

ENA Response to
Ofgem T3 Draft
Determinations
Finance Annex
26 August 2025

RIIO-T3 Draft Determinations (DD) – Finance Annex

We write on behalf of Energy Network Association's (ENA) Transmission Owner (TO) and Distribution Network Operator (DNO) members in response to the finance annex to Ofgem's RIIO-3 Draft Determinations (DD) consultation, published 1 July 2025.

We welcome the changes Ofgem has made to the financial package since the Sector Specific Methodology Decision (SSMD) and view these as a positive step in the right direction. We recognise positive changes in a Regulated Asset Value (RAV)-weighted cost of debt mechanism, expanded beta comparators and Ofgem's acknowledgement of the need to make changes to the financial package to secure the financeability of networks during the T3 period and beyond. However, Ofgem has not developed its investability framework to sufficiently account for the combined challenges, of:

- the material changes to the macroeconomic environment since the last price control review; and
- the very significant change in what networks will be required to deliver to achieve Clean Power 2030 (CP2030) and Net Zero.

The DD fails to deliver the 9-10% nominal returns for high performing networks required by investors

The DD contains a lot of well received positive language around investability, however Ofgem's approach to investability has been to use its limited set of established cross-checks as dual purpose: as Step 2 of its cost of equity calculation, and also as an investability test. We are disappointed that Ofgem has not adopted any defined additional tests to robustly assess investability. Further changes are required to secure an investable T3 package that enables the delivery of the net positive outcomes for customers and society.

Investors tell us they require earnings which keep pace with asset growth and achieve nominal returns of 9-10% for high performing networks, in line with returns available for making similar investments in different sectors or jurisdictions. To compete for capital internationally, TOs should have a reasonable expectation of earning 9-10% returns and must provide sufficient premium to equity investors over returns available to debt investors. Ofgem's baseline returns and incentives available fall short of that. We understand Ofgem views its DD position and proposed 7.7% cost of equity (nominal, assuming 2% inflation) as not significantly different to the 9-10% nominal returns available in the US, however what it actually signals to investors is that nominal returns in the US are more than one full percentage point higher than proposed in the UK. The DD does not deliver the required returns because:

- The baseline return is too low - a balanced review of relevant evidence supports a cost of equity in excess of 6% (CPIH-real, 55% gearing);
- There is downside risk across the framework that lowers expected returns further including the position on totex and reopeners; and
- The incentive framework is incomplete and insufficient to bridge the gap to 9-10% nominal returns.

Ofgem's proposed DD package risks undermining efforts to attract the unprecedented investment, to deliver key targets such as CP2030 and Net Zero and to achieve the full potential catalyst of T3 to UK economic growth.

Ofgem has been unbalanced in its approach to setting allowed returns and investability

Ofgem has failed to appropriately engage with cost of equity cross-checks. In particular, Ofgem has applied an inconsistent quality standard to its own and ENA's proposed equity cross-checks leading to it relying on a biased set of cross-checks. A balanced set of cross-checks clearly demonstrates that Ofgem's proposed T3 cost of equity is too low and that the T3 package does not meet Ofgem's own investability test.

Similarly, on Total Market Return (TMR) the UKRN has acknowledged that a 'through-the-cycle' approach could yield a TMR which is either too low or too high. We have proposed a balanced approach that encapsulates a relatively stable but not fixed TMR position to reflect the current economic environment which can be adopted on an enduring basis. What is at stake for customers and society in T3 is too great to allow a deliberately lower TMR than is currently required.

Now is the time to follow through on the investability promise

We, like potential investors, have been encouraged by Ofgem's language around investability. Ofgem has set the expectation that it will fully test and deliver an investable package. As we head towards Final Determinations (FD) we are at a critical juncture. It is time that, having signalled investability as an important theme for RIIO-3 price controls, Ofgem follows through and holistically considers the required components of an investable package and tests whether the proposals meet those requirements.

If a regulatory allowance is set below investor expectations, while this may not lead to a full blown and immediate withdrawal of capital, except in extremis, it is reasonable to expect investors to curtail and scale back their investment plans. This would simply be a rational response to allowed returns being set too low regardless of the underlying reason. On the same vein, potential investors may be deterred from deploying their capital in the sector. The impact of these rational investor decisions may not be immediately noticeable, where the full impact may only be discovered in hindsight, when customers are exposed to sub-optimal outcomes, policy objectives are not achieved and financing costs increase.

We do not want to lose investor confidence at this critical stage. This DD position is below what investors expect from the FD.

Making these changes is in the best interests of customers and society

The scale and pace of TOs' investment delivery required to achieve Net Zero is unprecedented. Ofgem and TOs have been transparent about the costs to customers of increased investment, however Ofgem has not fully set out the benefits case for the delivery of TOs' business plans. The overall benefits case is strikingly net positive. The positive impacts that the successful mobilisation of capital delivers, not just for bill payers but society as a whole, should not be understated:

- direct bill reductions which offset investment costs over the T3 period;
- economic growth driven by this investment which has an immediate and enduring impact on the UK economy, including GDP, jobs and household income; and
- supporting the delivery of Net Zero; the Office for Budget Responsibility reaffirmed in its July 2025 report¹ that the cost to achieve Net Zero is significantly lower than the cost of inaction.

The investability risk we currently face is therefore significant. As a path to a FD which is in the best interests of customers and society, we ask that Ofgem robustly tests and delivers on its investability promise. To ensure a FD we can all get behind and focus on delivery, allowed returns on equity should increase to in excess of 6%

¹ <https://www.carbonbrief.org/obr-net-zero-is-much-cheaper-than-thought-for-uk-and-unchecked-global-warming-far-more-costly/>

on a 55% gearing basis, allowing TOs to compete against the backdrop of other available opportunities, to incentivise investors to mobilise capital at the scale and pace required to deliver these firmly net positive benefits to our customers and society.

We provide more detailed views on Ofgem's Finance Annex to the T3 DD, along with accompanying supporting evidence, in the attached annex to this response.

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Finance Annex

Our response to the Finance Annex to Ofgem's Draft Determinations (DD)

This annex provides our more detailed views on a number of the questions posed in Ofgem's Finance Annex to the T3 Draft Determinations, along with accompanying supporting evidence. We identify Ofgem's consultation questions in relevant sections.

This submission is supported by the following reports:

- Oxera, RIIO-3 draft determinations—CAPM parameters and debt-based cross-checks, 22 August 2025
- Frontier Economics, Updated cost of equity cross-check evidence, 22 August 2025
- Frontier Economics, Assessing regulators' approach to setting the TMR - Implications for RIIO-3, 22 August 2025
- Frontier Economics, Cross-check standards of evidence, 22 August 2025
- NERA, Liquidity Cost & Cost of Carry Allowance at RIIO-ET3, 20 August 2025

This response is submitted on behalf of our Transmission Owner (TO) and Distribution Network Operator (DNO) members.

The changes that Ofgem has made to its financial package since its Sector Specific Methodology Decision (SSMD) are a positive step. However, further changes are required to achieve an investable package.

FQ16 Do you agree that our proposed package for gas and electricity companies is investable?

We recognise that Ofgem has made a number of changes to its financial package that have moved the package closer towards an investable package. We welcome the improvements to Ofgem's financial package including:

- improvements to Ofgem's cost of equity calculation such as the changes to its calculation of historical ex ante TMR and the expansion of beta comparators that it considers to include a wider range of regulated network comparators;
- the proposed implementation of a RAV-weighted cost of debt for all TOs, to reflect their rapidly changing investment programmes; and
- Ofgem's acknowledgement of the need to make changes to the financial package to secure the financeability of networks during the T3 period and beyond.

However, we are disappointed that, having signalled investability as an important new theme for RIIO-3 price controls, Ofgem has not followed through on this and has failed to consider holistically the required components of an investable package or to ensure that the proposals meet those requirements. An investable price control package is required to meet the combined challenges of the material changes to the macroeconomic environment since the last price control review and the very significant changes to investment requirements and risk arising due to CP2030 and Net Zero. Ofgem's approach to investability has focussed solely on the cost of equity and debt financeability. Whilst these are important components of an investable package, they are not the only considerations that investors weigh in deciding where to invest.

