

Decision

ED3 Sector Specific Methodology Decision - Finance Annex

Publication date:	21 May 2026
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This document sets out our decisions on the methodologies we will apply to the electricity distribution sector in the ED3 price control, which will run from 1 April 2028. In particular, it sets our decisions on the specific issues on which we sought views from respondents in our Sector Specific Methodology Consultation in October 2025.

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1. Executive summary

- 1.1 The costs of operating and developing the electricity distribution (ED) networks include the financing costs that the network companies incur. Consumers ultimately pay for these costs through their energy bills, which include the returns that we allow for debt and equity capital invested into network companies. We use incentives to encourage network companies to drive down costs and improve service quality. These incentives, as well as the ability for a company to make decisions around its actual capital structure, mean that a company's actual return can be higher or lower than its allowed return.
- 1.2 We set a financial framework, and associated policies and methodologies, for price controls that are broadly stable and predictable over time. This broad regulatory stability gives investors the confidence to continue to invest in the sector. It also helps us to achieve a low cost of capital without constraining our ability to act in the interests of consumers by adapting to changing circumstances and through adopting best practice.
- 1.3 The ED3 period will be vital in delivering a more secure, flexible and clean energy system. The transition to a decarbonised energy system will involve increasing electrification of heat and transport, alongside the integration of more local power sources such as solar panels and battery storage. This shift places new and evolving demands on local distribution networks, requiring them to plan more strategically in response to changing patterns of electricity generation and consumption.
- 1.4 Distribution Network Operators (DNOs) will play a critical role as the demand for, and generation of, electricity grows to support the energy transition. We are clear that DNOs need to build out the grid that supports energy efficiency, timely connections, low carbon technology and flexibility. This will mean that a step-change in investment is needed for the sector to deliver on ambitious targets.
- 1.5 We published our Sector-Specific Methodology Consultation (SSMC) in September 2025, consulting on our proposed approach to setting the financial framework for the ED3 period. In this Sector Specific Methodology Decision (SSMD) Finance Annex, we review the responses from stakeholders, present our analysis of the relevant evidence and lay out the methodology decisions we will take at this stage of the price control setting process. In this document we also signal a small number of areas where we will continue to engage with stakeholders on elements that require further analysis or development prior to making our determinations. At the SSMD stage, we are primarily defining the methodologies we will use to set the financial parameters in ED3. Where relevant and useful to stakeholders, we present an 'early view' of associated outcomes (such as the costs of equity and debt). These figures will change based on updated data and evidence and will be confirmed in our Draft and Final Determinations in 2027.

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- 1.6 On cost of debt, covered in Chapter 2, we expect in ED3 to apply a similar approach to RIIO-3. We have decided to use a nominal debt allowance for fixed rate debt to protect consumers from the impact of higher-than-expected levels of inflation. Other specific elements will be finalised at Draft and Final Determinations, such as the exact calibration of the allowance, assumed proportions of fixed and index-linked debt and additional costs of borrowing allowances.
- 1.7 Our cost of equity allowance, covered in Chapter 3, will follow the same Capital Asset Pricing Model (CAPM) methodology applied to RIIO-3, including the incorporation of comparable European utilities in setting the beta component. Our aim is to set an allowed equity returns that fairly reflect the cost of equity capital for ED networks.
- 1.8 We apply a notional level of gearing in deriving a weighted average cost of capital (WACC). This was set at 60% for ED2 and we will use this level for business planning purposes. We are actively considering whether increases in equity values due to higher-than-anticipated inflation over ED2 should be harnessed to support a reduction in the notional level of gearing used in ED3 and beyond. In this way, increases in equity values at companies will benefit customers by underpinning increased investment and supporting financeability. A reduction in the notional level of gearing from 60% to 55% (over the ED3 control period) would align with the approach already used in the ET sector.
- 1.9 In Chapter 5 we set out our methodology to assessing the financeability of licensees at the notional capital structure. We continue to believe it is in the consumer interest to make our assessment in line with the requirements of a BBB+/Baa1 credit rating, and will incorporate improvements to our approach, such as longer term modelling and replicating scorecard methodologies of other rating agencies to the extent possible. We will undertake our in-the-round financeability assessment at Draft Determinations, considering the ED3 package as a whole.
- 1.10 We confirm our intent that the financial resilience measures introduced in RIIO-3 will also apply to the ED sector. These were the introduction of a lock-up on distributions if licensees reach or exceed 75% gearing, a requirement to have more than one investment grade credit rating and amendments to the Availability of Resources obligations. These measures further increase confidence in the energy sector and help ensure that we protect consumers from any significant deterioration in resilience, whilst imposing no additional costs on network companies operating with responsible financing strategies. We recognise that the wider Energy Networks Ringfence Review, which includes ED companies and has regards to matters related to financial resilience, is ongoing and awaiting decision. The outcome of the Ringfence Review may provide an alternative or complementary route for implementing some of the financial resilience measures outlined in the SSMD.

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- 1.11 Regulatory depreciation primarily aims to allocate costs fairly between current and future consumers (sometimes referred to as intergenerational fairness); and ensures that company revenues reflect the licensee's need to make sustainable economic investments. The DNOs have highlighted regulatory depreciation policy as a key sector-specific topic for ED3. The DNOs argue that the RIIO-1 transition from a policy based on 20-year asset lives to one based on 45-year asset lives causes cash flow issues and contributes to financeability pressures in future price control periods.
- 1.12 As a starting point, we have carefully considered the economic principles that should underpin our approach to depreciation. At this stage, we continue to consider that our existing depreciation methodology is rational, a view that is supported by an external review conducted by CEPA. We agree that depreciation is one possible lever for adjusting any financeability pressures, but it is important that we consider all possible levers under our financeability assessment in our determinations. We will continue to engage with stakeholders on this issue ahead of Draft Determinations.
- 1.13 Our corporation tax allowance enables companies to recover appropriate amounts required to cover their tax costs while incentivising them to manage their tax affairs efficiently - thereby keeping costs lower for consumers. The tax clawback, tax review, and tax trigger event mechanism act as additional protections. The additional protections reduce the risk of consumers providing an allowance for tax costs which are not ultimately borne by the licensee. We have decided to replicate our RIIO-3 approach on corporation tax for ED3.
- 1.14 Chapter 9 covers our methodological approach to setting our Return Adjustment Mechanisms (RAMs), which we are minded to maintain from ED2. RAMs are an important tool for protecting companies and consumers alike from excessive or unexpected gains or losses and we see significant benefit in including them in ED3.
- 1.15 Chapter 10 covers other key financial issues and our proposed approaches for ED3. Our approaches largely replicate those taken in ED2 and in our RIIO-3 Final Determinations.

2. Allowed return on debt

The allowed return on debt provides an allowance that references an appropriate index that incentivises networks to minimise their debt costs, which over time feeds through into lower costs for consumers. In this chapter, we detail the methodology employed to establish the baseline allowance.

SSMC questions

- FQ1. Do stakeholders consider there to be good reasons (as defined in SSMC Paragraph 3.13) to deviate from the overall approach set out under the UK Regulators Network (UKRN) Guidance Recommendation 8?¹
- FQ2. Do stakeholders agree with our proposal to use a combination of the iBoxx £ Non-Financials A 10+ and iBoxx £ Non-Financials BBB 10+ indices rather than the iBoxx £ Utilities 10+ index?
- FQ3. Do stakeholders consider it reasonable to adjust our long-term Consumer Price Index with Housing costs (CPIH) forecast to the latest Office for Budget Responsibility (OBR) assumption?
- FQ4. Do stakeholders have any objections to our proposed approach to apply Inflation Option 1 (as defined in SSMC Paragraph 2.19)?
- FQ5. Do stakeholders have new evidence for us to consider in our review of the additional cost of borrowing allowances or infrequent issuer premium?
- FQ6. Do stakeholders agree with our proposed RAV-weighted approach for calibrating the index for ED networks?
- FQ7. Do stakeholders wish to propose any other alternatives to the approach for setting the allowed return on debt for ED3?

Our approach for ED3

SSMC summary

- 2.1 The allowed return on debt is an estimation of the return investors expect from an efficiently run company, taking account of both embedded debt from previous price control periods and new debt raised in the current price control period. The allowance, which is funded through consumer bills, is designed to ensure companies can raise and service debt to meet investment needs while incentivising efficient financing. Our approach helps to ensure that shareholders, not consumers, bear the risks and rewards of actual financing decisions.
- 2.2 As with previous price controls, we will set the cost of debt allowance based on network licensees adopting the notional capital structure and incurring forecast

¹ UKRN cost of capital guidance (2023), page 33

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efficient average sector debt costs. The notional capital structure assumes that companies finance their activities with a combination of fixed rate and index-linked debt (ILD) and adopt a specific level of gearing.

- 2.3 We outlined several methodological updates introduced in RIIO-3 SSMD that we consider relevant for ED3, which we will discuss in greater detail throughout the allowed return on debt section. We also reiterated our intention to align with Recommendation 8 of the UKRN Guidance, which states that regulators should assess the allowance for an efficient company using a notional capital structure, with actual debt costs appropriately benchmarked against wider market evidence.²

Summary of consultation responses

- 2.4 In FQ1 of our SSMC we asked, "Do stakeholders consider there to be good reasons to deviate from the overall approach set out under the UK Regulators Network (UKRN) Guidance Recommendation 8?".
- 2.5 All DNOs supported aligning the approach to calculating the allowed return on debt with UKRN Guidance Recommendation 8. Various companies provided detailed submissions regarding the specific implementation of Recommendation 8, which are addressed in the relevant sections below.

SSMD decision and rationale

- 2.6 We have decided to set the allowed return on debt in line with UKRN Guidance Recommendation 8. The UKRN Guidance is largely consistent with the RIIO-3 framework, and we believe that adherence to this guidance enhances regulatory transparency and predictability. Furthermore, such alignment serves the interests of consumers by ensuring that actual debt costs are suitably benchmarked against observable market benchmarks reducing the risk of over-remuneration.

Benchmark index selection

SSMC summary

- 2.7 A key consideration in the formulation of the cost of debt allowance is the management of uncertainty with respect to future debt costs. In the SSMC, we stated that we did not consider there to be any compelling reasons not to utilise an indexation-based approach in order to manage this risk.
- 2.8 Regarding benchmark index selection, we proposed adopting the average of iBoxx £ Non-Financials A 10+ (ISIN: DE000A0JY837) and iBoxx £ Non-Financials

² UKRN cost of capital guidance (2023), page 33

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BBB 10+ (ISIN: DE000A0JZAH1) indices. This approach represents a departure from the RIIO-ED2 methodology, which utilized the iBoxx £ Utilities 10+ index as the benchmark. The reason for this change is that the Utilities index has become influenced by well publicised financial challenges in Thames Water Utilities Ltd, causing price signals that may no longer accurately represent the efficient financing costs for energy network companies.

Summary of consultation responses

- 2.9 In FQ2 of our SSMC we asked, "Do stakeholders agree with our proposal to use a combination of the iBoxx £ Non-Financials A 10+ and iBoxx £ Non-Financials BBB 10+ indices rather than the iBoxx £ Utilities 10+ index?".
- 2.10 Three of the five DNOs were supportive of the proposal.
- 2.11 NPg disagreed with the move from the utilities index. NPg stated it would be sensible to wait until the Draft Determinations before making a final decision on the benchmark. They do not see a need to change indices, since none will perform ideally in all situations; factors leading Ofgem to alter indices could arise again, and the cost of water sector debt is likely to return to normal over time.
- 2.12 SSEN-D noted that both the proposed and previous benchmarks have their own strengths and weaknesses, and suggested monitoring both throughout the consultation period to assess their continued relevance.

SSMD decision and rationale

- 2.13 We have decided to proceed with a cost of debt indexation approach. This approach links the allowed cost of debt to an external market benchmark, typically a corporate bond index. This reduces the risks that allowed debt costs diverge from efficient debt costs.
- 2.14 We have decided to progress with the proposal to use the average of the iBoxx £ A and iBoxx £ BBB Non-Financials 10+ debt indices as the debt cost benchmark for ED3. This is the same benchmark used in the RIIO-3 price control.
- 2.15 We consider this benchmark a reliable measure of macro-level changes in network debt costs, offering a clear reference that aligns the debt allowance with the efficient costs faced by energy network companies under our notional capital structure and expected financial strength (BBB+).
- 2.16 While we acknowledge that non-financial indices are exposed to sectors outside the UK energy sector, we are of the view that considering a wider range of debt cost data helps prevent overdependence on the stability or fluctuations of any single sector, and reduces the risk that the index performance could become misaligned to efficient energy sector costs.

Inflation treatment

SSMC summary

- 2.17 In the SSMC, we noted that the cost of debt allowance for RIIO-ED2 utilised a trailing average methodology and that at each measurement point of the trailing average was deflated by a long run assumption of CPIH, being the year five OBR Consumer Price Index (CPI) forecast prevailing at that point. The long run CPIH inflation assumption has typically aligned to 2%.
- 2.18 We also noted that in its October 2024 Economic and fiscal outlook, the OBR introduced a long-run CPIH and CPI wedge assumption of 0.4%.³ We stated our intention to review whether an adjustment to the inflation assumption used in ED3 is warranted to reflect the OBR's long-run wedge.
- 2.19 In RIIO-3, following the closure of the Inflation Call for Input and having considered all relevant consultation responses, we decided to implement an approach under which the cost of debt allowance for fixed rate debt is provided on a nominal rather than real basis.^{4 5} We did this because it aligns the cash allowance with the servicing requirements of fixed rate debt capital, and we expect the option to result in lower costs for consumers over the long run. To effect this change, a portion of RAV, aligned to the notional fixed rate debt assumption, would be delinked from outturn inflation to avoid compensating investors twice. The indexation of the RAV for ILD and equity would be unaffected.
- 2.20 We did not consider a transition mechanism was required for the implementation of the semi nominal debt approach, noting that this minimises complexity, aligns to the notional approach and removes the inflation leverage effect on a notional basis immediately.
- 2.21 In ED3 SSMC, we considered applying the nominal allowance for fixed rate debt and the same method for RAV indexation within ED3.

Summary of consultation responses

- 2.22 In FQ3 of our SSMC we asked, "Do stakeholders consider it reasonable to adjust our long-term CPIH forecast to the latest OBR assumption?".
- 2.23 All DNOs except SSEN-D were supportive of the adjustment of our long-term CPIH inflation forecast to the latest 5th year OBR CPIH assumption.

³ OBR Economic and fiscal outlook, October 2024, page 39

⁴ Call for input - Impact of high inflation on the network price control operation

⁵ RIIO-3 Final Determinations Finance Annex

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- 2.24 SSEN-D stated that Ofgem's current approach of using the Bank of England's 2% inflation target as the long-term CPIH assumption is grounded in historical evidence and aligns with best practice.
- 2.25 With regards to the use of the OBR's long-term forecast of CPIH of 2.4%, all DNOs argued against an approach based on CPI estimates plus a 0.4% CPI-CPIH wedge, stating that it would introduce unnecessary uncertainty and undermine predictability in the price control framework, that historical evidence did not support a persistent wedge and that the forecast provided by the OBR lacked a tried and tested forecasting methodology.
- 2.26 Citizens Advice supported adjusting the long-term CPIH inflation forecast to include the latest OBR assumption of the CPI-CPIH wedge. It argued that this would improve the accuracy of the real cost of debt calculation and better align the allowance with long-term macroeconomic expectations. It stated that using a 2% long-run CPIH assumption to deflate the cost of debt likely understated long-term CPIH expectations and could lead to network companies receiving a windfall gain.
- 2.27 In FQ4 of our SSMC we asked, "Do stakeholders have any objections to our proposed approach to apply Inflation Option 1?". This approach would see the cost of debt allowance for fixed rate debt provided on a nominal basis rather than a real basis.
- 2.28 All respondents were supportive of the implementation of this approach for fixed rate debt, without the requirement for a transition mechanism.
- 2.29 Citizens Advice was in favour of the nominal allowance for fixed rate debt approach, but pointed out that debt indexation gives UK networks a degree of risk protection not found in similar sectors like those in the US. As a result, they believe this lowers the business risk profile, which should be fully reflected when determining the total cost of capital. Citizens Advice also highlighted the possibility of a continued 'inflation' windfall via the ILD-assumed portion of the notional capital structure, especially if the long-term CPIH used to deflate nominal yields is lower than outturn CPIH, and if the OBR's projected 0.4% difference between CPI and CPIH is not taken into account.
- 2.30 NGED supported the nominal allowance for fixed rate debt approach and suggested introducing a mechanism that allows licensees to recover costs from shifting from Retail Price Index (RPI) to CPIH in relation to ILD. NGED stated that the notionally structured company would have secured 25% of its debt as index-linked during RIIO-ED1 and RIIO-ED2, usually with terms of ten years or more. As a result, significant amounts of ILD will still be outstanding in 2030 when the transition occurs. NGED also suggested an ILD assumption ranging from 0-10% within the notional structure.

