** and our suite of **Business Plan Guidance** and templates for RIIO-3 business plans.
- We are grateful for the extensive engagement we have had to date from a broad range of stakeholders which has helped shape our decisions.

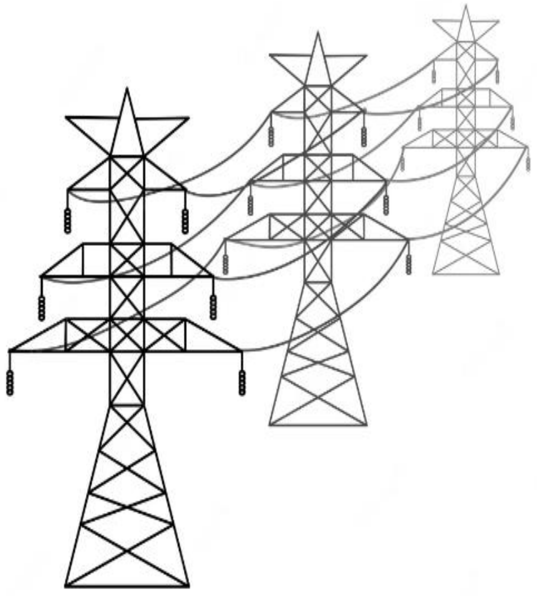
Key outcomes underpinning our approach

1. **Infrastructure fit for a low-cost transition to net zero:** Network companies must facilitate a low-cost, environmentally sustainable, low-carbon energy system that enables the transition to net zero, with infrastructure built at pace;

2. **Secure and resilient supplies:** Network companies must deliver a safe, secure and resilient network that is efficient, data rich and responsive to change. Consumers should have access to gas and electricity supplies that are resilient to physical, financial, climate and cyber shocks;

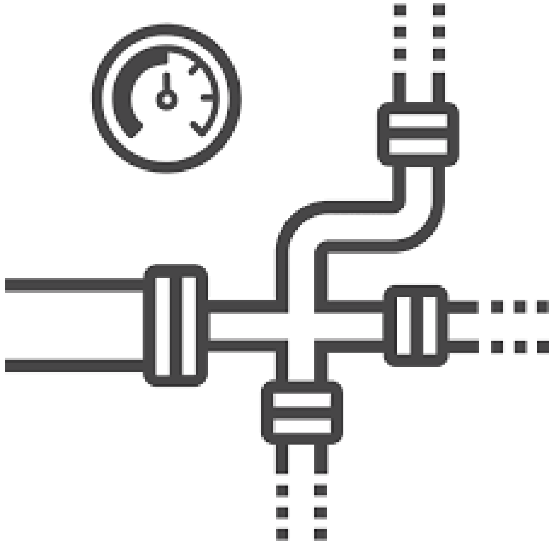
3. **High quality of service from regulated firms:** Network companies must deliver a high quality and reliable service to all consumers and network users, including those who are in vulnerable situations; and

4. **System efficiency and long-term value for money:** Network companies must deliver an efficient cost of service, minimise the costs to consumers of system transformation and ensure consumers and network users get a fair deal.



- **Acceleration with accountability** – build-out infrastructure in the right place and at the right time, whilst maintaining a good quality of service and asset health
- **Bringing greater certainty** for Transmission Owners, supply chain and financial markets
- **Flexible, proportionate regime** to enable acceleration of large projects
    - Consolidation of existing bespoke regimes under RIIO-ET2
    - Use of NESO centralised planning
    - Automatic early development funding
    - Protective mechanisms to hold TOs to account for on-time, efficient delivery
- Securing capacity to **overcome supply chain challenges**
    - Supply-side interventions to stimulate long-term capacity growth, now
    - Still expect TOs to take reasonable mitigating actions
- **Connections review ongoing** – we'll consult on incentives later in 2024
- Consistent **package of incentives** in areas that deliver direct consumer value
- Underpinned by a **stable and predictable financial package** with an appropriate balance of risk/reward

Gas Distribution (GD) and Transmission (GT) Sectors



- Continuing to have **safe, resilient, and reliable** GT and GD networks remains paramount
- But we also need to **balance investment with uncertainty** around the future of gas
  - **Net zero uncertainty mechanisms** will ensure our approach is flexible to accommodate government policy changes and support a low-cost transition – including on decommissioning and hydrogen
  - We will not provide upfront funding for **decommissioning** before government decisions on the scope, timing and funding sources
- We will accelerate the speed at which gas network investment is paid back through **regulatory depreciation charges** on bills to **protect future consumers and investors**
- We will continue to work with government to **ensure the transition to net zero is fair and at the lowest possible cost**

Mick Watson
Chief Financial Advisor

This is a vitally important period for the energy networks – Ofgem has a key role to play in supporting Great Britain’s transition to net zero.