A number of further changes will be required to achieve an investable package including:

- Ofgem's proposed cost of equity is too low. It fails to compete against alternative investments available to investors, such as the 9-10% nominal returns available to investors in US markets and the 10-12% nominal returns anticipated for investing in Sizewell C, or to provide a sufficient premium over safer debt instruments.
- the price control must combine strong, competitive base returns with targeted incentives that drive benefits to customers across the full spectrum of outputs. The DD provides insufficient detail on proposed T3 incentives to assess whether the DD achieves this, risking the total reward package for T3 being understrength relative to investor requirements. The FD needs to provide a credible pathway to 9-10% nominal returns based on a higher base cost of equity and scope for strong performance to earn additional returns.
- success will need electricity networks to scale up their businesses significantly, providing economic activity and growth in skilled jobs, directly and indirectly supporting growth right across the economy. It is vital that price control totex allowances support this business growth. Getting totex allowances right will need a lot of engagement – we stand ready to support Ofgem to achieve this.
- Ofgem's assumed dividend yield fails to meet with investors' expectations and benchmarks or to compete against dividend yield available elsewhere.

Oxera explores the changes required to achieve an investable package in its review of the investability of the DD for TOs.² Oxera concludes that *"the DDs remain short of overcoming the investability challenge outlined by investors"*.

ENA members, like potential investors, have been encouraged by Ofgem's language around investability. Ofgem has set the expectation that it will fully test and deliver an investable package. As we head towards FD we are at a critical juncture. It is time that, having signalled investability as an important theme for RIIO-3 price controls, Ofgem follows through and holistically considers the required components of an investable package and tests whether the proposals meet those requirements.

Investors have a choice as to where they invest their money. The DD proposals fail to compete and risk TOs being unable to secure sufficient investment to deliver key targets such as CP2030 and Net Zero or to support economic growth. If a regulatory allowance is set below investor expectations, while this may not lead to a full blown and immediate withdrawal of capital, except in extremis, it is reasonable to expect investors to curtail and scale back their investment plans, putting at risk objectives such as CP2030. This would be a rational response to allowed returns being set too low. Similarly, potential investors may be deterred from deploying their capital in the sector. The impact of these rational investor decisions may not be immediately noticeable; the full impact may only be discovered in hindsight, when customers are exposed to sub-optimal outcomes, policy objectives are not achieved and financing costs increase.

We do not want to lose investor confidence at this critical stage. This DD position is below what investors expect from the FD.

² Oxera, Investability of RIIO-ET3 draft determinations, 15 August 2025.

Ofgem's proposed cost of equity is too low. It fails to compete against alternative investments available to investors, risking the investability of the sector.

To compete for capital internationally TOs should have a reasonable expectation of earning 9-10% nominal returns and must provide sufficient premium to equity investors over returns available to debt investors. Ofgem's baseline returns and incentives available fall short of that.

We recognise the movement on Ofgem's cost of equity since the SSMD and welcome the improvements to Ofgem's Capital Asset Pricing Model (CAPM) cost of equity calculation such as its revisions to its calculation of historical ex ante TMR and its expansion of the comparator companies that it considers when determining its beta range to include a wider range of regulated network comparators.

However, Ofgem's proposed cost of equity is still insufficient. In particular:

- Ofgem has failed to appropriately engage with cost of equity cross-checks. In particular, Ofgem's assessment of Step 2 cost of equity cross-checks is incomplete and applies an inconsistent quality standard to its own and ENA's proposed equity cross-checks. A balanced assessment of Ofgem's own cross-checks and a wider set of cross-checks demonstrates that Ofgem's proposed T3 cost of equity is too low and that a cost of equity in excess of 6% at 55% gearing in current interest rate conditions would be appropriate.
- Ofgem's CAPM cost of equity range is too low due to a number of issues, in particular failure to account for evidence of a convenience premium embedded in government bonds in Risk Free Rate (RFR), failure to reflect prevailing TMR and due to the bottom end of Ofgem's beta range being too low.
- Ofgem has not appropriately considered its decision as to where in its CAPM cost of equity range to select its cost of equity point estimate. A wide body of evidence supports selecting a cost of equity point estimate that is much higher than Ofgem's proposed point estimate.

We set out further details of each of these in the following sections.

Ofgem's assessment of cost of equity cross-checks is incomplete and applies an inconsistent quality standard to its own and ENA's proposed equity cross-checks. A balanced assessment of Ofgem's own cross-checks and a wider set of cross-checks demonstrates that Ofgem's proposed T3 cost of equity is too low.

FQ12 Do you agree with the conclusions we have drawn from our chosen cross-checks?

In its SSMD, Ofgem set out that it would use cross-checks to its cost of equity to test investability. We agree that cross-checks to the cost of equity are an important component of testing that a price control package is sufficient. However, for the reasons set out below, Ofgem's approach to selecting cross-checks to the cost of equity is incomplete and its approach to assessing the results provided by cross-checks unbalanced. A balanced look at Ofgem's own cross-checks and a wider set of cross-checks demonstrates that Ofgem's proposed T3 cost of equity is too low; Ofgem's cost of equity is insufficient to retain and attract the equity capital that the sector requires.

Ofgem has applied an inconsistent quality standard to its own and ENA's proposed equity cross-checks leading to it relying on a biased set of cross-checks.

Ofgem has applied an inconsistent quality standard to its own and ENA's proposed equity cross-checks leading to it relying on a biased set of cross-checks. Frontier has reviewed Ofgem's approach to selecting cross-checks in its report.³ Frontier concludes that Ofgem has not appraised the merits of different types of cross-check on a consistent and objective basis and has taken a biased approach to deciding which cross-check evidence to rely on and which to discard.⁴

This bias in cross-check selection is particularly stark when we consider Ofgem's decision to continue to rely on the cost of equity inferred from MARs (which is based on Dividend Growth Model (DGM) analysis), while simultaneously dismissing entirely other DGM-based evidence, such as the TMR Glider, on the account of issues related to DGM analysis.⁵ Frontier sets out how the concerns raised by Ofgem regarding Frontier's DGM analysis apply equally to Ofgem's own analysis.

Table 1 – Frontier's summary of concerns raised by regulators on the DGM model and relevance for Ofgem's Market-to-Asset Ratio (MAR) inference model

Concern raised on DGM analysis	Relevance to regulators' MAR inference model
"The model is highly sensitive to changes in dividend and growth rate assumptions" ¹	<ul style="list-style-type: none"> ■ The inference model directly relies on assumptions on future dividends, outperformance, and growth. ■ These assumptions have to be developed by regulators in order to conduct the CoE inference exercise.
"[It] presupposes predictable and constant dividend growth, forcing the conclusion that changes in share price must be the result of changes in the discount rate" ²	<ul style="list-style-type: none"> ■ Regulators' perpetuity model relies on a constant dividend growth assumption.
"Estimates for the long-run dividend growth rate are subjective" ³	<ul style="list-style-type: none"> ■ Regulators' own perpetuity model requires regulators to make an assumption of long-run RAV growth which goes beyond the next price control.

Source: Frontier Economics⁶

Frontier also identifies that the concerns raised by Ofgem regarding the hybrid bond cross-check (use of a narrow sample and need for assumptions) are also present and accepted in Ofgem's own cross-checks.⁷

If Ofgem continues to rely on the approach it sets out in its DD, it must additionally consider evidence provided by debt-based cross-checks such as Frontier's hybrid bond cross-check and Oxera's debt premia framework (previously known as Asset Risk premium (ARP) – Debt Risk Premium (DRP)) and DGM based cross-checks to the TMR such as the TMR Gilder.

³ Frontier Economics, Cross-check standards of evidence, 22 August 2025.

⁴ Frontier Economics, Cross-check standards of evidence, 22 August 2025, executive summary.

⁵ Frontier Economics, Cross-check standards of evidence, 22 August 2025, section 3.

⁶ Frontier Economics, Cross-check standards of evidence, 22 August 2025, executive summary.

⁷ Frontier Economics, Cross-checks standard of evidence, 22 August 2025, section 4.

Ofgem has also set an inappropriate hurdle in setting out that debt-based cross-checks cannot “*definitively prove or 'back solve' to a required return on equity*”⁸. No cross-check can meet this test. It is therefore inappropriate to justify not using debt-based cross-checks on this basis.