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- 2.31 SSEN-D stated that it agreed with the proposed nominal allowance for fixed rate debt approach, but firmly opposed using a notional ILD assumption based on ED2 or sector averages. SSEN-D stated that the assumption should reflect each company's actual ILD position to remove the "leverage effect" that Ofgem aims to address. SSEN-D stated that this does not involve using company-specific debt costs but rather applying the same principles as RAV weighting for the notional debt cost allowance.
- 2.32 SPEN supported the nominal allowance for fixed rate debt approach but stated that it significantly diverges from a main UK regulatory principle agreed to by investors. SPEN stated that Ofgem should clearly communicate the consequences of this change to stakeholders. SPEN recommended efficient estimation of the ILD portion, ensuring market availability and an appropriate semi-nominal return for effective RAV recovery.
- 2.33 NPg supported the nominal allowance for fixed rate debt approach. NPg recommends assessing the notional ILD assumption ahead of Draft Determinations, as this represents a crucial input to the financeability evaluation within business plans. NPg observed that the current 25% assumption is unrealistically high, referencing its own analysis which suggests the electricity distribution sector's present proportion is approximately 12%. Given companies are likely to issue less index linked debt in the future, NPg considers a reasonable range to be between 0% and 10%.

SSMD decision and rationale

Approach to fixed rate debt allowance

- 2.34 We have decided to proceed with the proposed nominal allowance for fixed rate debt approach, aligning with our RIIO-3 decision. We will use a fixed rate debt assumption for the notional capital structure. The reasoning behind this approach is explained below.
- 2.35 We consider there is evidence of both historic and possible future consumer detriment from inflation spikes and a strong consumer interest in policy action. Additional RAV growth from periods of higher-than-expected inflation leads to concerns that consumers are not paying a fair price over the long-term. In addition, the effectiveness and legitimacy of the price control may be undermined where equity investor real returns are correlated to a macro-economic variable and not delivery for consumers.
- 2.36 In addition, we note evidence to suggest that large inflation shocks have historically been more likely to be positive (ie higher than expected) than

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negative, suggesting that there is not likely to be a fair balance of outcomes under the existing approach.⁶

- 2.37 In addition, this approach leads to a moderately positive impact on financeability and has been implemented without material issue for the companies subject to RIIO-3.
- 2.38 We will make a final decision on the notional assumed ILD proportion at Draft Determinations. We note that the current sector proportion of ILD debt (not including synthetic approaches) is around 12%. For business plan purposes, companies should use an assumption of 10%. Note this is also in line with our assumed ILD proportion in the ET3 price controls. We will also consider if an approach reflecting each company's actual ILD proportion could be incorporated, although at this stage it is not clear that this would bring a material benefit to the design of the financial framework.

Estimating index-linked debt costs

- 2.39 We are minded using the OBR's long-term CPIH forecast of 2.4% to deflate the ILD portion of assumed debt, replacing the previously used 5th-year CPI forecast from RIIO-ED2. Based on a notional ILD proportion assumption of 10% the impact of this this change would be to reduce WACC by around 0.01%.
- 2.40 Twice yearly, the OBR publishes its latest economic and fiscal outlook. Since its March 2025 publication, the OBR has published medium forecasts for CPIH. This means that instead of using the OBR's 5th-year CPI forecast as a proxy for CPIH we can now use its 5-year CPIH forecast.
- 2.41 However, in its October 2024 economic and fiscal outlook the OBR published its first long-term CPIH forecast which combined its CPI inflation forecast of 2.0% and a wedge of 0.4% (reflecting the addition of council tax and owner occupier housing costs which are not measured within CPI).
- 2.42 The OBR's resulting long-term CPIH forecast, set at 2.4% and unchanged since October 2024, contrasts with their updated fifth-year CPIH prediction of 2.1% from March 2026. This raises the question of which forecast is more appropriate for estimating the long-term level of CPIH.
- 2.43 While historical data does not support a 0.4% CPIH-CPI wedge, both CPI and CPIH measures of inflation have consistently exceeded the Bank of England's 2% CPI target since 2002. OBR forecasts suggest CPIH will likely remain above CPI in the long-term due to growth in owner occupier housing costs and council

⁶ There have been only 5 quarters since 1948 where the RPI YoY change has been below 0% whereas there have been 58 quarters where it was above 8%. We note that the UK has only adopted inflation targeting since 1992. Since 1992 there has been no quarters where the UK preferred inflation target measure (RPIX between 1992 and 2003 and CPI from 2003 onwards) has been 2% or more below the inflation target, but 12 quarters where the measure was 2% or more above the target.

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tax receipts. Additionally, in July 2025 the OBR published a report highlighting that their five-year ahead CPI inflation forecasts have, on average, underestimated inflation by 0.5 percentage points.⁷ Using a long-term inflation forecast is more likely to align with long-dated fixed-rate debt and less likely to misstate the real cost of that debt than short term inflation forecasts.

2.44 Recognising the uncertainty in both the level and makeup of the costs associated with the RPI to CPIH transition, we agree, in line with RIIO-3, that a close-out mechanism should be used to assess whether transition costs should be allowable. We recommend the close out mechanism considers costs in line with the following principles:

- whether costs are efficient and reasonable including whether the underlying documentation and compensatory provisions align to wider corporate standard practice
- costs should be considered only with respect to the notional capital structure

Additional costs of borrowing / infrequent issuer premium

SSMC summary

- 2.45 In the SSMC we noted that we intended to continue to provide allowances for additional costs of borrowing which we would expect to be incurred by an efficient operator adopting the notional capital structure. We noted that we would review and, if appropriate, update the methodology that underpins these allowances in line with our approach in RIIO-3, considering new and previously submitted evidence.
- 2.46 We noted that we were not currently considering any new additional allowances. The current allowances consist of transaction costs, liquidity/Revolving Credit Facilities (RCF) costs, cost of carry and the CPIH issuance/basis mitigation allowances. We further proposed to merge the cost of carry and liquidity/RCF cost into a single additional borrowing allowance, in line with our approach in RIIO-3, called the liquidity allowance as the sizing of cash balances and RCFs are likely to be driven by common causal factors.
- 2.47 Within the SSMC, we indicated our intention to evaluate an infrequent issuer premium, including whether such an allowance should be granted, the appropriate magnitude of the allowance, and the issuance threshold at which it would be applicable.

⁷ OBR Forecast evaluation report July 2025, page 17

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Summary of consultation responses

- 2.48 In FQ5 of our SSMC we asked, "Do stakeholders have new evidence for us to consider in our review of the additional cost of borrowing allowances or infrequent issuer premium?".
- 2.49 Citizens Advice stated that the CMA's PR19 redetermination, which allowed 10bps for additional borrowing costs, is appropriate.⁸
- 2.50 All DNOs referred to NERA's 'Liquidity Cost & Cost of Carry Allowance at RIIO-ET3' report for the Energy Networks Association (ENA) submitted to us in August 2025 as evidence that Ofgem underestimates the additional cost of borrowing allowances.
- 2.51 The NERA report examines both the cost of carry and liquidity/RCF allowances. According to NERA, Ofgem underestimated this allowance because it used backward-looking data for spreads and failed to consider a higher forward-looking cash assumption required to support greater RAV growth. Additionally, NERA claims that Ofgem undervalued the liquidity/RCF allowance by not accounting for the cost of drawn liquidity.
- 2.52 SSEN-D noted several other issues: transaction costs should reflect current market evidence, not historic benchmarks; CPIH transition and basis risks need explicit recognition; investors demand a new issue premium; proposed ring-fencing and liquidity requirements could increase pre-financing obligations.
- 2.53 SSEN-D, NGED and UKPN suggested Ofgem should introduce an infrequent issuer premium for ED3 despite NGED noting it being true that infrequent issuers will form most of the calibration group in the case of the DNOs.
- 2.54 SSEN-D indicated that smaller firms are subject to a structural disadvantage, which is further substantiated by KPMG's q-factor analysis.⁹ This analysis proposes that smaller entities experience elevated systematic risks, including liquidity constraints and information asymmetry, relative to their larger counterparts. KPMG argue that equity and debt spreads reflect these risks. SSEN-D argued that in the context of ED3, where networks are required to secure substantially greater capital compared to ED2, smaller licensees are expected to remain at a disadvantage due to the compounded effects of size-related risk and infrequent issuance.

⁸ The CMA PR19 redetermination is the CMA's re-assessment of Ofwat's PR19 price control determinations for certain water companies

⁹ KPMG - Exploring Multi-factor Models as a cross-check on allowed returns at ED3. This report was published within the responses to our [SSMC](#)

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- 2.55 NGED stated that higher debt issuance volumes in ED3 will widen the differences in DNOs' performance, and calibration does not sufficiently address the extra risk and cost for those issuing less frequently.
- 2.56 Citizens Advice supported the removal of the infrequent issuance allowance arguing that this allowance has generated unjustified premiums in previous price controls. It noted that in RIIO-3, we determined that where companies faced an infrequent issuance premium, this is already reflected in the main allowance and that providing an additional allowance would present a material risk of overcompensation of companies.

SSMD decision and rationale

- 2.57 We will make our decision on the additional borrowing allowances at Draft Determinations. Data analysed will include updated transaction cost data, daily cash balance data and daily RCF drawings. This data will be gathered via business plan submissions and follow-up data requests, as required.
- 2.58 Consistent with our RIIO-3 evaluation and in consideration of previous company submissions, we will determine the differential between the benchmark indices and the 3-month Sterling Overnight Index Average (SONIA) when calculating the cost of carry allowance. We will review and select a period of market data that accurately represents prevailing financing conditions at the commencement of the price control period.
- 2.59 The CPIH basis risk allowance reflects hedging costs associated with the risk resulting from the decision to switch indexation of the RAV from RPI to CPIH in ED2, we intend to evaluate whether:
- licensees generally hedge the associated risk in a manner the allowance methodology assumes
 - if not generally hedged, whether the basis risk constitutes a negative expected return for licensees
- 2.60 If we conclude that licensees generally do not hedge the associated risk as assumed and that the expected return from the basis differential is neutral, we intend to remove the allowance.
- 2.61 We will make our decision on the infrequent issuer premium at Draft Determinations. Consistent with ED2 and RIIO-3, we will identify infrequent issuers using an annual issuance threshold of £250m applied over the course of ED3. We will assess the evidence for any premium associated with infrequent issuance. We will consider an infrequent issuer premium based on the extent that such additional costs exist and are not already captured within the main calibration exercise.

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- 2.62 We consider the infrequent issuer premium to be determined by issuance characteristics, namely the size of the individual transaction, whether the issue is at or below benchmark size, and issuance frequency. Although these features may commonly arise for smaller entities, we do not agree that alleged liquidity constraints or information asymmetries specifically justify a further premium in observed spreads. Liquidity constraints, to the extent they are material and persistent, should already be captured in the issuer's credit rating and thus reflected in market spreads.
- 2.63 We agree that debt issuance volumes are likely to increase materially in ED3 due to the significant uplift in investment. Consequently, we believe that the risks associated with infrequent issuances are likely to lessen, as either the size or frequency of issuances would necessarily need to increase to support the required financing.
- 2.64 In practice, infrequent issuance can confer advantages as well as risks. Issuers that access the market less regularly are not compelled to refinance at points of temporarily elevated rates and may benefit from being able to time issuance during more favourable conditions, an option that is not typically available to frequent issuers who must refinance continuously. As such, infrequency does not create a systematic cost disadvantage that would justify calibrating the allowance on a high rate.
- 2.65 The conclusion reached in RIIO-3 provides useful context, but the cost of debt requirement for ED3 will be considered on its own merits. The characteristics of the DNOs, the scale and timing of expected issuances, and the calibration approach we will adopt will be taken into consideration before we decide whether an allowance is appropriate.

Calibration

SSMC summary

- 2.66 In the SSMC, we considered applying a RAV-weighted approach to calibration the cost of debt, consistent with the methodology adopted for the ET networks in RIIO-3. We proposed the following approach:
- within the trailing average window, each year's spot rate is weighted by the amount of (nominal) RAV additions
 - refinancing is assumed to occur to RAV additions from before the trailing average window and to the original opening RAV balance at the start of the analytical period

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- the opening balance RAV is refinanced assuming an even distribution per year. So, if a 17-year average tenor is assumed, then each year 1/17th of the original opening balance RAV is refinanced again. We anticipate this would ordinarily be aligned to the length of the trailing average assumed.
- 2.67 We recommended, as with RIIO-3, using a RAV-weighted trailing average with an appropriate calibration adjustment for ED. We recommended starting the RAV weighting from the start of RIIO-ED1 with an assumed refinancing period aligned to the trailing average assumption. We consider it reasonable to maximise the use of available data and a refinancing assumption aligned to the trailing average to minimise complexity.
- 2.68 We stated that we were considering excluding the following instruments from the calibration exercise:
- most derivatives (rationale provided in Paragraph 2.26 in our ED3 SSMC Finance Annex), see Paragraph 2.69 for derivatives we considered could be included
 - liquidity facilities, RCFs and overdrafts (as these are considered in the additional costs of borrowing)
 - intercompany loans other than back-to-back arrangements (as these do not generally represent commercial terms/pricing available from third parties)
 - subordinated instruments, such as 'Class B' debt
 - instruments with insufficient data to model
- 2.69 We also stated that where a company issues non-GBP debt and this is swapped back to GBP via a cross-currency swap, we intend to consider the swapped GBP rate within the calibration.

Summary of consultation responses

- 2.70 In FQ6 of our SSMC we asked, "Do stakeholders agree with our proposed RAV-weighted approach for calibrating the index for ED networks?".
- 2.71 All DNOs and Citizens Advice supported the introduction of a RAV-weighted approach for calibrating the index for ED networks.
- 2.72 In FQ7 of our SSMC we asked, "Do stakeholders wish to propose any other alternatives to the approach for setting the allowed return on debt for ED3?".
- 2.73 All DNOs stated the calibration cohort should only include DNOs and not transmission companies. The DNOs stated that the ED sector, where there are fourteen companies, provides a sufficiently large sample of data (unlike the situation in the ET sector where there are only three companies). SSEN-D noted, however, that there is a risk that two large DNOs could still disproportionately influence the outcome, particularly for embedded debt.