The Financial Framework methodology decisions we have published today give us the flexibility to adapt to evidence and set financial metrics for RIIO-3 that help to:

- ✓ **protect consumers**
- ✓ **provide attractive returns to investors**
- ✓ **support investment**

RIIO-2 → FSNR → RIIO-3

- RIIO-3 Finance framework is **substantially in line** with the approach taken in RIIO-2.
- Incremental improvements in areas such as calculation of the **cost of capital** and **financial resilience**.
- Structural improvements to the framework in areas such as **inflation** and **regulatory depreciation**.

Today we will focus on methodology decisions in relation to:

- Cost of capital
- Inflation
- WACC and Financeability
- Regulatory depreciation
- Financial resilience

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Our approach to **'Step-1'** assessment of the appropriate **cost of equity** remains substantially in line with both RIIO-2 and the 2023 UKRN Guidance.

UKRN Recommendation (summarised)	RIIO-2	RIIO-3
1. CAPM should be the primary approach for estimating the cost of equity.	✓	✓
2. Regulators should use recent yields on the index-linked gilts to estimate RFR	✓	✓
3. The equity risk premium (ERP) should be the difference between total market return (TMR) and the risk-free rate (RFR), and based on both historical ex-post and historical ex-ante evidence.	RIIO-2 methodology used primarily historical ex-post evidence.	✓
4. Estimation of equity beta for the notional company using comparable listed companies and standard regression techniques.	✓	Potential update to comparators
5. The RFR, TMR and (re-levered) equity beta assumptions should be combined using the CAPM to produce a cost of equity range.	✓	✓

Step-2: Ensuring that our estimates lead to an appropriate allowed return on equity

- **Investability** of the sector and balancing risk and reward are key factors across the RIIO-3 decisions.
- We have provided a framework of how we will factor in changes to risk/reward balance, cross-check our allowed returns and adapt to **any investability challenges in RIIO-3**.
- Financial framework is flexible and can adapt to evidence.
- Ofgem will set a return on equity that allows companies to attract **sufficient capital to meet investment needs**.

RoRE and RAMs

- For Gas Distribution and Transmission, we expect Return on Regulatory Equity (RoRE) ranges **broadly in line** with those for RIIO-2.

- For Electricity Transmission, there is the potential for a slight increase in the overall risk profile and RoRE range over RIIO-3 driven by **agreed ASTI delivery incentives** – we seek to maintain a broadly neutral risk profile for totex and non-project delivery incentives.

- We currently expect to maintain the current structure of Return Adjustment Mechanisms (RAMs) in RIIO-3, but will consider **impact of major investment programmes** such as ASTI and CSNP.

- We do not currently plan to include **financial performance** in the assessment of RAMs.

Allowed Return on Debt

Metrics	RIIO-2	RIIO-3
1. **Index selection -** iBoxx Utilities 10yr+ index (ISIN reference DE0005996532)	✓	✓
2. **Trailing average weighting**	Unweighted	Weighted by RAV for ET Unweighted for Gas
3. **Allowances for additional costs of borrowing –** Transaction costs, liquidity/RCF costs, cost of carry and CPIH basis mitigation	✓	To be reviewed at DD
4. **Infrequent Issuer Allowance –** Previously referred to as the smaller size/ less frequent additional allowance	✓	To be reviewed at DD
5. **Inflation Treatment –** Detail included on next slide	Allowance deflated by long run assumption – OBR 5th year forecast	Option 1 in proportion to notional capital structure
6. **Calibration Exercise –** Comparing forecast efficient pooled debt costs for all GD&T networks to potential calibration options	✓	Calibration cohorts split between Gas and ET

Inflation treatment – Allowed return on Debt

	RIIO-2	RIIO-3 - Nominal allowance for fixed rate debt (Option 1)	Effect
Cash allowance	Cash allowance provided in real terms	FRD* provided in nominal terms. ILD* remains provided in real terms	Cash allowance will be higher
RAV indexation	Full RAV indexed to CPIH	RAV indexed only in proportion to notional ILD & equity assumptions	RAV growth will be lower

*FRD = Fixed Rate Debt, ILD = Index Linked Debt. Allowances are set in proportion to notional capital assumptions not actual company capital structures.