Ofgem's methodological concerns with cross-checks proposed by ENA and its consultants are ill-founded and, in any case, are insufficient to justify Ofgem's decision to not rely on these cross-checks

All cross-checks to the cost of equity, including those relied on by Ofgem in its DD, have advantages and disadvantages. Over time, our consultants have reviewed the methodological concerns that Ofgem has identified regarding their cross-check formulations. We do not consider that any of the points raised by Ofgem in respect of the additional cross-checks proposed by ENA and its consultants are sufficiently material to justify Ofgem's decision to not consider the data from the cross-checks.

Our consultants set out their responses to Ofgem's criticisms in their respective reports. In summary:

- Frontier's hybrid bond cross-check: Frontier demonstrates that none of the concerns raised by Ofgem are sufficient to place no weight on the hybrid bond evidence. This is because the concerns are either mitigated or have been considered as part of Frontier's robustness analysis.⁹
- Frontier's DGM and associated TMR cross-checks: Frontier has detailed the numerous reasons why it is not appropriate to dismiss DGM evidence. Frontier has set out how the modelling has been made robust and objective: Frontier's calibrated DGM addresses concerns about dividend forecast subjectivity directly, revealing that Frontier's DGM outputs should be considered conservative. We therefore find that Ofgem has discarded relevant market-based evidence without reasonable justification. In any case, Ofgem continues to rely on MAR inference which is based on DGM so it needs to engage properly with Frontier's DGM-based TMR analysis.^{10,11}
- Oxera's debt premia framework cross-check: Oxera demonstrates that there is no clear correlation between the minimum ARP implied by the DRP and the RFR and the latest specification of the cross-check no longer relies on regulatory precedents to calibrate the framework.¹²

Ofgem must, therefore, incorporate the results from the cross-checks proposed by ENA and our consultants in its FD analysis.

A balanced look at Ofgem's own cost of equity cross-checks reveals a mean cross-check of around 6.5% - considerably in excess of Ofgem's chosen cost of equity, and consideration of a wider set of cross-checks clearly demonstrates that Ofgem's proposed T3 cost of equity is too low.

As explained above, Ofgem's cross-check assessment is incomplete. It dismisses relevant cross-check evidence that ENA and our consultants presented and applies an inconsistent standard to assessing the body of cross-check evidence.

Nonetheless, Ofgem's own cross-checks provide little comfort around its own Step 1 cost of equity. Ofgem's own cross-check evidence has an average mid-point of around 6.5%¹³, considerably in excess of Ofgem's chosen cost of equity.¹⁴ Ofgem does not elaborate on how it interpreted this evidence to provide comfort around its Step 1 range.

⁸ Ofgem, RIIO-3 Draft Determinations - Finance Annex, 1 July 2025, para 3.100.

⁹ Frontier Economics, Updated cost of equity cross-check evidence, 22 August 2025, section 2.

¹⁰ Frontier Economics, Updated cost of equity cross-check evidence, 22 August 2025, section 8.

¹¹ Frontier Economics, Cross-check standards of evidence, 22 August 2025, section 3.

¹² Oxera, RIIO-3 draft determinations—CAPM parameters and debt-based cross-checks, 22 August 2025, section 6.3.

¹³ Average of: Market to asset ratio (MARs)-implied CoE of 4.2–6.2% (5.2% CPIH-real midpoint); OFTO-implied equity IRR of 5.7% (CPIH-real); Infrastructure fund implied equity IRR of 8.5% (CPIH-real).

¹⁴ Ofgem, RIIO-3 Draft Determinations - Finance Annex, 1 July 2025, table 19.

Ofgem's suite of proposed cross-checks inappropriately excludes cross-checks to the prevailing cost of debt. A meaningful set of investability cross-checks must reflect the returns premium that equity requires over debt as a matter of rationality. Ofgem's proposed cost of equity for T3 is below the bottom of Frontier's hybrid bond range¹⁵ and fails to pass Oxera's debt-based cross-checks.¹⁶ In particular, using Ofgem's own assumptions, a comparison of Ofgem's own allowances demonstrates that the unlevered cost of equity is 15 bps lower than the cost of debt.¹⁷ The various debt-based cross-checks in relation to the minimum implied cost of equity all tell the same story: Ofgem's proposed cost of equity does not provide sufficient premium above returns that can be earned by investing in safer debt instruments.¹⁸

We do not consider that OFTO bids provide a relevant cross-check to the required T3 cost of equity. As explained by Frontier, there are no construction activities associated with OFTO bids and OFTOs do not operate under a RAV model. However, recent information regarding anticipated project IRRs for Sizewell C provide a much more relevant cross-check. Centrica reports that it expects a more than 10% nominal IRR in a 'high cost' scenario, and a more than 12% nominal IRR in a 'moderate cost' scenario for its 15% equity stake. Given the scale and risk profile, this is a direct and highly relevant cross-check for required equity returns on regulated businesses carrying out large network investments.¹⁹ We recommend that Ofgem considers this new information in the suite of cross-checks that it considers at FD.

As explained above, Ofgem also fails to recognise DGM-based cross-checks to the TMR. TMR cross-checks indicate that Ofgem's assumed TMR is too low²⁰, contributing to the mid-point of Ofgem's cost of equity range also being too low.

Consideration of a balanced range of cross-checks, including those relied on by Ofgem in DD and those recommended by ENA, demonstrates that the DD cost of equity is too low and supports a much higher cost of equity.

¹⁵ Frontier Economics, Updated cost of equity cross-check evidence, 22 August 2025, section 7.

¹⁶ Oxera, RIIO-3 draft determinations—CAPM parameters and debt-based cross-checks, 22 August 2025, section 6.4.

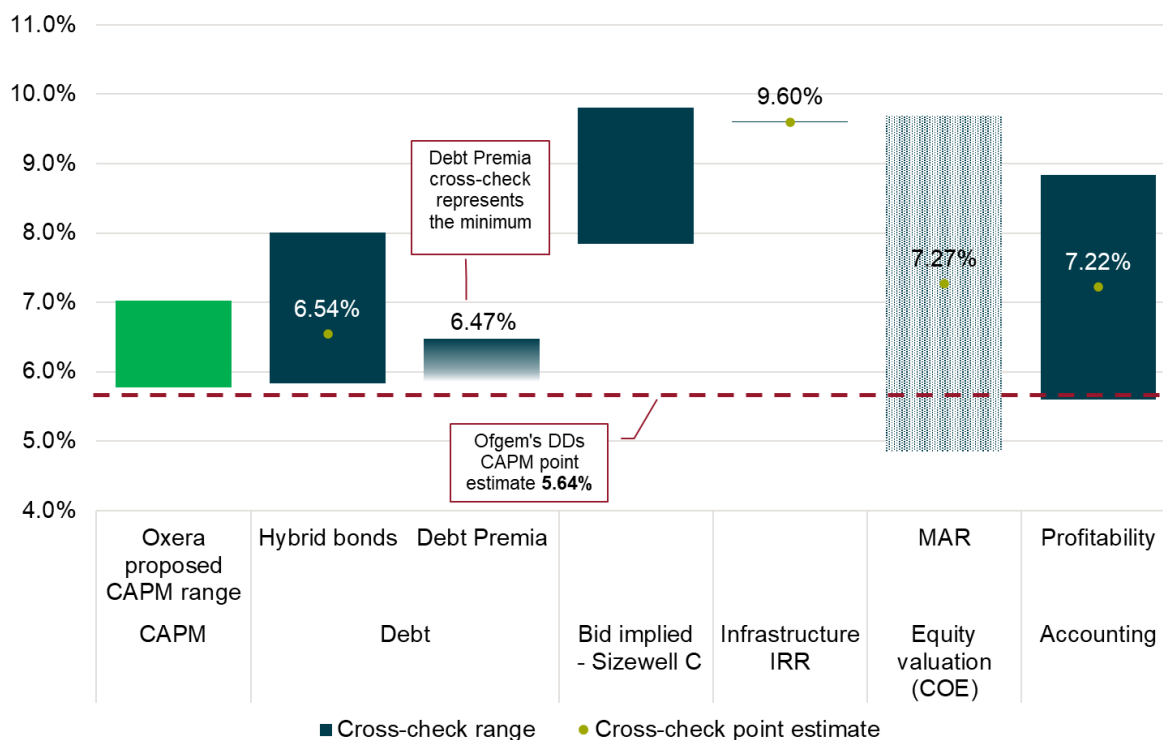
¹⁷ Oxera, RIIO-3 draft determinations—CAPM parameters and debt-based cross-checks, 22 August 2025, section 6.1

¹⁸ Ofgem's proposed cost of equity does pass the least tight of the specifications of Oxera's debt premia cross-check, but Oxera characterises that specification as a necessary but insufficient condition. See Oxera, RIIO-3 draft determinations—CAPM parameters and debt-based cross-checks, 22 August 2025, section 6.2.1.