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- 2.74 SPEN stated Ofgem should be open to the specific calibration of the of the RAV weighted mechanism, such that the cost of debt allowance is robust to changing circumstances over the RIIO-3 period and beyond. SPEN noted that it is important that the basis for the start of the legacy RAV is robust highlighting that in RIIO-ET3 Ofgem started the RAV weighting in RIIO-ET1 not RIIO-ET2 as recommended by NERA.
- 2.75 SSEN-D did not agree with aligning the refinancing assumption to the ED3 trailing average length but instead stated it should be aligned with the trailing average length applied in RIIO-ED1 (10-20 years) and RIIO-ED2 (17 years). SSEN-D stated an excessively long trailing average risks reducing responsiveness to systemic changes in inflation and interest rates, undermining the accuracy of the allowances during periods of significant volatility.
- 2.76 NGED proposed that weighting for RAV additions should start from ED3 in line with when we will see spend increase. They also propose that Ofgem waits to see business plans before deciding on the length of the trailing average.
- 2.77 NPg recommended that the length and starting point of the trailing average be determined through the calibration process rather than being arbitrarily set at the start of the ED1 period. NPg also stated that there is nothing to prevent Ofgem undertaking analysis to set an initial calibration of the cost of debt calculation for ED3 at the SSMD stage since almost all the embedded debt data is available and the move to a RAV weighted approach should make the calibration exercise less sensitive to future interest rates and RAV growth.

SSMD decision and rationale

- 2.78 In ED3 we have decided to continue to conduct a calibration approach that considers forecast average efficient debt costs.
- 2.79 We have decided to conduct further analysis ahead of finalising the composition of calibration cohort at Draft Determinations. This analysis will likely focus on a broad range of factors including business risk comparability, credit quality and rating comparability to enable an accurate estimation of the efficient cost of borrowing faced by efficient companies at the notional capital structure.
- 2.80 In our debt calibration certain instruments, we exclude certain instruments to ensure the calibration reflects the efficient, financeable, long-term cost of debt. We have decided to exclude the following instruments from the calibration exercise:
- most derivatives (rationale provided in Paragraph 2.26 in our ED3 SSMC Finance Annex), see Paragraph 2.81 for derivatives we have decided to include
 - liquidity facilities, RCFs and overdrafts (as these are considered in the additional costs of borrowing)

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- intercompany loans other than back-to-back arrangements (as these do not generally represent commercial terms/pricing available from third parties)
 - subordinated instruments, such as 'Class B' debt (as these rank below senior debt and carry materially higher credit risk)
 - instruments with insufficient data to model
- 2.81 Where a company issues non-GBP debt and this is swapped back to GBP via a cross-currency swap, we intend to consider the swapped GBP rate within the calibration. This is because these swaps are an integral part of the effective, hedged cost of debt faced by companies that issue foreign-currency debt. Excluding them would misstate the cost of debt.
- 2.82 We have decided to apply a RAV-weighted approach to calibrating the cost of debt. We consider this approach is likely to provide the most accurate and appropriate cost of debt allowance and note that this approach has broad stakeholder support. As a result, our overall approach will be consistent with the methodology adopted for the ET networks in RIIO-3. We expect to use the following approach:
- within the trailing average window, each year's spot rate is weighted by the amount of (nominal) RAV additions
 - refinancing is assumed to occur to RAV additions from before the trailing average window and to the original opening RAV balance at the start of the analytical period
 - the opening balance RAV is refinanced assuming an even distribution per year. So, if a 17-year average tenor is assumed, then each year 1/17th of the original opening balance RAV is refinanced again. We anticipate this would ordinarily be aligned to the length of the trailing average assumed but will conduct further analysis ahead of finalising this decision at Draft Determinations
- 2.83 Consistent with RIIO-3, we have decided to implement a RAV-weighted trailing average with appropriate calibration adjustments for ED3. Our preliminary position is to commence RAV weighting from the outset of RIIO-ED1, adopting a refinancing period that corresponds with the trailing average assumption. However, the final decision on the trailing average approach will be made at Draft Determinations. We believe it is reasonable to maximise the use of available data and align the refinancing assumptions with the trailing average methodology, thereby reducing complexity.

Working assumption for business plans

Without prejudice to the calibration of the index at Draft and Final Determinations, which will be based on scrutiny of the full information available at that time, we suggest that the networks use the following working assumptions for business plan submissions (see Table 1).

Main allowance

Table 1: Indicative forecast average efficient debt cost (nominal)

Sector	2028/29	2029/30	2030/31	2031/32	2032/33	Average
ED	5.02%	5.30%	5.70%	6.05%	6.31%	5.68%

Source: Ofgem analysis of network company data

2.84 We have compiled indicative forecast average efficient debt cost estimates utilising debt data submitted at the Regulatory Financial Performance Reporting (RFPR) submissions in 24/25 and making simplistic assumptions on the future ED3 period. These figures include a calibration adjustment and an additional cost of borrowing allowance (see Other working assumptions below).

Other working assumptions

- 2.85 The following working assumptions are indicative only. We will consider if there any unique factors in ED3 that warrant taking a different approach to that used in RIIO-ET3 while we complete our review of the cost of debt allowance assumptions.
- 2.86 ILD proportion: we consider 10% to be the most appropriate assumption within business plans while we complete our review of the allowances.
- 2.87 Additional cost of borrowing: we consider the RIIO-ET3 additional borrowing cost allowance of 19bps is the most appropriate assumption within business plans while we complete our review of the allowances.
- 2.88 Calibration adjustment: we consider the RIIO-ET3 calibration adjustment of 39bps is the most appropriate assumption within business plans while we complete our review of the allowances.
- 2.89 Calibration cohort: we consider the RIIO-ET3 calibration cohort is the most appropriate assumption within business plans while we complete our review of the allowances.
- 2.90 Trailing average: we consider the RIIO-ET3 trailing average of 14 years is the most appropriate assumption within business plans while we complete our review of the allowances.

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- 2.91 Start date for RAV weighting: we consider the start of ED1 is the most appropriate assumption within business plans while we complete our review of the allowances.

3. Allowed return on equity

Returns to equity investors serve as compensation for their investment in distribution network operators, consisting of a baseline allowance supplemented by performance-based incentives. In this chapter, we detail the methodology employed to establish the baseline allowance.

SSMC questions

- FQ8. Do stakeholders agree with our interpretation and proposed application of UKRN Recommendations 2 to 7?
- FQ9. Do stakeholders agree with the methodology for calculating the Capital Asset Pricing Model (CAPM) parameters: risk-free rate (RFR), total market return (TMR) and beta?
- FQ10. Do stakeholders agree with us using our proposed RIIO-3 beta comparators for ED3?
- FQ11. Do stakeholders agree with our proposed set of cross-checks in Step 2?
- FQ12. Do stakeholders agree that our proposed allowed return on equity ensures the investability of the sector?

SSMD early view summary

3.1 Our early view summary of the allowed return on equity is shown in Table 2.

Table 2: Early view summary of the allowed return on equity

CAPM cost of equity (CPIH-real)	Level	Calculation
RFR	2.09%	A
TMR	6.9%	B
Debt beta	0.075	C
Asset beta	0.375	D
Notional gearing	60%	E
Equity beta (to 2dp)	0.83	$F = (D - (C * E)) / (1 - E)$
CAPM implied cost of equity (midpoint)	6.08%	$G = A + F * (B - A)$

Source: Ofgem analysis (cut-off date end March 2026)

Our approach for ED3

SSMC summary

- 3.2 The allowed return on equity estimates the return needed to attract and retain equity capital for network companies in the ED sector. We set this return based on our assessment of the required return or cost of equity.
- 3.3 In the SSMC we said we considered there to be benefits from following all the UK Regulators Network (UKRN) Guidance recommendations on the methodology for setting the cost of capital unless there is good reason not to. We considered that the stability, consistency and predictability provided by this approach will allow investors to have ongoing confidence in the regulatory framework, ultimately helping to keep the cost of capital for the sector as low as possible.
- 3.4 UKRN Guidance Recommendation 2 states that since the cost of equity is not directly observable, it must be estimated using a widely accepted method. The recommendation is that regulators should continue to use the capital asset pricing model (CAPM) as their primary approach for estimating the cost of equity.
- 3.5 We said we planned to use a 'multi-step' method to determine the allowed return on equity, as we did in ED2 and RIIO-3 Final Determinations (FD).
- 3.6 Step 1 in the process involves evaluating the market cost of capital using the CAPM. Step 2 entails considering various factors to ensure that the estimate derived in Step 1 is both sufficient and not excessive. This phase incorporates multiple cross-checks and reviews any supporting evidence pertaining to investability. In Step 3, we determine whether expected returns are aligned with our most accurate assessment of the cost of capital.
- 3.7 In the SSMC we asked consultation questions that related to our approach to setting the allowed return on equity in ED3. As many of the answers relate to specific aspects of calculating return on equity, we have organised stakeholder feedback by topic (eg the three CAPM variables and cross-checks) instead of by question.

Summary of consultation responses

- 3.8 In FQ8 of our SSMC we asked, "Do stakeholders agree with our interpretation and proposed application of UKRN Recommendation 2 to 7?".
- 3.9 All the DNOs, along with the ENA, raised various concerns about how we plan to implement UKRN Recommendations 2 through 7. The DNOs stated that their key concern is that cost of equity estimates must reflect today's interest rate environment - which impacts the estimation of the total market return (TMR), the equity risk premium, cross-checks and choosing a CAPM point estimate for the cost of equity. Additional concerns raised by the DNOs include that index-linked

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gilts (ILGs) may underestimate the risk-free rate (RFR), the current beta calculation methodology may fail to account for all systematic risks, and the absence of a broader range of cross-checks.

- 3.10 Citizens Advice expressed their concerns regarding our approach, noting that, in their view, the UKRN Recommendations introduce a considerable upward bias in the permitted cost of capital and do not sufficiently incorporate consumer perspectives. They stated that available evidence demonstrates current methodologies may yield disproportionately high return estimates.
- 3.11 We address the issues raised by stakeholders throughout the remainder of this chapter.

SSMD decision and rationale

- 3.12 We have decided to adopt the approach proposed in the SSMC, which includes applying approaches that are in line with UKRN Recommendations 2 through 7. We will implement a multi-step process like that used in ED2 to help determine an appropriate allowed return on equity for ED3. Our rationale for this decision is explained below.
- 3.13 We do not agree with DNOs that the UKRN Guidance Recommendations are only suited to a low-interest rate environment. A key concern appears to relate to the assumption of a stable TMR, a common feature in UK price controls. We do not agree that our TMR estimate should incorporate an uplift to reflect higher market interest rates or an elevated RFR. A stable TMR approach has helped maintain consistency in allowed equity returns - an attribute we consider highly valuable to investors in energy networks, given that energy projects require significant, long-term capital commitments. This consistency also benefits consumers by reducing the risk of sudden price spikes or volatility, supporting more stable and affordable energy bills. We discuss our approach to estimating the TMR further in the TMR section below as well as addressing the other concerns of the DNOs.
- 3.14 Citizens Advice presented an alternative perspective, arguing that the UKRN Guidance Recommendations lead to an unnecessarily high estimate of the cost of capital. We also disagree with this assessment. In our process for determining a suitable allowed return on equity, Step 2 considers various factors to ensure that our Step 1 CAPM cost of equity estimate is balanced and neither too low nor too high. We discuss Step 2 below as well as addressing the other concerns of Citizens Advice.

Step 1: The CAPM cost of equity calculations

- 3.15 The CAPM has three inputs which need to be estimated to calculate the cost of equity and set an appropriate allowed return on equity:
- the RFR

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- the TMR
- and the Equity Beta (β)

3.16 These inputs are combined in the following way to calculate the cost of equity:

$$\text{CoE} = \text{RFR} + \beta (\text{TMR} - \text{RFR}).$$

Estimating the RFR

Proxies used in the estimation of the RFR

SSMC Summary

3.17 The RFR is, in theory, the rate of return required to invest at zero risk. In practice, no investment is truly risk-free, so this hypothetical risk-free rate of return must be estimated.

3.18 UKRN Guidance Recommendation 3 states that regulators should use recent yields on the ILGs, with a maturity which matches the assumed investment horizon for their sector to estimate the RFR.

3.19 Supported by the CMA's assessment of the RIIO-2 approach and in the absence of observing material new evidence on this matter, we continue to view ILGs as the most appropriate proxy for the RFR.¹⁰ Even though the CMA's case comes from a different sector, their use of the same CAPM model to calculate the cost of equity makes it pertinent in this context.

3.20 Consistent with the RIIO-3 methodology, we recommended estimating the RFR using the one-month (October, daily) average of 20-year ILG yields. If the RFR were being set for the entire control period, it may have been preferable to use a longer-term average of ILG yield data to mitigate the risk of embedding short-term volatility over the full duration of the control. However, given that the RFR will be updated annually to index the cost of equity, we concluded that a one-month average is suitable for this purpose.

3.21 We do not expect it will be necessary to adjust this figure based on implied forward rates. As noted in the CMA's Redetermination of PR19, such forward rates generally do not accurately predict spot rates and are more likely to weaken than improve our estimate of the RFR.¹¹ Furthermore, indexing the cost of equity should eliminate any advantage in trying to infer market expectations of future rates.

¹⁰ CMA RIIO-2 Final determination Vol 2A: Joined Grounds: Cost of equity, para 5.184

¹¹ CMA PR19 Final Determinations, para 9.234

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Summary of consultation responses

- 3.22 In FQ9 of our SSMC we asked, "Do stakeholders agree with the methodology for calculating CAPM parameters: RFR, TMR and beta?".
- 3.23 All DNOs and the ENA endorsed the use of ILGs for estimating the RFR but also recommended the application of a convenience yield adjustment. The convenience yield refers to the additional value investors ascribe to ILGs due to their distinct characteristics, such as inflation protection, safety, liquidity, and collateral utility.
- 3.24 Oxera's analysis for the RIIO-3 Draft Determinations (DD) was referenced to support adjusting ILGs for a convenience yield.¹² To calculate the convenience yield, Oxera employed the same approach as in its previous studies. The analysis consisted of comparing five-year average yields of the iBoxx £ AAA non-gilt 10+ and 10–15 indices with five-year average yields of AAA-rated gilts with maturities of 9.5 and 14.0 years. This method resulted in an estimated convenience premium of 0.24%.
- 3.25 SPEN highlighted that the discrepancy between breakeven inflation and forecasted inflation indicates that ILG yields may be understated.

SSMD decision and rationale

- 3.26 We have decided that the RFR for each year of the price control period will be estimated using the 1-month average yield of the 20-year ILG, without incorporating alternative proxies in our calculation. The rationale underlying this methodology is detailed below.
- 3.27 We acknowledge that there have been debates over the presence of convenience yields, or other reasons to use an estimate above the ILG yield, and that over time regulators have used a variety of methods to estimate the RFR. However, we continue to believe that ILGs provide an appropriate proxy without need for further adjustment and note that this approach has been consistently adopted across more recent regulatory decisions.
- 3.28 ILGs are a strong proxy for the RFR due to their inflation protection properties and extremely low default and liquidity risk. Alternatives like nominal gilts, SONIA swaps, and AAA-rated non-government bonds have additional risk premia that would not be present in the 'true' RFR and so require adjustments. These adjustments can introduce estimation errors that offset any improvements in accuracy.