- We have decided to adopt inflation **'Option 1'**.
- Assuming inflation aligns to the long run assumption of 2%, change is **neutral in present value terms** as **slower RAV growth** will be substituted by **higher immediate cash allowances**.
- We will engage further on implementation of this approach.
- We will switch the long run assumption used for the ILD assumed portion to the **Bank of England CPI target of 2%**.

WACC

- Our approach to WACC will be **broadly in line with RIIO-2**.
- We are minded to set unchanged notional gearing assumptions: 60% for Gas Distribution/ Transmission and 55% for Electricity Transmission. We will engage with stakeholders on whether a constant or dynamic assumption should be adopted via modelling workshops.

Financeability

- We have decided we will adopt an approach for assessing Financeability **broadly in line with RIIO-2**. We will also make the following incremental improvements:
  - Incorporating long form modelling into the financeability assessment.
  - Broaden the range of credit ratios modelled.
  - In our modelling we will substitute the assumption that debt costs align to the allowed return on debt with forecast efficient average debt costs utilised in the calibration exercise.

ET Sector:

- We will continue with an asset life assumption of 45 years and consider if this assumption remains appropriate following the RIIO-ET3 business plan submissions.

Gas Sectors:

- Taking no action on depreciation in RIIO-3 could cause intergenerational unfairness of consumer bills and increase the perception of asset stranding risk in the sector.
- Therefore, we have **decided to further accelerate depreciation** in the gas sector, beyond the existing 45-year sum of digit profile, and target the **repayment of investment in the RAV** for the gas distribution sector by the government's net zero target date, 2050.
- We will further engage further with stakeholders in the coming months as we assess the potential implementation of these decisions against four metrics: **RIIO3 bills**, **future bills**, **perceived asset stranding risks**, and **financeability**.

- We have decided to implement **incremental** improvements to our current resilience toolkit:

Topic	RIIO-2	RIIO-3 Decision
Credit Ratings	Licensees must "use reasonable endeavours" or "take appropriate steps" to maintain an investment grade rating.	**Require** companies to maintain **two** investment grade credit ratings.
Availability of Resources	Every year, the licensee's board must certify that it has sufficient financial resources for 12 months.	**Require** cover of the entire price control or a **minimum of 3 years**.
Dividend lock-up trigger	Pre-dividend certificate of compliance with licence conditions including credit rating.	**To be the earlier of** reaching: 1. BBB- with a negative watch / outlook; or 2. **75% regulatory gearing**.

- We see these measures as bringing in meaningful further protections for consumers at **little to no cost** to responsible companies and their investors.

Sector Specific Methodology Decision - Finance Next Steps

The Financial Framework methodology decisions we have published today give us the flexibility to adapt to evidence and set financial metrics for RIIO-3 that help to:

✓ **protect consumers**

✓ **provide attractive returns to investors**

✓ **support investment**

- There are a small number of areas where the implementation of methodologies requires **further engagement** and **collaboration** with stakeholders.
- Where appropriate, we will adapt to the **evidence** presented in company **Business Plans** and will give further details in Draft Determinations in the summer of 2025.

Q&A

Akshay Kaul
Director General for Infrastructure

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

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RIIO-3 Timelines

Calendar Year

Q3 2024 | **Q4 2024** | **Q1 2025** | **Q2 2025** | **Q3 2025** | **Q4 2025** | **Q1 2026** | **Q2 2026**

- ★ 18 July – SSMD
- ★ 18 July – Business Plan Guidance
- ▲ 31 July – Draft BPDTs
- ▲ 14 August – Draft BPFM
- ▲ 11 Dec Final Business Plans
- ★ 18 December – Call for Evidence
- ★ 10 February – Call for Evidence responses
- ★ Draft Determinations
- ★ Licence Consultation
- ★ Final Determinations
- ★ Licence Stat Con
- ★ 3 Feb – Licence Mods
- ◆ 1 April – RIIO3 Starts

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

We do this by:

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

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