¹⁹ Frontier Economics, Updated cost of equity cross-check evidence, 22 August 2025, section 5.

²⁰ Frontier Economics, Updated cost of equity cross-check evidence, 22 August 2025, section 10.

Figure 1 – Updated cost of equity cross-checks (CPIH-real, 55% gearing)



Source: Frontier Economics²¹

Based on its debt premia framework analysis, Oxera concludes that Ofgem's CAPM range is below the minimum threshold for the cost of equity implied from debt premia data, 6.47% (at 55% gearing).²² In contrast, a value towards the upper end of the Oxera cost of equity range would pass the test and would be appropriate to support investability of the networks.

Frontier's analysis shows that the lower half of Ofgem's CAPM range is entirely below the expected return on representative hybrid bonds. This is a clear indication that Ofgem's CAPM range is too low. Ofgem's point estimate cost of equity is also below the bottom end of the cost of equity range implied by the hybrid bond and significantly below the point estimate. Frontier also concludes that a value towards the top of the Oxera cost of equity range would be appropriate to support investability.²³

Ofgem's cost of equity at 55% gearing fails to provide a return commensurate with the risks of investing in transmission networks

One of the tools that Ofgem has opted to deploy to secure debt financeability is to maintain 55% notional gearing. Ofgem has also assumed a reduction in the cost of equity required by equity investors in the networks with lower gearing levels relative to its 60% gearing assumption for gas networks.

Notwithstanding the economic theory here, we note that not all investors follow the CAPM Harris-Pringle de-gearing assumptions used by Ofgem and some investors may perceive that the transmission sector is receiving a lower allowed return over a period where TOs need to undertake an unprecedented scale of investment.

²¹ Frontier Economics, Updated cost of equity cross-check evidence, 22 August 2025, section 7.

²² Oxera, RIIO-3 draft determinations—CAPM parameters and debt-based cross-checks, 22 August 2025, section 6.

²³ Frontier Economics, Updated cost of equity cross-check evidence, 22 August 2025, executive summary.

Lower gearing is generally associated with higher business risk, yet Ofgem has opted to award TOs a lower Weighted Average Cost of Capital on a like for like basis (i.e. once differences in index-linked debt proportions and RAV-weightings are held constant).

In effect, by using a lower notional gearing to help financeability metrics to pass investment grade, Ofgem assumes that in circumstances where companies may struggle to raise new debt (because of financeability stresses), equity investors will be willing to inject new equity at a lower rate of return than they would receive if the company did not face those challenges.

Furthermore, investors will also note the wider RORE range for electricity transmission than for gas distribution and strengthen their perception that they are being asked to accept a lower return for taking greater risks in investing in electricity networks.

Ofgem must revisit its cost of equity assumption at FD and ensure that a return commensurate with the risks that investors will take in investing in transmission networks is appropriately rewarded.

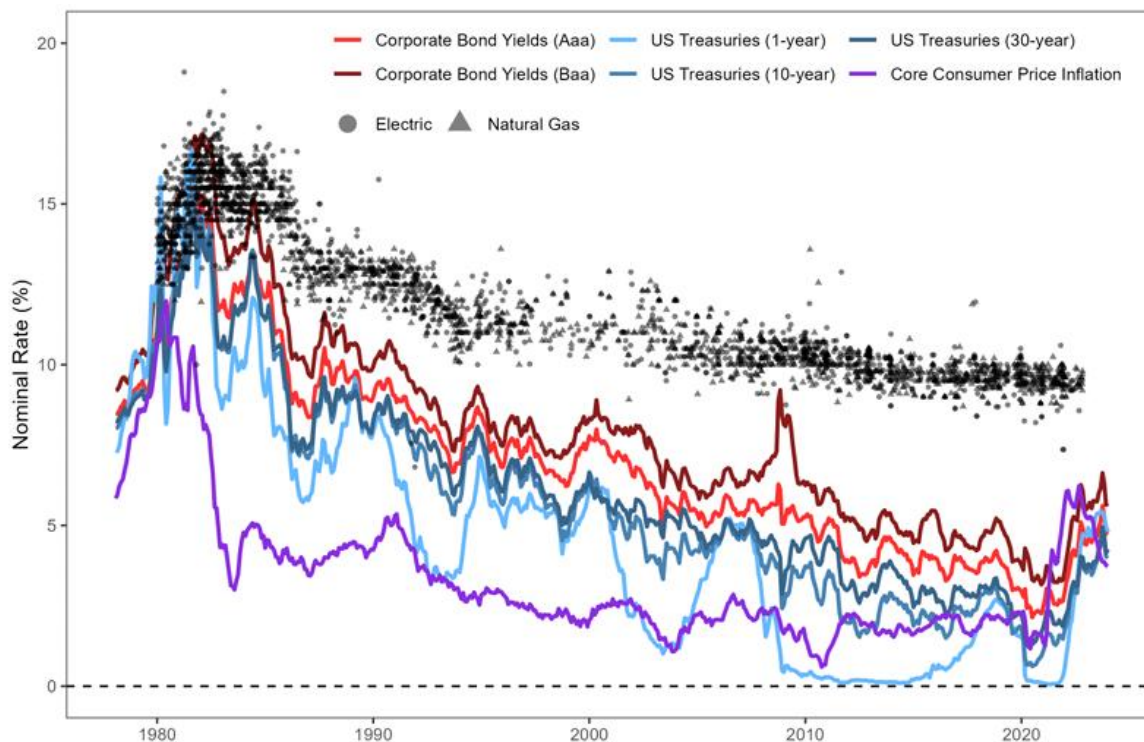
Ofgem's cost of equity fails to compete against returns available for making similar investments in different sectors or jurisdictions

Investors have many competing opportunities into which they can deploy capital, as countries all over the world also seek rapid progress towards their own decarbonisation objectives. As a result, networks face stiff competition globally for that capital from a suite of competing projects. Ofgem's cost of equity has to compete against these alternative investment opportunities. Investors have told us that they require at least 9-10% nominal returns for high performing networks to attract the investment required.

Ofgem's proposed cost of equity is lower than returns available from making similar investments in different jurisdictions, including the 9-10% nominal returns that are available to investors in US networks.²⁴

²⁴<https://haas.berkeley.edu/wp-content/uploads/WP329.pdf>.

Figure 2 - Authorised Return on Equity for US rate cases for gas and electricity utilities over the last 40 years



Source: Energy Institute at Haas²⁵

Ofgem's suggestion that somehow its proposed 7.7% cost of equity for TOs (nominal, assuming 2% inflation) is not significantly different to the 9-10% nominal returns available in the US is simply inexplicable. What it actually signals to investors is that nominal returns in the US are more than one full percentage point higher than proposed in the UK.

In addition to the evidence on returns available to investors in US utilities, recent announcements from UK listed water companies on targeted nominal returns (e.g. Severn Trent, Penmon targeting >9%^{26,27}), and inputs from the Global Infrastructure Investor Association into the recent Cunliffe review also demonstrate returns available to investors from competing opportunities. The recent announcements from Centrica of their Sizewell C investment, also provide a strong viewpoint of the type of returns and package that are required to attract capital into a significant multi-billion investment under a conventional RAV model.

The FD needs to provide a credible pathway to 9-10% nominal returns. Determining a more appropriate base cost of equity will be an important component of this, however in addition there needs to be sufficient visibility, through design of the incentive framework, that high performing efficient networks can make up the difference between base return and the 9-10% required by investors.

²⁵ <https://haas.berkeley.edu/wp-content/uploads/WP329.pdf>.

²⁶ Penmon plc, 'Investor Summary: PR24 Final Determinations', 28 January 2025.

²⁷ Barclays, UPDATE: Final Determination Out: First glance positive, 19 December 2024.