¹² Oxera - RIIO-3 draft determinations - CAPM parameters and debt-based cross-checks. This report was published within the responses to our [SSMC](#)

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- 3.29 Oxera has asserted that Ofgem should adopt a methodology informed by recent regulatory determinations from the CMA and other regulators. The CMA (and other sectors regulators) have used an estimate above the ILG yield in past decisions - although these have not necessarily been characterised as representing a convenience yield.¹³ However, in its recent Final Determination of the PR24 appeal, the CMA opted not to adjust for a convenience yield, noting that such an adjustment would be subjective and unlikely to enhance the accuracy of the RFR estimate.¹⁴ Similarly, Ofwat decided against making a convenience yield adjustment in PR24, citing a lack of sufficient relevant evidence. Ofcom in its March 2026 Telecoms Access Review 2026-31 did not use a convenience yield adjustment. The Civil Aviation Authority (CAA), in its April 2026 Initial Proposals for the H8 price control, also recommended excluding the convenience yield from the RFR estimation. Accordingly, our first principles decision not to adjust for a convenience yield also aligns with a broad range of relevant regulatory precedent.
- 3.30 Oxera has stated that it is unnecessary to adjust AAA corporate bond yields for liquidity and credit risk premia when comparing to ILGs. However, as we noted in the RIIO-3 FD, despite the considerable uncertainty inherent in estimating these premia, they are present and should be considered. Our view is aligned with the CMA in its PR24 Final Determinations which stated that AAA corporate bond yields include liquidity and default premiums, which would be expected to account for some of the spread compared to gilts.¹⁵ See Paragraph 3.34 for more on this topic.
- 3.31 Oxera agreed with Ofgem that none of the academic papers they presented contain evidence of a convenience premium in long-term UK gilts. Despite this, Oxera argues that even if a convenience premium cannot be directly estimated for 20-year gilts, its value could be inferred by looking at the evidence from shorter-term instruments. Ofgem's view is that there is no compelling evidence to show that inferences from shorter-term instruments can be extended to longer-term ones. Ofgem's view is supported by the CMA in its PR24 Final Determination observation that research into how maturity affects convenience yields is scarce and often presents conflicting findings.¹⁶
- 3.32 Oxera attempted to show empirical evidence that 20-year UK gilts have a convenience premium by matching the duration rather than the tenor of AAA non-government bond indices and UK gilts. However, Oxera themselves noted they are unable to do this analysis in a meaningful and robust way. The longest average duration of any index in their analysis is 17.6 years. This is the iBoxx £ Non-gilt AAA 15+ index. This index currently consists of six issues from three

¹³ See for example CMA PR19 and UREGNI RP7

¹⁴ CMA PR24 Final Determinations Volume 4: Allowed return - chapter 7, para 7.277

¹⁵ CMA PR24 Final Determinations Volume 4: Allowed return - chapter 7, para 7.277

¹⁶ CMA PR24 Final Determinations Volume 4: Allowed return - chapter 7, para 7.260

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issuers and three of the issues are foreign issued bonds. As noted in RIIO-3 FD, the iBoxx AAA indices are thinly populated, with limited market coverage and a high proportion of foreign-issued instruments. Moreover, the maturity and duration profiles differ materially from the 20-year ILGs used in our RFR estimation. Oxera did find a short period (less than two years) where the iBoxx £ Non-gilt AAA 15+ index had a duration of around 20 years and estimated a convenience yield of 0.20%. As Oxera themselves highlighted there are obvious limitations to this analysis. We note that this index currently has a duration of 16.9 years. These limitations undermine the robustness of the convenience premium estimate and reinforce our view that ILG yields remain the most appropriate input for estimating the RFR.

- 3.33 Oxera highlighted the Brennan CAPM framework, which recognises that investors face different borrowing and lending rates, and suggests that the appropriate RFR lies between the two. While we acknowledge that the Brennan CAPM is a recognised theoretical model, and that it was taken into consideration by the CMA in its RFR decisions for the appeal of PR19,¹⁷ it remains one of several approaches. The Sharpe-Lintner CAPM, which assumes a single RFR accessible to all investors, is widely used by regulators and practitioners due to its simplicity and transparency. As noted by the CMA in their PR24 Final Determinations, both models are theoretically valid.¹⁸ Given the practical challenges in identifying and estimating a convenience premium, and the lack of consensus on the required magnitude of any other adjustment, we continue to rely on the Sharpe-Lintner CAPM framework. This approach supports the use of observable ILG yields as the most appropriate input for estimating the RFR.
- 3.34 Regarding SPEN's comments on the difference between breakeven and forecast inflation, we consider that the observed price differences between nominal gilts and ILGs are more likely driven by factors such as aggregate inflation expectations, liquidity risk premiums, and inflation risk premiums. Due to limited transparency around the relative contribution of these factors, it is difficult to isolate and quantify their individual impact and therefore challenging to incorporate them reliably into the assessment of the true RFR. This conclusion is in line with recent CMA findings that we cannot exactly know the inflation assumptions used or liquidity premium required by market participants when pricing the two instruments and therefore we cannot accurately assess the presence of any distortions to either price.¹⁹

¹⁷ CMA PR19 Final Determinations, para 9.263

¹⁸ CMA PR24 Final Determinations Volume 4: Allowed return - chapter 7, para 7.295-7.296

¹⁹ CMA PR19 Final Determinations, para 9.184

Setting the RFR in CPIH-real terms

SSMC Summary

- 3.35 ILGs are considered RPI-real instruments, meaning that both their coupon payments and principal repayments are adjusted according to changes in the RPI. The RFR, however, is calculated using CPIH-real values, which account for owner occupiers' housing costs and council tax. To use ILGs as a substitute for the RFR, it is necessary to revise their yields to reflect CPIH-real terms by estimating the difference between CPIH and RPI inflation over the horizon of the gilt, commonly known as an inflation 'wedge'.
- 3.36 Recognising that there is no completely accurate way to calculate the view being taken by a broad spectrum of ILG investors, we proposed to use inflation wedge data based on a simple assessment of:
- official OBR forecasts of CPIH²⁰ and RPI up to the point of convergence of RPI and CPIH growth rates (assumed to be February 2030);²¹
 - a zero wedge for the period ranging from the point of convergence to the maturity of the ILG being measured

Summary of consultation responses

- 3.37 All DNOs supported Ofgem's ongoing practice of adjusting RPI-real ILG yields to CPIH-real terms using the methodology specified in the SSMC.
- 3.38 NPG did not agree that Ofgem can assume a February convergence point, stating that RPI inflation for the purposes of index linked debt is lagged. However, they did acknowledge that any effect on the wedge will be relatively small.
- 3.39 All DNOs considered that an additional adjustment to account for the OBR's estimate of the long-term wedge between CPI and CPIH would be unnecessary.

SSMD decision and rationale

- 3.40 We have decided to adjust RPI-real ILG yields to CPIH-real terms for ED3 based on a 'wedge' calculated using the official forecast methodology described in our RIIO-3 FD and proposed in the SSMC. This methodology has the support of all DNOs. Note that as we use the OBR's annual forecasts of CPIH for this purpose, their long-term forecast of 2.4% has no impact in the calculation.
- 3.41 While we recognise NPG's rationale about assumptions regarding an exact convergence point between RPI and CPIH in 2030 given the three-month lag structure in UK ILGs issued after 2005, we agree with them that the potential

²⁰ We note that official forecasts for CPIH are now available from the OBR

²¹ Office for National Statistics - Calculating the Retail Prices Index

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impact would be negligible. Reflecting this lag by making an allowance for a potential additional one to two quarters of the RPI-CPIH wedge would not impact the calculation sufficiently to make any adjustment. This is because the OBR's estimate of RPI and CPIH in 2030/31 are currently the same and because the current wedge estimate is small at 0.04%.

Indexing the cost of equity via updating the RFR

SSMC Summary

- 3.42 In line with the approach used during RIIO-ED2, we continue to view an annual update of the estimate of the RFR to be the simplest and most effective way to index the cost of equity. This should ensure that allowed returns on equity remain in line with relevant market rates.
- 3.43 We propose to update the RFR used within our CAPM calculation annually (in relation to both the RFR and the calculation of the Equity Risk Premium (ERP) as the TMR minus the RFR) based on the one-month (October, daily) average of 20-year ILG yields, plus our assessment of the appropriate RPI-CPIH 'wedge'.

Summary of consultation responses

- 3.44 Stakeholders made no comments relevant to this issue.

SSMD decision and rationale

- 3.45 We have decided to update the RFR used within our CAPM calculation annually (in relation to both the RFR and the calculation of the ERP as the TMR minus the RFR) based on the one-month (October, daily) average of 20-year ILG yields, plus our assessment of the appropriate RPI-CPIH 'wedge'.

RFR Estimate

- 3.46 For the purpose of the early view of the cost of equity, our RFR estimates are summarised in Table 3 below.

Table 3: Early view of RFR estimate

Metric (as at end Mar 2026)

ILG Yield	2.05%
RPI-CPIH 'wedge'	0.04%
RFR	2.09%

Source: Ofgem analysis of Bank of England and OBR data.

Estimating the TMR

SSMC Summary

- 3.47 The TMR is an estimate of the return that investors expect for taking the market-average level of risk. The CAPM calculation requires an estimate of the ERP, the additional return over the RFR that investors expect for taking the market-average level of risk. The TMR used for calculating the ERP in the CAPM is typically estimated using long-run historical averages of relevant broad equity indexes as the best proxy for long-term future expectations. The TMR can also be estimated using forward-looking methodologies such as surveys of the expectations of professional investors, or via a combination of historical and forward-looking methodologies.
- 3.48 UKRN Guidance Recommendation 4 advises that regulators estimate the ERP within the CAPM as the difference between the TMR and the RFR. The guidance suggests that the TMR should be principally derived from both historical ex post and ex ante evidence. It further observes significant alignment among regulators regarding the overall methodology for assessing TMR and ERP, noting that recent UK regulatory determinations have favoured a stable TMR estimated directly from historical equity returns data. To promote consistency across sectors and over time, the UKRN Guidance recommends continued adherence to this approach.
- 3.49 In the SSMC, we proposed to continue to estimate the TMR rather than the ERP and propose to calculate the ERP as TMR minus the RFR and not to adjust our estimates up or down to reflect current market conditions.

Summary of consultation responses

- 3.50 In FQ9 of our SSMC we asked, "Do stakeholders agree with the methodology for calculating CAPM parameters: RFR, TMR and beta?".
- 3.51 All DNOs have expressed concerns regarding the current methodology for establishing the TMR. They stated that minimal or no consideration should be given to the ex ante TMR method due to the underlying assumptions it relies upon. Additionally, the DNOs assert that the existing TMR estimation approach places too much emphasis on long-term historical averages and does not adequately reflect the recent increase in interest rates.
- 3.52 All DNOs referred to Frontier Economics (Frontier) analysis undertaken on behalf of ENA that argues that the assumed TMR should be increased.²² Frontier's analysis proposed two TMR cross-checks. One is a TMR Glider that uses a

²² Frontier Updated Cost of Equity Cross-Check Evidence. This report was published within the responses to our [SSMC](#)

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dividend growth model (DGM) and current interest rates to calculate a TMR. The other cross-check Frontier recommended is the Fernandez TMR survey. SSEN-D noted that survey-based forecasts, such as the Fernandez TMR survey, do not carry the weight of observable market evidence.

- 3.53 All DNOs referred to Oxera's analysis of CAPM parameters, provided to the ENA for RIIO-3.²³ Oxera stated that the notable rise in gilt yields has created a reasonable expectation among investors for higher returns. Furthermore, Oxera observed that revising the TMR to align with prevailing interest rates would be consistent with historical regulatory precedents and guidance issued by the UKRN.
- 3.54 Citizens Advice agreed with Ofgem's suggestion to keep estimating the TMR instead of the ERP. They stated that the TMR may be overestimated because it relies on average returns from UK equities, rather than a broader, more diversified investment portfolio. Citizens Advice also believe that using historical data probably leads to an upward bias in the TMR, which should be considered when Ofgem chooses its point estimate for the cost of equity.
- 3.55 Citizens Advice also recommended that Ofgem include adjusted investment managers' TMR cost of equity, using a plausible equity beta, ie significantly lower than 0.9, for ED3.

SSMD decision and rationale

- 3.56 We will adopt the SSMC position and estimate TMR instead of ERP. The ERP will be calculated as our TMR estimate minus our RFR estimate. We will cross-check our TMR estimate with our UK investment manager survey on expected equity market returns. This transparent, predictable method supports an effective TMR policy.
- 3.57 We will set the TMR range using both ex ante and ex post estimates. To balance the strengths of each approach and maintain simplicity, we will apply equal weighting to both. We consider that the TMR is appropriately calibrated, supported by our investment managers' long-term market return forecasts and validated through cross-checks against our cost of equity allowance, where TMR is a key input. This approach aligns with regulatory precedent, UKRN Guidance, and recent CMA Determinations.^{24 25}
- 3.58 We do not agree that our TMR estimate should incorporate an uplift to reflect higher market interest rates or an elevated RFR. A stable TMR approach has helped maintain consistency in allowed equity returns, an attribute we consider

²³ Oxera CAPM parameters and debt-based cross-checks. This report was published within the responses to our [SSMC](#)

²⁴ UKRN cost of capital guidance (2023), page 21

²⁵ CMA PR24 Final Determinations Volume 4: Allowed return - chapter 7, para 7.309

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highly valuable to investors in energy networks, given that energy projects require significant, long-term capital commitments. This consistency also benefits consumers by reducing the risk of sudden price spikes or volatility, supporting more stable and affordable energy bills. For example, had we adopted a methodology based on a stable ERP, the returns allowed under RIIO-2 would have been significantly lower. Adjusting the TMR estimate methodology to shield investors when interest rates are low and then revising it to benefit them when rates rise would not represent a 'fair bet' and would fail to adequately safeguard consumer interests. An effective TMR policy should be stable and insulated from short-term fluctuations.

- 3.59 In its PR24 Final Determinations, the CMA used both ERP and TMR evidence to set a TMR range.²⁶ The CMA noted UKRN Guidance acknowledges that, depending on prevailing economic conditions, a stable TMR approach may either overestimate or underestimate the returns required by investors in a particular price control period. Accordingly, the CMA calculated a historical ex post ERP and combined this with their RFR estimate to determine the upper bound of their TMR range.
- 3.60 We conducted an analysis using several established methodologies for calculating ERP and compared the outcomes to our own implied ERP. Note we include a Gordon Growth Model analysis, for illustrative purposes, despite our issues with dividend growth models (DGM) highlighted in our TMR Glider comment in the cross-check section below. This analysis indicated that Ofgem's implied ERP of 3.9%, the premium of our TMR estimate over 20-year nominal gilts, is in line with the average of other methodologies. This cross-check analysis ensures we have reflected contemporaneous market data and supports our decision not to adjust our current TMR estimate. The results of our analysis are shown in Table 4 below.

Table 4: Equity risk premium estimates

Methodology (end 2025)	ERP	Notes
TMR Glider implied ERP	5.0%	DGM plus link to gilts
CMA PR24 FD implied ERP	4.8%	Dimson Marsh & Staunton (DMS) data & CMA calculations
Historical implied ERP	3.9%	DMS 1899-2024 equity returns minus bond returns

²⁶ CMA PR24 Final Determinations Volume 4: Allowed return - chapter 7, para 7.309

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Methodology (end 2025)	ERP	Notes
Gordon Growth Model implied ERP	2.9%	MSCI UK Index
Fed Model implied ERP	2.3%	MSCI UK Index forward earnings yield minus end 2025 20Y gilt yield
Average	3.8%	
Ofgem implied ERP	3.9%	RIIO-3 TMR (nominal) minus Dec 2025 20Y gilt yield

Source: Ofgem analysis. Note figures rounded to one decimal place.

- 3.61 Oxera argued for a higher TMR by noting that in our previous decisions, we reduced the TMR allowance when gilt yields fell, attributing only part of this reduction to the switch from RPI to CPIH. Oxera claimed that ignoring rising interest rates now would be inconsistent.
- 3.62 As outlined in our RIIO-3 SSMD, the RIIO-2 TMR estimate was not specifically changed to match current market conditions, and it was above the estimates given by investment managers and advisors.²⁷ Likewise, in RIIO-3, we did not make manual changes to the TMR in response to current market conditions. Not adjusting our TMR estimate in previous decisions means we are not required to re-adjust it now.
- 3.63 Our most recent TMR estimate is 6.9% and is based on both historical ex post and ex ante evidence. Our latest TMR estimate is higher than the 5.7% average of long-term market return estimates provided by investment managers and advisors. It is worth noting these investment manager long-term market return estimates may be below the long-term historical returns because the UK market is near all-time highs currently and they have to show a duty of care and not over-promise. Our preference for a stable TMR is discussed in Paragraph 3.58. The results of the investment manager UK market return estimates are shown in Table 5 below.

Table 5: Investment manager long-term UK equity market return estimates

Author	Date	Horizon	Nominal TMR	Real TMR
Schroders	Jul-25	10Y	10.7%	8.4%

²⁷ RIIO-3 SSMD-Finance Annex, paragraph 3.95

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Author	Date	Horizon	Nominal TMR	Real TMR
Deutsche Bank	Dec-25	10Y	10.0%	7.7%
Quilter	Sep-25	10Y	9.9%	7.6%
Janus Henderson	Jan-26	10Y	8.7%	6.4%
Invesco	Jan-25	10Y	7.9%	5.6%
Capital Group	Feb-25	20Y	7.5%	5.2%
Northern Trust	Jan-26	10Y	7.2%	5.0%
BlackRock	Aug-25	10Y	6.6%	4.4%
Vanguard	Jan-26	10Y	6.2%	4.0%
Ninety One	Sep-25	10Y	5.4%	3.2%
Average			8.0%	5.7%

Source: Ofgem, company websites.

3.64 Frontier's TMR Glider estimates a TMR using a DGM. We agree with Frontier Economics that DGMs are commonly used to estimate the cost of equity. However, we continue to have reservations about their application. The DGM assumes that dividends grow at a constant rate indefinitely, an assumption that is rarely realistic. This is particularly relevant in the electricity transmission and distribution sectors, where elevated regulated asset value growth may result in variable dividend patterns, undermining the model's core premise. Moreover, the DGM cannot be applied to firms that do not pay dividends, excluding many growth-oriented companies that now represent a significant and growing share of equity markets. Finally, the model is highly sensitive to both the assumed dividend growth rate and the required rate of return. Therefore, we believe that using the TMR Glider, which is based on a DGM, as a TMR cross-check is not suitable. It is notable that the CMA in determination of the RIIO-2 appeals considered that there is significant uncertainty regarding the calibration of DGMs given their sensitivity to input assumptions and volatility over time.²⁸

²⁸ CMA Final Determinations: Volume 2A: Joined Grounds: Cost of Equity (2021), paragraph 5.286

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- 3.65 Frontier recommend the use of a TMR survey. We already incorporate an investment manager-based TMR cross-check, the details of which are provided in this chapter. Frontier recommended an alternative Fernandez TMR survey, which is conducted via email outreach to over 14,000 finance and economics academics, analysts, and corporate managers. For the UK-specific TMR estimate, no information is available regarding the identity or credentials of the respondents. In contrast, our survey incorporates insights from well-established and respected investment firms, offering a robust and credible foundation for validating the TMR. Therefore, we do not see the need for an additional survey to the investment manager-based TMR cross-check we already employ.
- 3.66 In response to Citizens Advice, we note that while the classical CAPM model assumes the TMR reflects the return on all risky assets, this assumption is widely regarded as impractical. It would require inclusion of numerous obscure assets with no observable prices. To our knowledge, no regulator or financial institution applying CAPM adopts such an approach. Regarding concerns that historical data may overstate future returns, we agree this could be a risk if short time periods with elevated returns were used. However, our estimate is based on over 120 years of market data, which helps mitigate this concern and provides a more robust foundation for our TMR estimate. Finally, with respect to the concerns regarding the use of a beta to adjust investment managers' TMR cost of equity, we are now applying this cross-check to the TMR itself rather than to the cost of equity. Therefore, a beta adjustment is no longer required.

Adjusting historical returns for inflation

SSMC Summary

- 3.67 Our proposed approach to using historical inflation data aligns with UKRN Guidance and our RIIO-3 methodology. For 1900-1949, before RPI, CPI, or CPIH were available, we believe the Consumption Expenditure Deflator (CED) is more suitable than the Cost-of-Living Index (COLI), as it handles weights for consumed goods more realistically. Between 1950 and 1987, regulators now generally prefer using backcast CPI or CPIH data over RPI. Since 1988, there has been enough data to directly measure CPI and CPIH inflation rates.

Summary of consultation response

- 3.68 Stakeholders made no comments relevant to this issue.

SSMD decision and rationale

- 3.69 We have decided to use the historical inflation approach used in RIIO-3. For the period of 1900-1949 (which predates the collection of RPI, CPI or CPIH data), we will use the Consumption Expenditure Deflator (CED). For the period 1950-1987,

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we will use backcast CPI or CPIH data. From 1988 onwards, sufficient data exists to directly observe rates of CPI and CPIH inflation.

Calculating the TMR

SSMC Summary

- 3.70 The UKRN Guidance notes that all regulators place weight on historical ex post approaches and many of them on historical ex ante methods. Some regulators have also considered forward-looking evidence in their most recent decisions. The UKRN Guidance recommends that the TMR should be primarily based on historical ex post and historical ex ante evidence. Reflecting the UKRN Guidance, as well as recent relevant precedent, we proposed to give equal weight to both historical ex ante and historical ex post analysis when estimating the TMR.²⁹
- 3.71 In line with our RIIO-3 FD, we proposed using the DMS decompositional approach, also applied by the CMA in its Provisional Determination of PR24, to establish the ex ante TMR.³⁰ This method calculates the geometric average of dividend yields and adjusts for the real dividend growth rate and converts the result from a geometric to an arithmetic average.
- 3.72 In line with our RIIO-3 FD, we proposed to base our estimate of the ex post TMR on the 1-year arithmetic average of historical returns from the DMS dataset.

Summary of consultation responses

- 3.73 Stakeholders made no comments relevant to this issue.

SSMD decision and rationale

- 3.74 We have decided to give equal weight to both historical ex ante and historical ex post analysis when estimating the TMR.
- 3.75 We have decided to use the DMS decompositional approach to establish the ex-ante TMR. The decompositional approach uses historical average dividend yield and dividend growth data from the 2026 edition of the DMS dataset and the inflation dataset discussed in Paragraph 3.69. We adjust this data from its geometric terms into an equivalent arithmetic average. We have estimated our ex-ante TMR estimate to be 6.79%. Our calculations are shown in the table below.

Table 6: Ofgem ex ante TMR analysis

²⁹ UKRN cost of capital guidance (2023), page 21

³⁰ [CMA PR24 Provisional Determinations Volume 4, Chapters 7-10, para 7.256](#)

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Ex ante TMR	Figure	Calculation step
Geometric mean dividend yield	4.55%	A
Growth rate of real dividends	0.64%	B
Geometric-to-arithmetic conversion	1.61%	C
Arithmetic ex ante TMR estimate	6.79%	D = A + B + C

Source: Ofgem using 2026 DMS returns data and Ofgem's inflation dataset

- 3.76 We have decided to base our estimate of the ex post TMR on the 1-year arithmetic average of historical returns. Our estimate of the ex post TMR uses historical returns from the 2026 edition of the DMS dataset and the inflation dataset discussed in Paragraph 3.69. We have estimated our ex post TMR estimate to be 6.92%.
- 3.77 We acknowledge that the CMA in their final determination of PR24 calculated an ex ante TMR range of 6.7-6.8% and an ex post of 6.9%. For the top end of their TMR estimate range they added an historical ex post ERP of 4.8% to their RFR estimate of 2.4% to give a TMR estimate of 7.2% rather than use their ex post estimate. Their resultant range was 6.70% to 7.20% with a midpoint of 6.95% versus Ofgem's 6.9%. Our preference for a stable TMR approach over a stable ERP approach has been covered earlier in this section.

TMR Estimate

- 3.78 When setting the TMR, it is important to remember that this figure represents a long-term estimate of expected market returns. On this basis, we do not think that it is feasible that long-term expectations of this figure are likely to be defined to two decimal places 'unrounded'. As a result, we present the TMR range and point estimate rounded to one decimal place. For the purpose of the early view of the cost of equity, our TMR estimates are summarised in Table 7 below.

Table 7: Our early view of TMR (to one decimal place)

TMR Approach	Estimate
Ex ante	6.8%
Ex post	7.0%
Midpoint	6.9%

Source: Ofgem analysis, DMS data

Estimating Beta (β)

Proposed methodology to setting the beta parameter

SSMC Summary

3.79 Beta is the measure of an asset's exposure to undiversifiable systematic risk, relative to the average exposure of assets in the market. The average exposure to systematic risk is defined as a beta of one.

3.80 The relative systematic risk faced by investors in an asset is called the asset beta. The asset beta (β_a) can be split into equity beta (β_e), the exposure of shareholders to systematic risk, and debt beta (β_d), the exposure of debt investors to systematic risk. To calculate the asset beta, we weight the debt beta by the proportion of debt (g) or 'gearing' in the capital structure and the equity beta by the proportion of equity ($1-g$) in the capital structure, as shown below.

$$\beta_a = (g \cdot \beta_d) + (1-g) \cdot \beta_e$$

3.81 We can rearrange the asset beta formula to solve for equity beta.

$$\beta_e = (\beta_a - (g \cdot \beta_d)) / (1-g)$$

3.82 Recommendation 5 of the UKRN Guidance suggests that regulators should estimate equity beta for the notionally capitalised company using comparable listed companies and standard regression techniques (ie Ordinary Least Squares (OLS)). The UKRN Guidance also notes that where the listed comparator has different gearing to the notional company, regulators should continue to de-lever and re-lever the raw equity beta.

3.83 We agree with the UKRN Guidance Recommendation which is in line with the RIIO-ED2 and RIIO-3 approaches. We proposed to base our beta analysis on OLS regressions of relevant listed comparators, de-gearing data to make asset beta comparisons before re-gearing to the notional capital structure to estimate an appropriate equity beta input for the CAPM cost of equity.

3.84 We proposed to consider a range of timeframes and frequencies when analysing equity beta data. We intend to weight data based on regulatory judgement and will confirm the exact calibration of our calculations on the basis of the evidence considered. We expect to utilise comparator firms such as listed UK energy and water networks, which were included in RIIO-ED2 beta assessment, as we continue to believe that these firms are likely to be representative of the core risks faced by GB energy networks. However, as in RIIO-3 FD, we said we may consider including a broader set of comparable companies such as relevant European utility comparators in addition to UK Water companies and National Grid plc.

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3.85 Debt beta is generally more difficult to measure than equity beta. Debt securities do not tend to trade in the same liquid fashion as listed equities, and so the quality of bond return data is likely to make accurate debt beta analysis difficult.

Summary of consultation responses

- 3.86 In FQ9 of our SSMC we asked, "Do stakeholders agree with the methodology for calculating CAPM parameters: RFR, TMR and beta?". In FQ10 of our SSMC we asked, "Do stakeholders agree with us using our proposed RIIO-3 beta comparators for ED3?".
- 3.87 All DNOs and the ENA raised several concerns about our approach for calculating beta. One major point was the suggestion that Ofgem include forward-looking adjustments to beta, based on the DNOs view that they face greater risks in future periods. KPMG's analysis was cited as providing evidence of these increased risks in ED3.³¹ NPg also argued that, in practical terms, investors need additional compensation for specific risks they encounter.
- 3.88 All DNOs also stated that electricity distribution faces risks comparable to those of transmission, citing Frontier analysis of international evidence showing that regulators have assigned similar beta estimates to both sectors.
- 3.89 The ENA discussed the effects of market volatility on short-term betas, citing Frontier's analysis of this subject. The ENA also referred to Oxera's examination of the 'low beta anomaly'.
- 3.90 SPEN raised concerns regarding the suitability of water companies as beta comparators and cited the NERA analysis, which examined US and GB beta values for comparison.
- 3.91 All DNOs and the ENA argued that, in determining the cost of capital, factors beyond just the single market factor should be considered, citing KPMG's Multi-Factor model (MFM) analysis conducted for the ENA.³²
- 3.92 Citizens Advice stated that using UK equity market indices instead of global asset indices to estimate equity betas likely leads to higher beta values for UK regulated companies.
- 3.93 Citizens Advice stated that there is evidence suggesting potential limitations with the application of OLS regression. They recommend that Ofgem consider employing a generalised autoregressive conditional heteroskedasticity (GARCH) model, or alternatively, utilising lower frequency and longer-sample data if OLS

³¹ KPMG RIIO-ED3 Risk Assessment. This report was published within the responses to our [SSMC](#)

³² KPMG Exploring Multi-factor Models as a cross-check on allowed returns at ED3. This report was published with the responses to our [SSMC](#)

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is adopted. This advice references an Ofgem-commissioned report authored by Donald Robertson on the subject.³³

- 3.94 Citizens Advice stated that, for inclusion at ED3, Ofgem must provide a rationale as to how European comparators would now facilitate a more accurate estimation of beta, given Ofgem's previous acknowledgment of the "inherent difficulties" involved. They further note that the divergence observed in European betas indicates that country-specific or firm-specific factors, rather than sector-specific factors, may be influencing these values, rendering them unsuitable as comparators for the UK sector. Additionally, Citizens Advice requested that Ofgem clarify whether it considers the associated risks within the electricity sector to be systematic or non-systematic, as this distinction would determine whether such risks should be incorporated into the CAPM estimation.
- 3.95 There were no specific comments on debt beta.

SSMD decision and rationale

- 3.96 We have decided to base our beta analysis on the same approach used in RIIO-3. We will base our beta analysis on OLS regressions of relevant listed comparators. We will de-gear these to assess unlevered equity betas, combine these estimates with our debt beta assumption to make asset beta comparisons, and then re-gear these estimates to the relevant notional level of gearing to estimate an appropriate equity beta input for the CAPM cost of equity.

Regression method and indices used

- 3.97 Both GARCH and OLS regression methodologies are seen as returning good estimates of long run beta over longer runs of data.³⁴ Given this, we will continue to base our beta analysis on OLS regressions in line with precedence and the UKRN guidance which recommends relying on standard regression techniques such as OLS.³⁵ We will use the most diversified local index for each company. For the GB companies the index used is the FTSE All-Share Index, for the European companies the index used is the STOXX Europe 600 Price Index.
- 3.98 Regarding Citizens Advice's comments around global asset betas, we do not agree that using global betas would result in a more accurate estimate of the cost of capital. Consistent with the position outlined in the UKRN Guidance, we consider that the most diversified local index denominated in the relevant currency offers the most meaningful insight into the systematic risk faced by energy networks.

³³ Donald Robertson, Estimating Beta (April 2018)

³⁴ Donald Robertson, Estimating Beta (April 2018), page 39

³⁵ UKRN cost of capital guidance (2023), page 23

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3.99 We consider that the most relevant measure for an energy network is relative exposure to the domestic (or, where relevant) regional economy. World indices are typically dominated by companies in the United States. While we understand the potential benefit from assessing beta as a global investor (against a global benchmark), we consider that, on balance, more relevant information about the relative risk exposure of network companies is made with reference to domestic markets trading in the same currency (or regional markets where domestic indexes are insufficiently diversified).

Timeframe and measurement frequency

3.100 In using OLS as the standard regression technique to estimate equity beta we will rely most heavily on longer-term (10-year) timeframes. This approach is in line with Citizens Advice's position that regulators should focus on longer timeframes when measuring beta.

3.101 Regarding Citizens Advice's comments on OLS regression we agree with the UKRN Guidance that using daily beta data is appropriate for the types of stocks under consideration, as they are typically highly traded and liquid. Compared to weekly or monthly data, daily observations offer a reasonable balance between analytical efficiency and reliability.