Ofgem's CAPM cost of equity range is too low due to a number of remaining issues with its CAPM parameter assumptions

We recognise that Ofgem has reviewed its approach to setting its CAPM parameters since its SSMD and agree with the improvements that Ofgem has made to its CAPM parameters since then. In particular, we agree with its changes to the calculation of historical ex ante TMR and its expansion of the beta comparators that it considers to include a wider range of regulated network comparators. However, a number of issues remain with Ofgem's CAPM parameter assumptions. Oxera considers Ofgem's approach to CAPM parameter ranges and point estimates in its updated report.²⁸

Ofgem has failed to account for the considerable evidence of a convenience premium embedded in government bonds when estimating the RFR

FQ7 Do you agree with our methodology for calculating the RFR?

FQ8 Do you agree with our methodology for calculating the inflation wedge?

Ofgem has failed to account for the convenience premium embedded in government bonds when estimating the RFR leading to its assumed RFR being too low.

There is extensive evidence supporting the inclusion of the convenience premium, including academic literature and recent regulatory precedents. Ofgem argues that the literature and empirical estimates presented by stakeholders do not provide evidence of a convenience premium in UK gilts at the 20-year investment horizon.²⁹ Oxera provides new evidence that shows empirically that a large and positive convenience premium can be observed across the gilts yield curve, including at the 20-year investment horizon. While the level of the convenience premium can fluctuate over time, depending on the underlying market conditions, Oxera shows that the convenience premium has been present during periods of calm and distressed financial markets.³⁰ Including the convenience premium leads to a RFR of 2.25% (CPIH-real).

We agree with Ofgem's approach of not applying a CPI-CPIH wedge when calculating its RFR. Oxera identifies several reasons why the Office for Budget Responsibility's (OBR) CPI-CPIH wedge should not be considered including that (i) the historical evidence does not support the existence of a stable or predictable CPI-CPIH wedge; (ii) the CPI-CPIH forecast wedge estimated by the OBR does not have the track record and evidential basis needed to support regulatory application; and (iii) some of the underlying drivers of CPIH cannot be forecast reliably.³¹ We also note that the OBR's near-term forecast is much lower and not significantly different to 2%.

Ofgem's TMR of 6.9% is inconsistent with a wide body of cross-check evidence that shows that a higher assumption is needed to reflect latest market expectations

FQ9 Do you agree with our methodology change in calculating the ex ante TMR?

We support the improvements in Ofgem's approach to historical ex ante TMR evidence, including Ofgem's proposal to exclude the Cost of Living Index - Consumption Expenditure Deflator and serial correlation adjustments from the calculation. We note that in selecting a point estimate at the top end of its own TMR range, Ofgem effectively places less weight on historical ex ante evidence in its chosen TMR assumption. We have always maintained that Ofgem should place less weight on the historical ex ante TMR result.

²⁸ Oxera, RIIO-3 draft determinations—CAPM parameters and debt-based cross-checks, 22 August 2025.

²⁹ Ofgem, RIIO-3 Draft Determinations - Finance Annex, 1 July 2025, paras 3.23 to 3.32.

³⁰ Oxera, RIIO-3 draft determinations—CAPM parameters and debt-based cross-checks, 22 August 2025, section 2.1.

³¹ Oxera, RIIO-3 draft determinations—CAPM parameters and debt-based cross-checks, 22 August 2025, section 2.2.

However, Ofgem's proposed TMR is much too low. We believe that this issue with proposed TMR materially contributes to Ofgem's cost of equity being too low. This under-estimation of TMR arises due to two main issues:

- Ofgem has failed to engage with issues with its 'through-the-cycle' policy. In particular whether it is proportionate for TMR to be constrained at the long-run historical average, when TMR was lower than that long-run average when interest rates were low, and credible indicators suggest the expected rate is considerably above average at present. Holding TMR at historical averages, while evidence shows that the current market levels are higher than historical average, suggests that investors get the lower than long-term average when the market is low and they get the average when the market is high.
- Ofgem applies an inconsistent standard to cross-check evidence: e.g. DGM based cross-checks and regarding the sample size of the Fernandez survey. Ofgem's TMR is inconsistent with a wide body of cross-check evidence that shows that current market conditions necessitate a higher TMR assumption.

We explore these issues further below.

Failure to engage with the issues with Ofgem's 'through-the-cycle' TMR policy

Ofgem sets out in its DD that it continues to believe that it is inappropriate to make manual adjustments to the TMR to reflect prevailing interest rates.³² This is despite the UKRN guidance acknowledging that a 'through-the-cycle' approach could yield a TMR which is either too low or too high.³³ This is not a theoretical issue: TOs need to attract considerable capital and setting TMR below the rate required by the market creates a material risk of the cost of equity being too low to attract that capital.

Frontier explores this important issue in their report.³⁴ Frontier reviews and critiques Ofgem's and other regulators' approach to estimating the TMR in the context of setting the allowed equity returns. It shows that while regulators' stated policies are to retain a 'fixed TMR' and 'through-the-cycle' approach, regulators have, in fact, deviated from the stated approach, and the resulting estimates are far from being 'fixed'.³⁵ Frontier finds that the 'through-the-cycle' approach taken by regulators to date is inconsistent, opaque, and unpredictable.³⁶

Frontier identifies a number of negative consequences of Ofgem's 'through-the-cycle' approach including:³⁷

- a rigidly executed 'through-the-cycle' fixed TMR tends to be misaligned with market conditions. It overstates TMR in periods of low interest rates, potentially leading to high asset valuation, which can spur public scrutiny and questions about regulatory legitimacy. In contrast, during times of constrained capital markets and higher interest rates, such as the current environment shaped by geopolitical shifts and inflationary pressures, this same long-term averaging can underestimate the returns required to attract capital, risking underinvestment and a loss of investor confidence.
- in practice, regulators, including Ofgem, have not consistently applied a 'through-the-cycle' approach to setting the TMR. Instead, regulators have relied heavily on arcane technical arguments to flex the TMR, which erodes the credibility of the stated approach.

³² Ofgem, RIIO-3 Draft Determinations - Finance Annex, 1 July 2025, para 3.47.

³³ UKRN, UKRN guidance for regulators on the methodology for setting the cost of capital, 23 March 2023, page 19.

³⁴ Frontier Economics, Assessing regulators' approach to setting the TMR - Implications for RIIO-3, 22 August 2025.

³⁵ Frontier Economics, Assessing regulators' approach to setting the TMR - Implications for RIIO-3, 22 August 2025, section 3.

³⁶ Frontier Economics, Assessing regulators' approach to setting the TMR - Implications for RIIO-3, 22 August 2025, executive summary.

³⁷ Frontier Economics, Assessing regulators' approach to setting the TMR - Implications for RIIO-3, 22 August 2025, section 4.

Frontier concludes that there is a clear need to reform the way TMR is set in a regulatory context, recommending that:

- TMR should reflect contemporaneous market data/expectations to some extent;
- the estimate should be stable and insulated from short-term fluctuations; and
- the TMR-setting approach should be transparent and predictable.³⁸

Frontier recommends adaptations towards a more sustainable, transparent and predictable approach to estimating the TMR and sets out a framework to operationalise the relationship between the market-implied required TMR and gilt yields.

It seems clear that regulators reduced their TMR estimates to below the long-term average when prevailing rates were low. As it has now proposed to increase TMR to slightly below the long-term average, over time, Ofgem's policy would seem to give less than average historical TMR when rates are low and average when rates are high. Overall, this provides investors with lower than historical average returns.

Ofgem inappropriately dismisses evidence from cross-checks to the TMR that clearly demonstrate that Ofgem's TMR estimate is materially below market expectations

In evidence submitted with TOs' business plans³⁹, we showed that cross-checks to the TMR, including DGM-based cross-checks, demonstrate that Ofgem's TMR is inconsistent with forward-looking expectations.

In its report, Frontier explains that Ofgem's rationale for discounting evidence from DGM-based TMR cross-checks is inconsistent with its decision to place weight on evidence from Market-to-Asset ratios (MARs) which are also DGM-based.⁴⁰ Frontier also observes that Ofgem implies that the sample of 82 responses to the Fernandez survey is small, while finding a sample of nine observations sufficient in its own investment manager TMR cross-check.⁴¹

Frontier provides updated evidence of the latest TMR cross-checks in its report.⁴² This latest data clearly demonstrates that Ofgem's proposed TMR is much lower than prevailing market expectations; the TMR Glider value from March 2025 of 8.0% and the 2 year moving average of 7.8% both suggest that Ofgem's historical TMR of 6.9% is materially below the current equity return required by the market.⁴³ Evidence from the Fernandez survey points to a significant increase in the TMR since RIIO-T2 decisions were taken: an increase of around 3 percentage points from 6.9% in 2020 to 9.7% in 2024 in nominal terms.⁴⁴

³⁸ Frontier Economics, Assessing regulators' approach to setting the TMR - Implications for RIIO-3, 22 August 2025, section 5.