Choice of comparators

3.102 We have decided to include three sets of comparators in our estimation of beta:

- UK water stocks-Severn Trent (SVT), United Utilities (UU), Pennon (PNN)
- National Grid plc (NG)
- a group of comparator European energy utilities (Enagas, SNAM, Red Electrica, Terna and Italgas)

3.103 SPEN raised doubts about whether water companies serve as suitable beta benchmarks for electricity distribution. They proposed that Ofgem might benefit from considering international comparisons, such as examples from the United States. The NERA report titled 'US Allowed Cost of Equity' is mentioned in this context.³⁶

3.104 We see continued value in using UK water company betas as supporting evidence, particularly in the absence of pure-play GB energy network comparators. These companies operate within a similar GB regulatory framework, and investors in UK utilities are likely to assess them in relation to energy networks. Moreover, some energy network companies themselves

³⁶ NERA US Allowed Cost of Equity vs Ofgem DD. This report was published within the responses to our [SSMC](#)

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reference the allowed returns in the UK water sector, reinforcing the relevance of water company betas in this context.

- 3.105 We do not consider it appropriate to use US energy company comparators. We do not consider the US utility regulatory system as a valid comparator for several reasons. US utility regulation tends to be on an ex post basis, meaning there is greater risk for US utilities in recovering costs incurred. US regulation is conducted on a state-by-state basis, which complicates aggregated comparisons. Even when aggregated, S&P (the financial information and analytics company) analysis shows that US utilities often earn below their authorised returns.
- 3.106 Citizens Advice correctly observed that, during RIIO-2, we recommended exercising caution with the use of European beta comparators. The electricity sector across many jurisdictions is facing a phase of elevated levels of investment. Our RIIO-2 beta comparators had limited direct representation of energy companies. On balance, we consider that including European energy companies facing broadly the same industry dynamics as a justified and appropriate way to ensure that our beta estimate is appropriately accurate and representative of systematic risks faced by the companies subject to the price control. As previously stated, we continue to find value in referencing UK water company betas as evidence, particularly given these entities operate under a similar GB regulatory regime, and investors in UK utilities are likely to evaluate them in relation to energy networks. Nonetheless, since the Spanish and Italian regulatory frameworks closely mirror the GB model, we determined it was appropriate to include energy companies from those countries to ensure a robust energy component in our estimation of the beta for GB energy firms. The selected companies are predominantly regulated (about 85-90% of revenues), have BBB+ / A- S&P Global credit ratings, and market capitalizations between €4bn and €20bn, ensuring sufficient trading liquidity (which should help to minimise estimation errors).
- 3.107 SSE plc (SSE) and Iberdrola SA (IBE) are excluded as comparators due to the significant scale of their unregulated business activities, which limits their relevance for comparison with GB energy network companies. In fiscal 2025 SSE's regulated networks represented 59% of total adjusted operating profit.³⁷ In fiscal 2025 Iberdrola's networks business represented 57% of total operating profit.³⁸

Setting an asset beta range

- 3.108 Our asset beta estimate will place emphasis on the 10-year asset betas. We have decided to set a wide asset beta range of 0.30 to 0.45 that incorporates all

³⁷ SSE Annual Report 2025, Financial Statements, page 182

³⁸ Iberdrola Annual Report 2025, page 60

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of the current 10-year estimates and use the 0.375 midpoint of that range as our asset beta estimate. We purposely avoid averaging the individual beta estimates due to the small sample size of eight values, as any one estimate could significantly skew the results. Additionally, we reserve the discretion to apply judgment and may choose, for example, to include estimates from the 5- and 2-year estimation windows if we deem it appropriate. This choice will reflect the balance between the relevance of historical data and the efficiency of the estimator (an estimator with higher variance is considered less efficient). For example, using a longer timeframe helps prevent short-term crises from disproportionately affecting betas, while a shorter timeframe may better capture current perceived risks.

3.109 We agree, in general, with the KPMG conclusion that the overall risk profile of ED3 is broadly similar in significance but different in profile to ET3.³⁹ The reduced risk from fewer large projects, as seen in ET3, is likely balanced by increased complexity due to project volume, geographic distribution and uncertain demand timing and location. In addition, Frontier's analysis of European regulated energy networks demonstrate that those regulators treat electricity distribution and transmission sectors broadly in a similar fashion.⁴⁰ For these reasons we have decided to take the same approach to estimating beta in ED3 as in RIIO-3.

3.110 The ENA referred to Frontier's 'low beta puzzle' report (2024) where Frontier observed that utility betas tend to be negatively correlate with market volatility.⁴¹ This is not an issue we will consider when estimating beta because attempting to judge the direction of market volatility is near impossible. Even if one could attempt to forecast future market volatility, judging the relationship between utility betas and future market volatility would be very difficult to measure. We prefer a transparent and robust approach to estimating beta.

3.111 The ENA also referred to Oxera's discussion of the 'low beta anomaly' which suggests that the cost of equity estimated through the CAPM may underestimate the required returns for regulated utilities. There are reasons to doubt the existence of a lasting 'low beta anomaly'. We believe market inefficiencies are likely to be corrected over time as mispricing creates profit opportunities, financial markets are highly competitive and investors learn to spot inefficiencies. Also, survivorship bias, focusing only on companies that survived, can distort results, especially if riskier, failed firms with higher betas are left out. Behavioural factors like investor irrationality may also explain the anomaly, rather than a true market flaw. Step 2 in estimating the cost of equity ensures that our Step 1 estimate is neither too high nor too low. This allows us to identify

³⁹KPMG - RIIO- ED3 Risk Assessment. This report was published within the responses to our [SSMC](#)

⁴⁰Frontier for NGED - International evidence on allowed equity return for electricity distribution. This report was published within the responses to our [SSMC](#)

⁴¹ Frontier The low beta puzzle. This report was published within the responses to our [SSMC](#)

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and address any irregularities that may be present in our CAPM parameters. Note that the equity beta in our cost of equity estimate midpoint, at 0.83, is not particularly low.

3.112 Citizens Advice correctly pointed out that betas fluctuate over time. We have noted divergences across time periods, across sectors and within sectors. At the time of RIIO-3 FD, we observed that the two- and five-year average water asset betas were higher than both their 10-year average and the corresponding averages for gas and electricity within the same periods. We also found that the two-year and five-year average betas for gas and electricity were significantly lower than their 10-year averages, although National Grid's two-year beta had increased and surpassed those of the European betas. At present, we do not consider these divergences to warrant the exclusion of any comparator companies. Citizens Advice is also correct that changes in betas may be driven by country-specific and firm-specific factors, not solely sectoral influences. We would further extend these influencing factors to include, among others, market volatility, regulatory conditions, and liquidity considerations. We recognise that a perfect beta comparator set does not exist; however, we remain focused on ensuring that the comparator set we use is as relevant and effective as possible.

Debt beta estimate

3.113 Our proposed debt of 0.075 is the same estimate used in RIIO-3 and is in line with the 0.05 to 0.125 range in UK regulatory decisions since December 2019.⁴² We note that the CMA retained Ofwat's final determination debt beta range of 0.05-0.15, and that our debt beta estimate sits within this range. We will continue to consider the appropriate debt beta estimate over time and may update our approach in the future if there is compelling evidence to do so.

3.114 We calculated the following asset betas for our chosen set of comparators. Please see Table 8.

Table 8: Asset betas at 0.075 debt beta

Company	2-year	5-year	10-year
UU	0.37	0.31	0.31
SVT	0.38	0.32	0.32
Pennon	0.42	0.41	0.38
National Grid	0.42	0.32	0.36

⁴² CMA PR24 Final Determinations Volume 4: Allowed return - chapter 7, para 7.610

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Company	2-year	5-year	10-year
Enagas	0.21	0.24	0.34
Snam	0.19	0.31	0.43
Red Electrica	0.20	0.23	0.31
Terna	0.24	0.33	0.42
Italgas	0.23	0.34	N/A

Source: Ofgem analysis

Beta Estimate

3.115 For the purpose of the early view of the cost of equity, our beta estimates are summarised in Table 9 below.

Table 9: Our early view of betas

Metric	Low	Midpoint	High	Calculation
Debt Beta	0.075	0.075	0.075	A
Asset Beta	0.30	0.375	0.45	B
Notional gearing	60%	60%	60%	C
Equity Beta	0.64	0.83	1.01	$D = (B - (A * C)) / (1 - C)$

Source: Ofgem analysis of Bloomberg data.

CAPM cost of equity for ED3 early view

3.116 Based on the metric-level decisions above, our early view of the cost of equity at 60% gearing is 5.10%-7.05% with a midpoint of 6.08%. The key metric decisions are summarised in Table 10 below.

Table 10: Our early view of the cost of equity

Metric	Low	Midpoint	High	Calculation
RFR	2.09%	2.09%	2.09%	A

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Metric	Low	Midpoint	High	Calculation
TMR	6.8%	6.9%	7.0%	B
Debt beta	0.075	0.075	0.075	C
Asset beta	0.30	0.375	0.45	D
Notional gearing	60%	60%	60%	E
Equity Beta	0.64	0.83	1.01	$F = (D - (C * E)) / (1 - E)$
Step 1 Cost of Equity (early view)	5.10%	6.08%	7.05%	$G = A + F * (B - A)$

Source: Ofgem analysis (CoE rounded to 2dp)

Step 2: Checking our Step 1 estimate is neither excessive nor insufficient

3.117 Investability is about making sure we get the balance of risk and reward right to attract investment, as has been the case with all our past price controls. We consider investability in several ways:

- equity investability primarily measured via cross-checks to our Step 1 - CAPM-based estimate of the cost of equity
- the potential need for additional cross-checks
- the assessment of additional risk factors
- picking a point estimate from the cost of equity range
- our dividend yield assumption
- assessing equity issuance costs

The use of cross-checks

SSMC Summary

3.118 Recommendation 7 of the UKRN Guidance suggests that cross-checks may be used to sense check the CAPM derived point estimate. However, the Guidance recommends that regulators should only deviate from the mid-point of the CAPM cost of equity range if there are strong reasons to do so.

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3.119 We proposed to use a range of cross-checks to assess whether our CAPM-based estimate is materially out of line relative to estimates suggested by relevant market data and other estimation methodologies.

3.120 In our RIIO-3 FD we used investment manager TMR forecasts as a cross-check to TMR and the following cross-checks to our CAPM cost of equity estimate:

- transaction Market-Asset-Ratios (MARs)
- traded MARs
- infrastructure fund implied equity internal rates of return (IRRs).

3.121 We proposed to continue to use these cross-checks for the purpose of ED3 price controls.

Summary of consultation responses

3.122 In FQ11 of our SSMC we asked, "Do stakeholders agree with proposed set of cross-checks in Step 2?".

3.123 All DNOs argued that Ofgem's cross-checks are too limited and recommend using a broader set. They claimed Ofgem unreasonably dismissed their suggestions and applied inconsistent standards to additional cross-checks. SSEN-D added that MARs are unreliable due to estimation and interpretation issues.

3.124 Citizens Advice expressed support for Ofgem's application of MARs, particularly the use of transaction MARs, as they provide substantive, real-world evidence of the significant premiums associated with network acquisitions. They emphasized that MARs should exclude any additional outperformance assumption. Furthermore, they referenced research indicating that required returns from regulated utilities are generally among the lowest within the infrastructure sector, suggesting a below-average beta.⁴³ They recommended that Ofgem takes this into account when assessing infrastructure fund implied equity returns in ED3.

SSMD decision and rationale

3.125 We have decided to continue to use transaction and traded MARs, along with an Infrastructure fund implied IRR, to cross-check our Step 1 cost of equity estimate. These cross-checks utilise market-based data, as they capture actual pricing and incorporate embedded expectations that offer forward-looking insights. Their approach is straightforward and transparent. We regard these methods as rigorous cross-checks of the CAPM model given the information

⁴³ The research was from HMK Advisory Ltd in a report 'RIIO-2 Cost of capital' from February 2020

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they give about the broad appetite for equity investment in the sector. The CMA supported our view of MARs in the PR23 FD.⁴⁴

- 3.126 We discuss the broader set of cross-checks recommended by the DNOs later in this chapter in 'The need for additional cross-checks' section below (see Paragraph 3.132 onwards).
- 3.127 In RIIO-3 FD we revised our MAR analysis to present implied cost of equity estimates from both transaction and traded MARs. To improve clarity and robustness and, after considering feedback from the networks and their consultants after RIIO-3 DD, we removed any reliance on dividend and asset growth assumptions embedded in the MAR calculations. Removing the embedded dividend growth assumption means we are consistent in our criticism of the TMR Glider (which uses a dividend growth model). The impact of removing the dividend and asset growth assumptions is minimal (ie around 0.3%). We have, however, assumed 1.0% operational outperformance, as history shows us that networks typically outperform as a result of the incentive basis of the RIIO regulatory approach. Our updated analysis results in an implied cost of equity of 4.5% from transaction MARs and 5.1% from traded MARs, which sit at or below the low end of our Step 1 cost of equity range of 5.10% to 7.05%. As noted previously, the purpose of cross-checks is to ensure our CAPM-based cost of equity estimate is appropriately calibrated, neither insufficient nor excessive. Please see the Table 11 and Table 12 below for our updated MAR analysis.
- 3.128 In 2024, several major transactions were announced that continued to demonstrate acquisitions being made at premiums to regulated asset values (RAVs).⁴⁵ These often substantial MAR premiums are difficult to justify without assuming either that allowed returns on capital are, or are expected to be, higher than the actual cost of capital or sustained and significant outperformance by the target company. For example, in January 2024, Pennon Group plc announced its acquisition of Sutton and East Surrey (SES) Water, with the transaction reflecting a premium of approximately 6% to SES Water's RCV, as noted in Ofwat's PR24 Final Determinations.⁴⁶ In July 2024, Macquarie Asset Management exercised its option to acquire the remaining 20% equity interest in National Gas from National Grid.⁴⁷ Macquarie confirmed the deal matched their previous National Gas investments, with an implied enterprise value of £9.6bn. This is around a 26% premium to National Gas' March 2025 closing RAV of around £7.6bn (source: Ofgem Price Control Financial Model (PCFM)). In August 2024, Iberdrola agreed to acquire 88% of Electricity North West (ENWL).⁴⁸ Iberdrola valued ENWL at an enterprise value of approximately £4.2bn, around

⁴⁴ CMA PR24 Final Determinations Volume 4: Allowed return - chapter 7, para 7.643

⁴⁵ Note that RAV and RCV are interchangeable terms.

⁴⁶ Pennon Group Investor Information (January 2024)

⁴⁷ Macquarie Asset Management press release (July 2024)

⁴⁸ Iberdrola press release (August 2024)

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49% higher than ENWL's closing RAV of around £2.8bn at March 2025 (source: Ofgem PCFM). In February 2026 ENGIE announced that it had signed an agreement to acquire 100% of UK Power Networks (UKPN).⁴⁹ The transaction details implied a premium of around 50% for UKPN's regulated asset base. The average implied cost of equity from this selection of transactions was 4.3% and can be seen in Table 11 below.

Table 11: Transaction MARs implied cost of equity

Transaction MARs	SES Water	National Gas	ENWL	UKPN	Reference
MAR (at transaction date)	106%	126%	149%	150%	A
Gearing (notional)	55%	60%	55%	60%	B
Debt value	100%	100%	100%	100%	C
Equity market value	51%	66%	94%	90%	$D = A - (B \times C)$
Notional value of equity	45%	40%	45%	40%	$E = (1 - B)$
Equity MAR	113%	165%	209%	225%	$F = D/E$
Allowed return on equity	5.10%	6.04%	5.23%	6.00%	G
Implied cost of equity	4.50%	3.66%	2.50%	2.67%	$H = G/F$
Debt outperformance	0.0%	0.0%	0.0%	0.0%	I
Operational outperformance	1.0%	1.0%	1.0%	1.0%	J
Implied cost of equity (with outperformance)	5.50%	4.66%	3.50%	3.67%	$K = (H + I + J)$
Average of above	4.33%				

⁴⁹ ENGIE press release (February 2026)

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Source: Ofgem analysis

3.129 For traded MARs, we reference the MAR premia of the UK listed water sector as of January 2026. At January 2026, the average MAR premium stood at 11%, closely aligned with the sector's long-run average of 10%. Based on this analysis, the average implied cost of equity was 5.14%, as shown in Table 12 below.

Table 12: Traded MARs

Listed water companies	United Utilities	Severn Trent	Pennon	Reference
MAR (Jan 2026)	107%	116%	109%	A
Gearing (notional)	55%	55%	55%	B
Debt value	100%	100%	100%	C
Equity market value	52%	61%	54%	$D = A - (B * C)$
Notional value of equity	45%	45%	45%	$E = (1 - B)$
Equity MAR	116%	136%	120%	$F = D / E$
Allowed return on equity	5.10%	5.10%	5.10%	G
Implied cost of equity	4.41%	3.76%	4.25%	$H = G / F$
Debt outperformance	0.0%	0.0%	0.0%	I
Operational outperformance	1.0%	1.0%	1.0%	J
Implied cost of equity (with outperformance)	5.41%	4.76%	5.25%	$K = (H + I + J)$
Average of above	5.14%			

Source: Ofgem analysis

3.130 We have updated our Infrastructure Fund implied equity IRR cross-check. The average implied real IRR from our analysis is 8.3%, which is above the top end of

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our cost of equity range. It is important that our cross-checks remain both relevant and practical, we also aim to keep them simple and objective; applying a risk adjustment to each infrastructure fund or relying solely on the lower end of the IRR range, as suggested by one consumer group, would undermine this approach by adding complexity and subjectivity. Please see Table 13.

Table 13: Infrastructure Fund implied equity IRR

Fund	Share price (p)	Fund NAV	P/NAV	Discount rate	On-going charges ratio	Implied IRR⁵⁰	Real implied IRR
Greencoat Renewables (€)	68.7	99.0	0.69	7.5%	1.18%	9.11%	6.82%
HICL Infrastructure	116.4	156.0	0.75	8.4%	1.10%	9.78%	7.48%
Bluefield Solar	68.5	107.8	0.64	8.5%	1.01%	11.79%	9.45%
Int'l Public Partnerships	125.2	151.5	0.83	9.1%	1.12%	9.66%	7.36%
Greencoat UK Wind	98.1	133.5	0.73	9.0%	0.95%	10.95%	8.63%
Foresight Solar Fund	64.4	99.2	0.65	8.1%	1.17%	10.71%	8.39%
GCP Infrastructure Investments	74.4	100.3	0.74	8.3%	1.21%	9.56%	7.26%
The Renewables Infrastructure Fund	68.9	104.0	0.66	9.0%	0.98%	12.11%	9.76%

⁵⁰ Implied IRR = (Discount rate - ongoing charge ratio) / (P/NAV)

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Fund	Share price (p)	Fund NAV	P/NAV	Dis-count rate	On-going charges ratio	Implied IRR ⁵⁰	Real implied IRR
Average							8.14%

Source: Ofgem analysis and company websites.

Step 2 cross-check summary for ED3 early view

3.131 The range (defined by the average across the methodologies) for our Step 2 cross-checks is 5.03% to 6.89%, which compares to our Step 1 cost of equity estimate range of 5.10% to 7.05%. At this stage, these cross-checks, in aggregate, help to build confidence that our Step 1 cost of equity estimate is appropriately balanced, neither insufficient nor excessive. Please see Table 14.

Table 14: Step 2 cross-check range versus Step 1 cost of equity estimate

	Low	Midpoint	High
Transaction MARs	3.50%	4.50%	5.50%
Traded MARs	4.76%	5.09%	5.41%
Infrastructure Funds	6.82%	8.29%	9.76%
Step 2 range (average)	5.03%	5.96%	6.89%
Step 1 range	5.10%	6.08%	7.05%

Source: Ofgem analysis

The need for additional cross-checks

SSMC Summary

3.132 We stated that we would evaluate whether additional cross-checks are necessary to supplement our cross-checks of our Step 1 CAPM-derived estimate of the cost of equity.

Summary of consultation responses

3.133 All DNOs considered Ofgem's cross-checks to be too limited and suggested including more. They recommended the following additional cross-checks:

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- hybrid bonds (Frontier analysis was referred to)
- debt premia (Oxera analysis was referred to)
- unlevered cost of equity versus the cost of debt (CMA PR24 Draft Determinations were referred to)
- long term profitability
- other infrastructure projects (eg Sizewell C)
- international regulated returns in the US and EU
- Multi Factor Models (KPMG analysis was referred to)

SSMD decision and rationale

3.134 Our current view is that for the reasons we set out below, we have not seen compelling evidence that using the additional cross-checks as suggested by DNOs (see list in Paragraph 3.133) would improve our cost of equity estimate.

3.135 We have decided not to use the hybrid bond cross-check. Frontier sought to use hybrid bonds to estimate a cost of equity. As in RIIO-3, we remain concerned about this cross-check due to variable spreads between hybrid bond yields and the iBoxx utilities index. Frontier also noted that 80% of observed spreads range widely from 100 to 213 basis points. Additionally, as noted by the CMA in their PR24 Final Determinations, the implied cost of equity from Frontier's hybrid bond analysis is highly sensitive to assumptions around default risk pricing and the degree of equity-likeness attributed to the hybrid bond.⁵¹ These sensitivities result in a wide range of outcomes for the implied cost of equity. We conducted a hybrid bond analysis at the end of 2025 (see Table 15) and derived an implied real equity return of 5.49%, below the 6.08% midpoint of our early view cost of equity range. Despite this, we agree with the CMA that this does not serve as a useful cross-check for determining a point estimate of the cost of equity.

Table 15: Ofgem version of Frontier hybrid bond cross-check

Metric	Figure	Reference
Spread at issue (NGG 2073 hybrid bond yield minus iBoxx A/BBB 10+ yield on 18th March 2013)	1.12%	A
Default risk adjustment (Frontier estimate)	-0.15%	B
Spread (adjusted for default risk)	0.97%	C = A+B
Equity-likeness	50%	D

⁵¹ CMA PR24 Final Determinations Volume 4: Allowed return - chapter 7, para 7.713

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Metric	Figure	Reference
Implied premium of equity over debt	1.94%	E = C/D
iBoxx Non -Financials A/BBB 10+ yield (2025 average)	6.09%	F
Nominal equity returns	8.03%	G = E+F
Implied real equity returns (2.4% inflation)	5.49%	$H=(1+G)/(1.024)-1$

Source: Ofgem analysis as at end December 2025

3.136 We have decided not to use the debt premia cross-check. Oxera's debt premia analysis estimates a lower bound of for the cost of equity by adjusting the cost of debt for gearing through analysing the premia on assets over debt. As in RIIO-3 we continue to have concerns with this cross-check. The assumption that real equity returns do not respond one-for-one with the RFR is a generally accepted UK regulatory principle. This means that when interest rates rise the asset risk premium is likely to fall and so the relationship is unlikely to be constant as presented by Oxera. We ran the debt premia cross-check as at the end of 2025 (see Table 16) and derived an implied minimum real cost of equity of 5.65%, below the 6.08% midpoint of our early view cost of equity range. We note the CMA's PR24 Final Determinations where they disagreed with Oxera's interpolation to 100% gearing and the implication of using the debt premia analysis as a strict lower bound on the cost of equity.⁵² For these reasons we do not see this cross-check as useful for determining the lower end of the cost of equity range.

Table 16: Ofgem version of Oxera's debt premia cross-check

Metric (end 2025)	Figure	Reference
RFR, CPIH real (Dec 2025) includes Oxera's convenience premium	2.44%	A
TMR, CPIH real (RIIO-3)	6.9%	B
Asset beta (RIIO-3)	0.375	C
ARP	1.67%	$D = C*(B-A)$

⁵² CMA PR24 Final Determinations Volume 4: Allowed return - chapter 7, para 7.705

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Metric (end 2025)	Figure	Reference
Cost of new debt, nominal (5Y average iBoxx £ A/BBB 10+ indices to end 2025)	4.79%	E
RFR, nominal (5Y average nominal gilts with maturity matching modified duration of above indices ie 12Y)	3.33%	F
Convenience premium (Oxera estimate)	0.27%	G
Expected loss (Frontier estimate)	0.30%	H
DRP	0.89%	I = E-F-G-H
Notional gearing	60%	J
ARP implied by 100% gearing	1.48%	K=(I/J)

Source: Ofgem analysis as at end 2025

3.137 Unlevered cost of equity: the risk faced by equity investors, for a given level of gearing, exceeds that faced by debt investors, as debt holders have priority over equity holders in both routine cash flows and in the event of insolvency. This concept extends to the observation that the debt risk premium should not surpass the equity risk premium for an unlevered firm. As gearing increases, the risk profile of debt gradually aligns with that of equity, ultimately resembling the risks assumed by equity investors in an unlevered entity. The CMA in its PR24 Final Determinations noted that it can therefore be useful to compare the cost of equity for a fully equity financed company (ie an unlevered company) with the cost of debt.⁵³ The CMA considered the allowed return on equity with the cost of new debt allowance as a cross-check to the allowed return on equity. The CMA, in their PR24 Final Determinations analysis, estimated a cost of new debt that was 0.21% below the unlevered cost of equity and considered that gap to be relatively narrow. The CMA also noted that there is no defined level or required premia between the cost of equity and the cost of debt. As of December 2025, our analysis (Table 17) shows our cost of new debt to be 0.78% below the unlevered cost of equity and so we do not face the same issue as the CMA identified in PR24 Final Determinations. We agree with the CMA that there is no specific premium between equity and debt costs and do not envisage using this analysis as a cross-check to our cost of equity estimate.

Table 17: Ofgem version of CMA's unlevered cost of equity cross-check

⁵³ CMA PR24 Final Determinations Volume 4: Allowed return - chapter 7, para 7.687

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Metric	Figure	Reference
RFR (Dec 2025)	2.17%	A
Asset beta (RIIO-3)	0.375	B
TMR (RIIO-3)	6.9%	C
ERP	4.73%	D= C-A
Unlevered cost of equity	3.94%	E= A+ (B*D)
Cost of new debt (December 2025 average iBoxx A/BBB 10+ yield)	5.94%	F
Expected loss (Frontier estimate)	0.30%	G
Return on new debt	5.64%	H = F-G
CPIH (long-term)	2.40%	I
Cost of new debt (real)	3.17%	J = ((1+H)/(1+I))-1
Unlevered CoE vs CoND	0.78%	I = E-J

Source: Ofgem analysis

3.138 We have decided not to use a long-term profitability cross-check. Frontier's long-term profitability analysis looked at companies' profitability to benchmark equity returns. As in RIIO-3 our key concerns with long-term profitability benchmarking as a cross-check centre on the difficulty of ensuring meaningful comparability between regulated and non-regulated companies, as well as the limitations and inconsistencies in accounting metrics used across firms. Additionally, this cross-check produces a wide range of outcomes for the implied cost of equity. Given these factors, we do not consider it a reliable or useful tool for determining an estimate of the cost of equity.

3.139 We do not consider Sizewell C to be a valid cross-check to our cost of equity estimate:

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- network companies argued that Sizewell C's allowed cost of equity (reported by Centrica as 10.8% real) demonstrates that our cost of equity allowance is too low. However, this return applies only to the 12–15-year construction phase, the riskiest part of the project, and excludes the operational phase when the plant generates electricity. In contrast, network companies both build and operate their assets, and our allowed cost of equity covers the entire lifecycle. For this reason, we do not consider Sizewell C a valid comparator
- Sizewell C is a single, large-scale nuclear construction project with few suitable comparators. Characteristics such as the high incidence of cost overruns in nuclear projects and investor hesitancy toward nuclear infrastructure likely influenced the government's approach. Moody's Ratings credit opinion on Sizewell C noted its credit quality is constrained by the significant construction risk and highlighted other credit considerations including the reliance on certain key contractors, the exposure to single site and single technology, a leveraged profile and weak cash flow-based metrics. These factors make the project fundamentally different from the regulated energy networks under our assessment. For these additional reasons we do not consider Sizewell C a valid comparator

3.140 Frontier Economics suggested that authorised returns for comparable US utilities, typically in the 9% to 10% nominal range, should be considered as a crosscheck. However, we do not consider this a valid comparator for several reasons:

- US allowed returns are largely ex post authorised returns, meaning US utilities bear an element of inflation risk that UK regulated companies do not
- US regulation is conducted on a state-by-state basis, making aggregated comparisons problematic
- even when aggregated, S&P analysis shows that US utilities often earn less than their authorised returns. Between 2020 and 2024, the average achieved nominal return was 9.1% for electricity utilities and 8.3% for gas utilities—equating to real returns of around 4.0% (US inflation averaged around 4.4% during 2020-2024) compared to RIIO-2's real cost of equity allowance of 4.55%. In 2024 Iberdrola achieved nominal returns of just 4.9% in Maine and between 5.9% and 7.1% in New York, compared to allowed returns of 9.35% and 9.2%, respectively. National Grid's electricity and gas businesses in Massachusetts and New York (Niagara Mohawk) delivered nominal returns ranging from 4.64% to 8.6% in 2025, despite allowed returns between 9.0% and 9.7%

3.141 International regulator returns, Europe: Frontier Economics stated that the equity premium over the RFR, adjusted for consistent gearing, is lower in the UK

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than in many comparable European jurisdictions. In response, we note UBS (the global investment bank) analysis indicating that allowed real returns for Italian electricity distribution are around 5.6%, while Spanish electricity distribution nominal returns are around 6.58%. Utilities in these jurisdictions were among those recommended by network companies as beta comparators, and their allowed returns are comparable to, or below, our proposed ED3 cost of equity. As with other international comparisons, we emphasise that cross border regulatory benchmarking is inherently complex and should be approached with caution. Nonetheless, the Spanish and Italian regulatory frameworks share notable similarities with the GB regime, which is why we have considered including Spanish and Italian energy companies in our beta dataset to be appropriate.

3.142 KPMG analysis suggested that MFMs, which incorporate additional risk dimensions to the CAPM, explain observed returns more effectively than the CAPM. The KPMG analysis focused on the q-factor model. We have several concerns with this analysis which make it unsuitable as a cross-check for our cost of equity estimate:

- the report relies on the analysis of only one academic paper using UK data;
- we are unaware of any work of the q-model for firms in regulated markets, which have different characteristics to competitive markets
- the q-factor model in the KPMG analysis is based on one comparator, National Grid. With nine listed companies in our comparator set we would welcome broader analysis
- with National Grid being much larger than the DNOs, the analysis estimates a size premium by running a long-short analysis by taking a long position in Pennon and a short position in an equally weighted portfolio of Severn Trent and United Utilities. This introduces a substantial degree of subjectivity and complexity to the analysis

Other investability related issues

SSMC Summary

3.143 We said we would consider investability in several other ways including the assessment of additional risk factors; picking a point estimate from the cost of equity range; and assessing equity issuance costs.

Summary of consultation responses

3.144 In FQ12 of our SSMC we asked, "Do stakeholders agree that our proposed allowed return on equity ensures the investability of the sector?".