³⁹ Frontier Economics, Updated cost of equity cross-check evidence, 22 November 2024, figure 2.

⁴⁰ Frontier Economics, Cross-check standards of evidence, 22 August 2025, section 3.

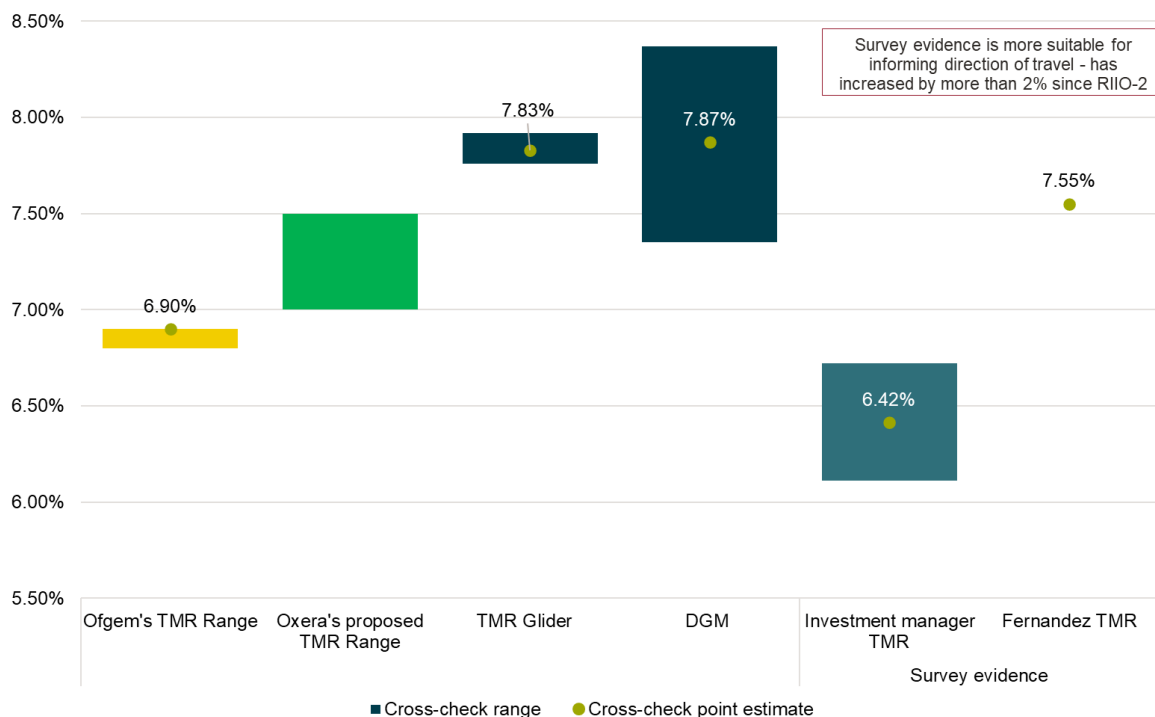
⁴¹ Frontier Economics, Cross-check standards of evidence, 22 August 2025, section 4.

⁴² Frontier Economics, Updated cost of equity cross-check evidence, 22 August 2025.

⁴³ Frontier Economics, Updated cost of equity cross-check evidence, 22 August 2025, section 10.

⁴⁴ Frontier Economics, Updated cost of equity cross-check evidence, 22 August 2025, section 9.

Figure 3 – TMR Cross-checks (CPIH-real)



Source: Frontier Economics⁴⁵

In its FD, Ofgem must take account of the evidence from TMR cross-checks and increase its TMR assumption accordingly.

Ofgem must not see the long-run average historical TMR as a constraint on the top of the TMR range. We have proposed a balanced approach that yields a stable TMR and reflects the current economic environment. We consider this approach could be adopted on an enduring basis. In the current environment this would lead to a TMR above the long run average by a modest margin, mirroring the downwards adjustment Ofgem implicitly made at RIIO-2. Even if Ofgem does not accept that the reduced TMR values reflected lower interest rates at the time, the reality that investors currently require a TMR above the long run average cannot be ignored.

What is at stake for customers and society in T3 is too great to allow a deliberately lower TMR than is required. Ofgem must send a positive signal to encourage investment into the sector. Accepting a TMR estimate that is higher than long-run average - in line with latest TMR cross-checks - would be an effective way to achieve that policy objective.

Difficulty replicating Ofgem's TMR calculations

Notwithstanding our view that the TMR should be set at a level that is higher than the long-term average to reflect prevailing investor expectations, we also note that Oxera's calculations of both the historical ex ante and historical ex post TMR yield different, slightly higher, results to Ofgem's published calculations, despite being

⁴⁵ Frontier Economics, Updated cost of equity cross-check evidence, 22 August 2025, section 10.

based on the same data set and Ofgem's stated methodology.⁴⁶ This may indicate an error in Ofgem's calculations. We encourage Ofgem to explore this ahead of its FD.

Ofgem needs to select a value within the top half of its beta range to reflect forward looking risks and the 'low beta anomaly'

FQ10 Do you agree with our methodology for estimating beta?

FQ11 Do you agree with our proposed set of comparators which also incorporates selected European utility stocks?

FQ13 Do you agree with our treatment of risks to the ET and Gas sectors as non-systematic?

We agree with Ofgem's proposal to include Pennon and European comparators into its beta comparator set. These changes will provide Ofgem with a more representative sample of comparators from which to determine its beta range.

However, Ofgem has not fully reflected forward-looking and systematic risk in its beta estimate. While we support Ofgem's proposed move towards a more comparable comparator set, this is not the same as considering whether the risks that networks face are fully reflected in backwards-looking beta data. Many factors are placing upward pressure on the energy networks' risk, and it is unclear whether these are fully reflected in the comparators' historical betas.

We observe that in RIIO-T1, Ofgem allowed a higher asset beta for companies with higher capex/RAV ratios, reflecting its assessment of increased systematic risk associated with larger capex programmes.⁴⁷ Given the investment intensity associated with delivery of Net Zero targets in the T3 period, this is highly relevant precedent. However, this has not been reflected by Ofgem in its DD.

Furthermore, the extensive evidence on the 'low beta anomaly' suggests that the cost of equity estimated based on Ofgem's assumed beta may underestimate the required returns for regulated utilities. Frontier considered this issue in its 2024 report.⁴⁸ Oxera considers these matters further in its report.⁴⁹

Oxera considers that the lower part of Ofgem's proposed asset beta range of 0.30–0.45 neither addresses the 'low beta anomaly' nor adequately reflects the challenges that energy networks are expected to face during RIIO-3, leading to a point estimate based on the midpoint of this range risking being too low to ensure that allowed returns are sufficient to enable companies to attract and retain capital and to support the investability of the energy sector. Oxera recommends that Ofgem narrows the asset beta range to the upper half of the estimated range to account for forward-looking risks and the 'low beta anomaly'.⁵⁰

Selecting a beta point estimate in the top half of the beta range would be consistent with Ofgem's statement in its SSMD that *"this [beta] is a specific area of the cost of equity calculation where the midpoint of our current wider range may not necessarily provide the most accurate forward-looking estimate."*⁵¹ Having identified this issue at SSMD, it would be reasonable for Ofgem to take this into account at FD by selecting a beta point estimate in the top half of its beta range.

⁴⁶ Oxera, RIIO-3 draft determinations—CAPM parameters and debt-based cross-checks, 22 August 2025, pages 40 and 45.

⁴⁷ Ofgem, RIIO-T1: Final Proposals for National Grid Electricity Transmission and National Grid Gas, 17 December 2021, para 3.19.

⁴⁸ Frontier Economics, The low beta puzzle, 5 March 2024.

⁴⁹ Oxera, RIIO-3 draft determinations—CAPM parameters and debt-based cross-checks, 22 August 2025, section 4.

⁵⁰ Oxera, RIIO-3 draft determinations—CAPM parameters and debt-based cross-checks, 22 August 2025, section 4.

⁵¹ Ofgem, RIIO-3 Sector Specific Methodology Decision – Finance Annex, 18 July 2024, para 3.225.

Ofgem needs to increase its CAPM cost of capital range in light of these issues

Overall, our analysis of Ofgem's CAPM parameter assumptions shows Ofgem's CAPM parameter range to be too low. The following table compares Ofgem's CAPM parameter ranges with Ofgem's DD assumptions.

Table 2 – Comparison of Ofgem's and Oxera's CAPM parameter ranges

CPIH real, 55% gearing	Ofgem low	Ofgem high	Oxera low	Oxera high
RFR	2.01%	2.01%	2.25%	2.25%
TMR	6.80%	6.90%	7.00%	7.50%
Equity beta (at 55% gearing)	0.58	0.91	0.74	0.91
Cost of equity	4.76%	6.45%	5.77%	7.02%

Source: Oxera⁵²

We note that Ofgem's proposed cost of equity of 5.64% (at 55% gearing) falls below the bottom of Oxera's CAPM cost of equity range, demonstrating that Ofgem's proposed cost of equity is too low.

A wide body of evidence supports selecting a cost of equity point estimate that is much higher than Ofgem's proposed point estimate.

It is important to calibrate the return on equity allowance such that it ensures the investability of the regulatory settlement. In its redetermination of the PR19 price control review, the CMA⁵³ set out a number of factors that are relevant when considering the point estimate to select. These include:

- asymmetry in CAPM parameter uncertainty;
- asymmetry of risk in the package;
- cross-checks to the determined level; and
- the need to promote investment.

Oxera explored how the choice of a point estimate within the cost of equity range supports the investability of the sector in its report submitted to Ofgem by TOs.⁵⁴

Ofgem has not fully considered these relevant factors in deciding where in its CAPM cost of equity range to select its proposed cost of equity. A thorough review of relevant factors would have prompted Ofgem to select a proposed cost of equity from higher in its cost of equity range.

Asymmetries in CAPM parametric uncertainty merit aiming up within Ofgem's CAPM range

We disagree with Ofgem's assessment that its CAPM parameter ranges are likely to be symmetrical.⁵⁵ For the reasons set out in the sections above, we believe them to be negatively skewed. In particular:

- deciding to not reflect convenience premium in its proposed RFR creates negative asymmetry in its proposed RFR;
- there is clear evidence that current market-based TMR cross-checks imply a TMR value which is much higher than the DD; and

⁵² Oxera, RIIO-3 draft determinations—CAPM parameters and debt-based cross-checks, 22 August 2025, section 5.

⁵³ Competition and Markets Authority, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, Final Report, 17 March 2021, chapter 9.

⁵⁴ Oxera, RIIO-3 risks and investability topics, 9 December 2024, section 4.

⁵⁵ Ofgem, RIIO-3 Draft Determinations - Finance Annex, 1 July 2025, para 3.123.

- selection of a beta value at the mid-point in Ofgem's proposed asset beta range neither addresses the 'low beta anomaly' nor adequately reflects the challenges that energy networks are expected to face during RIIO-3.

Taken together, the negative asymmetry in its CAPM parameter ranges would justify selecting a proposed cost of equity from much higher in its CAPM cost of equity range.

Asymmetries in the T3 package of cost allowances and incentives cannot yet be fully assessed in detail

FQ17 Do you agree with our working assumption that there is risk symmetry within the aggregate balance of the whole price control?

Ofgem has provided insufficient detail of its proposed incentive package to make a meaningful assessment of whether the price control package represents a "fair bet" for investors. Ofgem must provide TOs with more detail to allow this assessment to be undertaken. There is downside risk across several elements of the framework that lowers expected returns. In particular, the following issues with the proposed framework which increase downside risk include:

- negative skew in ODI-F;
- a proposed 1% p.a. ongoing efficiency challenge although the evidence shows this level has not been achieved in any sector since 2008;
- a lack of totex funding or pathway for funding for indirect costs through baseline totex and uncertainty mechanisms;
- a reduction in risk and contingency allowances from 7.5% in RIIO-T2 to 5% in T3; and
- the lack of a workable reopener framework.

In general, we agree with Ofgem that there is a difference between possible outcomes and probable outcomes and that it would be incorrect to assume that the largest downside shown in any RoRE chart has precisely the same probability as the largest upside.⁵⁶ Ofgem must review the framework ahead of its FD to ensure that it represents a "fair bet" for investors.

Ofgem's proposed cost of equity is not competitive versus the set of other opportunities that exist

As explained earlier in this response, Ofgem's assessment of whether its proposed cost of equity is competitive against other opportunities is incomplete. A thorough review of cross-checks to the cost of equity would conclude that the proposed T3 cost of equity is too low.

Aiming up is also needed to promote investment

Setting the return on equity too low could induce underinvestment risk, which could in turn lead to detrimental welfare consequences. The ambitious investment programmes to be delivered in T3 and beyond are necessary to decarbonise the energy system efficiently, and will also generate large welfare benefits through growth and job creation, consistent with the focus of Ofgem's new Net Zero and growth duties. In this context, the detrimental welfare consequences of setting the return on equity too low would be exacerbated. Setting Ofgem's allowed return too low risks underinvestment against these key programmes due to networks being unable to raise the finance necessary to support investment.

If a regulatory allowance is set below investor expectations, while this may not lead to a full blown and immediate withdrawal of capital, except in extremis, it is reasonable to expect investors to curtail and scale back their investment plans, putting at risk objectives such as CP2030. This would simply be a rational response to

⁵⁶ Ofgem, RIIO-3 Draft Determinations - Finance Annex, 1 July 2025, para 3.145.

allowed returns being set too low regardless of the underlying reason. Similarly, potential investors may be deterred from deploying their capital in the sector. The impact of these rational investor decisions may not be immediately noticeable; the full impact may only be discovered in hindsight, when customers are exposed to sub-optimal outcomes, policy objectives are not achieved and financing costs increase.

Assessment of relevant factors for which data is available would point towards a higher cost of equity estimate being required. It is in customers' interests to select a cost of equity point estimate that is higher than Ofgem's proposed cost of equity in light of these factors. Doing so would avoid the welfare losses of underinvestment and account for capital market constraints.

Cost of equity conclusion: Ofgem's proposed cost of equity for T3 is too low

For the reasons explained above, Ofgem's proposed cost of equity for T3 is demonstrably too low.

It is critical Ofgem implement the following at FD:

- Apply a consistent quality standard to appraise available cross-check evidence submitted thus far- this will provide a more balanced and transparent approach to investability and allow Ofgem to cross-check the overall adequacy of its financial package for T3 in the face of international competition for capital.
- Recognise the convenience premium in government gilts in its proposed RFR;
- Increase TMR to account for forward-looking expectations (in line with the TMR cross-check evidence) and adopt a more sustainable and transparent approach to TMR-setting; and
- Aim up in the beta range until the overall cost of equity package comfortably satisfies investability assessment.(i.e in excess of 6% at 55% gearing in current interest rate conditions)

Taking all factors into account, selecting a cost of equity point estimate towards the upper end of the Oxera cost of equity range would be appropriate to support investability of the networks.

Ofgem's assumed dividend yield fails to meet with investors' expectations and benchmarks or to compete against dividend yield available elsewhere.

FQ14 Do you agree with our proposed dividend allowance policies for the notional gas and electricity companies?

An investable price control package must ensure that dividend yields can be maintained at a level that is consistent with investors' expectations and benchmarks. Ofgem's assumed dividend yield of 3% is lower than investors' expectations.

Oxera explored the importance of this in its report for TOs.⁵⁷ Oxera concluded that, from a theoretical perspective, investors in utilities might favour dividend payments over share price appreciation as a form of remuneration due to clientele effects, and noting that safeguards already exist against unreasonable distributions of cash by networks through ring fence requirements, it concluded that networks should be able to adopt a dividend policy that reflects their investors' preferences. Oxera also showed that this preference is evidenced by empirical data, as European electricity networks have maintained a stable dividend yield relative to the profile of their investments over time, at an average level that is higher than the 3% base assumption in Ofgem's DD. Similarly, UK utilities have consistently exhibited higher dividend yields than the market average.

⁵⁷ Oxera, RIIO-3 risks and investability topics, 9 December 2024, section 3.

We welcome Ofgem's proposed implementation of a RAV-weighted cost of debt for all TOs. Ofgem's proposed allowance for additional costs of borrowing has materially under-estimated a number of components, leading to the efficient costs of servicing networks' debt being underfunded.

FQ1 Do you agree with our approach to estimating efficient debt costs and calibrating the index?

FQ4 Do you agree with our approach to setting the additional cost of borrowing allowances?

FQ5 Do you agree with our proposed treatment of inflation with respect to the allowed return of debt?

As TOs prepare to raise considerable amounts of new debt to fund increasing investment programmes, it is more important than ever to ensure that Ofgem's cost of debt allowance will fund networks' efficient costs of raising and servicing debt.

Given the rapidly changing investment programmes for TOs, we agree with Ofgem's proposal to implement a RAV-weighted cost of debt for all TOs. We also support the proposed move to a semi-nominal cost of debt from the start of T3.

Ofgem's proposed allowance for additional costs of borrowing has under-estimated networks' efficient costs

Ofgem's proposed allowance for additional costs of borrowing has under-estimated networks' efficient costs, leading to the efficient costs of servicing networks' debt being underfunded. In particular, Ofgem's backwards-looking approach has materially under-estimated its cost of carry and liquidity allowances because it has failed to take account of greater new debt issuance costs and carry-cost over T3 and has omitted key elements of TOs' efficient liquidity costs. In the attached report⁵⁸, NERA explains the drivers of that under-estimation.

Ofgem fails to reflect forward-looking cash deposit rates and increasing cash/ debt ratios required to fund increasing investment programmes leading to material under-estimation of the cost of carry allowance

Ofgem's cost of carry allowance is materially under-estimated for two main reasons:

First, Ofgem assumes the iBoxx-cash deposit rate spread based on a backwards-looking 5 year average of 1.45%, but forward-looking data shows spread to be 3.00%. Ofgem's estimate is not a reliable estimate of carry cost for T3, as it includes the 2023-24 period which is a period of abnormally low spreads. Correcting for this issue alone increases Ofgem's allowance from 11 bps to 23 bps.

Second, Ofgem assumes a cash/debt ratio of around 8% based on a 2 year average of RIIO-2 data. This does not reflect the impact of substantial RAV growth and associated new debt issuance in T3. RAV growth during T3 will require TOs to hold higher cash balances than RIIO-2 to pre-finance greater debt issuance. A greater cash/debt ratio is required to reflect this. NERA calculates that T3 RAV growth implies an increase in cash/debt percentage to 12%.⁵⁹ NERA notes that this RAV growth assumption is conservative as it reflects only base case totex and a 6-month pre-financing period.

⁵⁸ NERA, Liquidity Cost & Cost of Carry Allowance at RIIO-ET3, 20 August 2025.

⁵⁹ NERA, Liquidity Cost & Cost of Carry Allowance at RIIO-ET3, 20 August 2025, slide 7.

Taken together, these two issues mean that Ofgem's cost of carry allowance materially underfund TOs' efficient cost of carry.

Table 3 – Comparison of Ofgem's and NERA's cost of carry allowance calculations

	Ofgem	NERA
Cash assumption (% debt) [A]	7.7%	12%
iBoxx-cash rate spread [B]	1.45%	3.0%
Cost of carry allowance [C=A*B]	11 bps	36 bps

Source: NERA⁶⁰

Failure to fund cost of draw-down and understatement of revolving credit facilities leads to underestimation of liquidity allowances

Ofgem's liquidity allowance is too low because it does not allow cost of draw-down and understates size of revolving credit facilities. In practice, companies draw facilities to fund working capital requirement and operational needs. NERA estimates liquidity costs of 5 bps p.a., based on average draw-down of 3.1% and a revolving credit facility requirement that is better aligned with company forecasts.⁶¹

NERA estimates a combined cost of carry and liquidity allowance of 41 bps for TOs, comprising 36 bps of cost of carry allowance, and 5 bps of liquidity cost allowance. This is materially greater than Ofgem's estimate of 13 bps.

Table 4 – Comparison of Ofgem's and NERA's liquidity and cost of carry allowances

	Ofgem	NERA
Cost of carry allowance	11 bps	36 bps
Liquidity allowance	2 bps	5 bps
Liquidity and cost of carry allowance	13 bps	41 bps

Source: NERA⁶²

Making corrections to just these elements of Ofgem's additional cost of borrowing allowances will increase allowances from 19 bps to 47 bps.

We also note that Ofgem has not properly engaged with the work undertaken by NERA on the need for an allowance to reflect the efficient costs of new debt issuance relative to Ofgem's benchmark index (New Issue Premium).⁶³ In particular, we see no justification for Ofgem's suggestion that evidence from SSE's corporate bonds should not be considered in assessing the efficient costs.

⁶⁰ NERA, Liquidity Cost & Cost of Carry Allowance at RIIO-ET3, 20 August 2025, slide 3.

⁶¹ NERA, Liquidity Cost & Cost of Carry Allowance at RIIO-ET3, 20 August 2025, slide 11.

⁶² NERA, Liquidity Cost & Cost of Carry Allowance at RIIO-ET3, 20 August 2025, slide 3.

⁶³ NERA, Additional Cost of Borrowing for the RIIO-3 Price Control, 22 February 2024.

We welcome Ofgem's acknowledgement that changes to the T3 package are required to secure financeability. We agree with Ofgem that such changes are in customers' interests. Ofgem needs to consider more sustainable solutions to secure financeability into the longer term.

FQ18 Do you agree with our approach to assessing financeability?

FQ19 Do you agree with our proposal to adjust bucket 2 capitalisation rates from natural rates to 85% for all ET licensees to support financeability? Are there alternative measures that stakeholders consider more appropriate?

FQ20 Do stakeholders have views or evidence on long-term financeability considerations, including the appropriateness of the proposed asset lives?

We welcome Ofgem's acknowledgement that changes to the T3 package are required to secure financeability. We agree with Ofgem that such changes are in customers' interests.

Given Ofgem's proposal to require TOs to hold a minimum of two investment grade credit ratings, it is important that Ofgem's approach to assessing financeability tests whether all ratios used by all major credit rating agencies meet at least BBB+/Baa1. We note that Ofgem seems to have omitted Moody's FFO/ net debt ratio threshold of 11% from its financeability assessment. Ofgem must not be selective as to which credit rating agencies' ratios must be met; this key test should also be included in Ofgem's financeability assessment for FD.

We welcome Ofgem's decision to assess financeability over the long term and its recognition that changes (relative to T2) will also be required to secure financeability for T4 and beyond. We note that Ofgem forecasts that many key financial ratios continue to deteriorate after the end of T3, despite the changes that Ofgem has applied for T3. As gearing and capitalisation rates are typically reviewed at every price control decision, and Ofgem's DD relies on assumptions that are misaligned with "natural" assumptions, investors face the risk that a future regulator may make changes to financial policies for T4 that cause debt financeability to deteriorate to below investment grade credit ratings in the future. This is a concern for both debt and equity investors because of the long-term nature of investors in networks. Ofgem will need to identify a more sustainable solution for future price controls such as considering changes to RAV depreciation.

It is important that any changes to resilience standards are established in a manner that does not undermine investability and that Ofgem's price control assumptions are determined on a basis that is internally consistent with any changes to the resilience standards.

FQ21 Do you agree with our proposal to implement the Financial Resilience measures as laid out in our SSMD and the proposed methodologies set out above?

The key benefits associated with safe and reliable networks can only be achieved if networks are financially resilient as well as able to source sufficient investment. Companies take their financial resilience obligations very seriously.

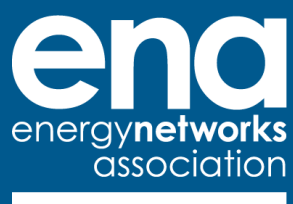
We note that Ofgem has announced a review of the ring fence arrangements that may introduce further changes to the ring fence arrangements beyond those consulted on in the DD. In introducing any further changes, Ofgem must take account of interactions with these price control review processes, including its

assessment of investability and financeability. Any future changes to those arrangements need to be assessed very carefully and associated costs must be fully funded. It is unclear to us what process Ofgem will follow to achieve this.

Next steps

We trust that our evidence is helpful to Ofgem. We would be happy to meet with Ofgem to explore our evidence in more detail, and to provide Ofgem with access to our advisers.

We stand ready to work with Ofgem and look forward to discussing our proposals and evidence with you.



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