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- 3.145 UKPN, SSEN-D and SPEN implied that a real cost of equity of at least 6.8%, matching Oxera's RIIO-3 midpoint estimate (at 60% gearing), is needed to ensure investability. NPg suggested Ofgem set baseline returns and incentives such that a 'good' performing notional company can expect more than an 8% real return. NGED stated that US investors in energy networks expect returns of 9-10%. Additional risks associated with ED3 have been highlighted by all the DNOs, who asserted that the permitted return on equity should account for these risks, often citing KPMG's analysis as a reference. SSEN-D noted that electricity distributors encounter greater exposure to asymmetric risks within the overall framework, including ex post cost assessments, penalty-only delivery incentives, and stringent delivery targets.
- 3.146 All DNOs stressed the importance of appropriate cross-checks for the cost of equity and suggested potentially adjusting upward within the beta or equity ranges to account for higher risks. The impact of underinvestment on customer welfare was highlighted, especially since the energy transition could reduce customer bills. An Oxera analysis examining bill effects was cited to support this view.⁵⁴
- 3.147 Dividend assumption: all DNOs suggested raising the dividend assumption to 5% or higher, instead of 3%, to better attract investors.
- 3.148 Equity issuance cost allowance: two DNOs considered a 5% equity issuance cost allowance to be the minimum required.
- 3.149 Citizens Advice argued that using the term 'investability' could be a way to justify higher returns for companies. In their opinion, the sector is already very financeable, and therefore also "investable". They note they have not seen any evidence of a significant risk of failing to attract adequate investment and believe that claims about lacking investability should only be made if there is strong supporting evidence.

SSMD decision and rationale

- 3.150 Additional risks: a key finding of the KPMG assessment of ED3 risk exposure is that the risks present in ED3 and ET3 can reasonably be considered comparable.⁵⁵ We broadly agree and, as noted in the sections above, are using the same methodologies to estimate the cost of equity in ED3 as were used in ET3. Investment growth, macroeconomic conditions, and competition for capital in ED3 are generally comparable to what was seen in ET3. As KPMG notes, it is challenging to assess whether risk exposure has systematic aspects, and if so, to what extent. We are not convinced that factors affecting capital delivery risk,

⁵⁴ Oxera - ENA- RIIO-ED3 household energy bills forecast. This report was published within the responses to our [SSMC](#)

⁵⁵ KPMG- RIIO-ED3 Risk Assessment. This report was published within the responses to our [SSMC](#)

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such as those related to supply chains, have significant systematic components. In our view, such risks should be addressed through policy rather than financial frameworks. As with RIIO-3, we anticipate a favourable asymmetry in the overall package as a result of the RIIO incentives package that helps to drive performance for customers. We agree with Citizens Advice that robust evidence would be needed to support any claims that the price control is not investable. We have not seen substantial evidence that would suggest the need to vary our allowed return on equity estimate because of additional risks.

- 3.151 **Selecting point estimates:** the UKRN recommends considering five key factors when selecting a point estimate within the cost of equity range. After evaluating each at Draft and Final Determinations we will pick the appropriate point estimate. At this stage we anticipate picking the mid-point of the cost of equity range.
- 3.152 **Market-Based Cross Checks:** our cross-checks suggest a cost of equity range of 4.92-6.84%, which aligns well with our proposed cost of equity allowance range of 5.10-7.05%, supporting a mid-point selection.
- 3.153 **Potential Welfare Impact of Underinvestment:** investor sentiment remains robust, as demonstrated by Iberdrola's €5 billion equity issuance in July 2025, which was oversubscribed by a factor of 3.8, and SSE's £2 billion equity raise in November 2025, where shares were issued at a 4% premium to the prior day's closing price. Furthermore, SSE plc, National Grid plc, and Iberdrola SA continue to receive generally favourable recommendations from analysts. We have no evidence to aim up because of the risks of underinvestment.
- 3.154 **Asymmetries in Incentive Structures:** companies have historically exceeded their allowed returns due to the performance incentives within the RIIO framework. Subject to further assessment of the balance of the overall ED3 package, we see no reason why investability would be threatened at the midpoint of our allowed return on equity range.
- 3.155 **Asymmetries in CAPM Parameters:** our CAPM inputs are robust. The inclusion of European energy firms in the beta estimate, a TMR that exceeds equity market cross-checks, and our proposed cost of equity range aligning with our cross-check range all reinforce confidence in our parameter choices.
- 3.156 **Financeability:** we expect our analysis in Draft and Final Determination stages to confirm that licensees are financially resilient, with the ability to maintain appropriate credit ratings under the proposed cost of equity assumptions.
- 3.157 **Equity issuance cost allowance:** we consider the equity issuance allowance level of 5% used in RIIO-3 to be at least sufficient and will continue to consider the appropriate use of this allowance when considering the required equity capital for ED3.

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3.158 Dividend assumption: we see significant value in the expected growth in the ED sector during ED3. Retained earnings will be essential to support this expansion, and a 3% dividend yield alongside attractive dividend growth presents an attractive proposition for investors. Therefore, we have decided to maintain a 3% notional company dividend yield assumption.

Step 3: Expected versus allowed returns

SSMC Summary

3.159 We proposed we would only expect to make a Step 3 adjustment if future decisions in relation to the design of the price control led to an intentional and material skew in expected outcomes relative to allowed returns.

3.160 In assessing changes in risk, it is vital that we do so on a 'net' basis. In other words, we must assess the overall change in risk, including new or updated mitigations used throughout the price control package. The presence of individual asymmetric risks within the package is not a reason to provide additional returns. It is the aggregated balance of the whole price control that should influence the associated balancing of overall risk and reward.

3.161 We will further calibrate our methodology for setting the allowed return after the overall price control package has been established, we have analysed business plans and the expected outcome 'in the round' is better understood.

Summary of consultation responses

3.162 Stakeholders made no comments relevant to this issue.

SSMD decision and rationale

3.163 At present, we have not identified any SSMD decisions that would indicate an asymmetric return. A 'Step 3' adjustment would be considered only if subsequent decisions regarding the design of the price control result in a deliberate and significant deviation in expected outcomes compared to allowed returns. Our objective would be to ensure that such adjustments do not compromise the effectiveness of incentives, provided they continue to deliver beneficial outcomes for consumers.

3.164 As a result, our early view of the cost of equity remains in line with the midpoint of our Step 1 estimate, 6.08% at 60% gearing.

4. Weighted Average Cost of Capital (WACC) allowance

The WACC allowance remunerates debt and equity investors for their investment in network services. Accurate remuneration will secure investment during ED3 and help keep consumer charges in line with efficient costs.

SSMC questions

- FQ13. Do stakeholders consider there to be good reasons to deviate from the respective approaches set out under UKRN Recommendations 1 and 9?
- FQ14. Do stakeholders consider there to be good reasons to deviate from the notional gearing assumption applied to ED companies in the RIIO-ED2 price controls?
- FQ15. Do stakeholders consider there to be good reasons to maintain notional gearing levels for each year of the price control? Do stakeholders have a preference for how this assumption is managed within the price control process?

Our approach for ED3

SSMC summary

- 4.1 The total allowed return for companies in this price control is calculated as a WACC. The allowed WACC consists of three inputs:
- the allowed return on debt
 - the allowed return on equity
 - and the relative weights of debt and equity. The WACC calculation combines the allowed returns on debt and equity according to the following formula (where K_d = cost of debt, K_e = cost of equity, g = gearing):
- $$WACC = K_d * g + K_e * (1 - g)$$
- 4.2 UKRN Guidance Recommendation 1 is that regulators estimate allowed returns using a notional firm's WACC in price controls. We support this and plan to base returns and financeability assessments on a notional capital structure.
- 4.3 Recommendation 9 of the UKRN Guidance advises that notional gearing should be based on the regulator's risk assessment, a wide range of benchmarks on gearing levels, and overall policy goals—not just the actual company's gearing. We expect to maintain RIIO-ED2's 60% gearing assumption for all DNOs in these price controls, pending confirmation of company-specific investment plans.
- 4.4 We are reviewing how we apply notional gearing during price control. Currently, we set notional gearing at the start and adjust it based on cash generation across the period. Alternatively, we could keep the capital structure fixed yearly and vary debt and equity issuance to maintain it.

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Summary of consultation responses

- 4.5 All DNOs agreed with UKRN Recommendations 1 and 9 and all agreed with Ofgem's expectation of maintaining RIIO-ED2's 60% gearing assumption.
- 4.6 All DNOs agreed that Ofgem should maintain its current approach to applying notional gearing. NPg mentioned that it is appropriate for Ofgem to consider alternatives, but only if there is a sufficient allowance for equity issuance costs and changes to maintain gearing are limited to adjustments in debt and equity issuance.

SSMD decision and rationale

- 4.7 We have decided to maintain our current methodological approach of setting a notional gearing level as there is no compelling evidence in support of a change from our approach.
- 4.8 We apply a notional level of gearing in deriving a WACC. This was set at 60% for ED2 and we will continue to use this level for business planning purposes only.
- 4.9 We have also been monitoring the increase in equity values at companies over the ED2 period. This increase has been driven by higher-than-anticipated inflation over recent years - and may be exacerbated if inflation continues to be higher than previously forecast. In times of higher-than-anticipated inflation, equity holders in network companies benefit from the indexation of the RAV - as the costs of fixed rate debts remains stable (and so falls in real terms). The opposite impact happens when inflation is lower-than-anticipated.
- 4.10 We have addressed this issue from ED3 onwards through the introduction of a nominal allowance for fixed rate debt. For further information on this change, please see Paragraph 2.34. However, we must also consider how best to protect consumers during the remainder of the ED2 period. In our 2023 Call for Input on the impact of high inflation, we ruled out a performance 'true up' on inflation - noting that we believe that such an option would likely result in net detriment to consumers overall.⁵⁶ Instead, we think that it is likely that net benefit to consumers will come from ensuring that the DNOs use their equity gains to underpin upcoming higher levels of investment and to support the ongoing financeability of the sector. As a result, we are minded to use the benefits of the inflation leverage effect to facilitate a reduction in notional gearing over the ED3 period.
- 4.11 We currently expect that notional gearing would fall on an annual basis over ED3, transitioning from 60% to 55% by the end of the ED3 control period. We previously made a similar adjustment to the ET sector, which now operates at 55% notional gearing. Should we consider the equity gains over the ED2 period to

⁵⁶ [Call for Input - Next Steps - Final.pdf](#)

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be sufficient, it would be logical to enact the transition to a lower gearing assumption without equity issuance cost allowance support - further reducing costs for consumers. We will engage further with stakeholders on this position and the appropriate approach to transitioning between notional gearing levels, ahead of making a formal decision at Draft Determinations.

- 4.12 Our SSMD baseline allowed return on capital is shown in Table 18 below. Note, for the cost of debt we use the average of the RAV weighted (14 years) cost for the ED3 period and assume a calibration adjustment of 0.39% and additional borrowing cost allowance of 0.19%. To deflate the fixed rate cost of debt we have used an inflation assumption of 2.4%. This is an 'early view' of the cost of capital, presented to reflect the methodology decisions described above. The cost of capital for ED3 will be updated for DD and FD.

Table 18: SSMD baseline allowed return on capital

Component	ED3
Notional Gearing	60%
Cost of equity allowance (real)	6.08%
Cost of debt allowance (semi-nominal)	5.42%
WACC allowance (semi-nominal)	5.68%
WACC allowance (real)	4.35%
WACC allowance (nominal)	6.85%

Source: Ofgem analysis (values may not sum due to rounding)

5. Debt financeability

Section summary

Our in-the-round financeability assessment, which is undertaken at a licensee level, protects consumers by ensuring that an efficient operator adopting the notional capital structure is financeable. We confirm here our proposed approach to assessing financeability at Draft Determinations stage, including our incorporation of longer term modelling and our aim to target an overall Baa1/BBB+ credit rating for an efficient company adopting the notional capital structure.

SSMC questions

- FQ16. What, if any, improvements should Ofgem make to its proposed approach to the assessment of financeability in the next price control?
- FQ17. What evidence, if any, should Ofgem consider in relation to expanding its assessment of financeability?
- FQ18. What evidence, if any, should Ofgem consider in relation to expanding financeability 'levers'?

Our approach for ED3

SSMC summary

- 5.1 GEMA is required to have regard to the need to secure that network companies are able to finance the activities which are the subject of obligations imposed by or under a range of legislation.⁵⁷ The assessments we perform to discharge this duty are often referred to as assessments of 'financeability'.
- 5.2 We assess the financeability of energy networks on the basis of an efficient licensee adopting the notional capital structure. This is to ensure that consumers are protected from risk associated with actual financing decisions that licensees and their shareholders have made. Consistent with previous price controls, we consider it appropriate that the risks and rewards arising from financing decisions reside with investors.
- 5.3 In order to assess debt financeability, we proposed to adopt an approach similar to that adopted for RIIO-3. We noted that we intend to conduct an in-the-round assessment that targets an efficient licensee adopting the notional capital structure broadly achieving an investment grade credit rating. Within this assessment we stated we plan to consider:

⁵⁷ Ofgem's principal statutory objective is to protect the interests of existing and future gas and electricity consumers. Ofgem also has a range of secondary duties including its duty to have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed on them (See section 3A(2)(b) of the Electricity Act 1989 and section 4AA(2)(b) of the Gas Act 1986).

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- financial projections from our financial model(s)
 - the implied Moody's methodology rating (as this is the most transparent and therefore replicable methodology of the three rating agencies that we currently rely upon)
 - the strength of quantitative metrics for credit quality, particularly those emphasised by credit rating agencies or that are under pressure
 - the strength of other metrics and qualitative factors
 - stress testing results
- 5.4 We noted that our financeability testing should consider financial ratios on the basis of both baseline totex allowances and additional totex allowed through variant ex post expenditure.
- 5.5 We proposed proceeding with incorporating long-term modelling into the financeability assessment for ED3, consistent with the approach adopted in RIIO-3.
- 5.6 Incremental improvements we suggested:
- changing the way we calculate simulated credit ratios (for example, using the forecast sector average cost of debt rather than the cost of debt allowance in our analysis to avoid an unintended consequence whereby an upwards calibration adjustment designed to provide more headroom results in an adverse movement in financeability metrics)
 - including additional credit ratios in our analysis utilised by S&P and Fitch;
 - assessing broader indicators of equity cost, such as dividend yield expectations
 - assessing the appropriate equity issuance cost allowance
- 5.7 We noted, in line with UKRN Guidance Recommendations, we do not consider 'aiming-up' of the allowed return on capital to be in consumers' interest. In the event financeability constraints are identified, we could consider a number of financeability 'levers' including:
- changing the gearing assumption
 - adjusting the depreciation methodology
 - reducing the dividend assumption
 - adjusting capitalisation rates

Financeability assessment

Summary of consultation responses

- 5.8 In response to FQ16 ("What, if any, improvements should Ofgem make to its proposed approach to the assessment of financeability in the next price

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control?"), four DNOs agreed with our proposal to assess financeability against metrics associated with a BBB+/ Baa1 credit rating, consistent with our decision in RIIO-3. There was also consensus that our assessment should evaluate the notional company's credit strengths and associated credit metrics across multiple credit rating agencies, ensuring any updates or developments in rating agency methodology are appropriately reflected in the analysis. The DNOs additionally supported adopting a longer-term approach to modelling financeability.

- 5.9 NGED argued that DNOs have greater complexity of triaging and prioritising projects than ET in order to deliver capacity upgrades in the right place and at the right time. As a result, the impact of the complexity of capital programmes factor in rating agency considerations will have to be re-assessed compared to the ED2 level. It noted that in NGET's RIIO-ET3 business plan submission, an adjustment to this scorecard factor can have a material impact on the indicated rating. It suggested that we should also assess financeability under a range of scenarios including where additional equity financing is not available for a period of time. NGED stated that it is important to ensure sufficient headroom in credit metrics to absorb periods of higher investment and higher leverage without threatening the credit ratings of the licensees.
- 5.10 The ENA emphasised the importance of assessing whether all key financial ratios used by the major credit rating agencies meet the thresholds for a strong investment-grade rating of at least BBB+/Baa1. It advised that the financeability assessment must not be selective in the choice of credit rating agency ratios, arguing instead that all should be considered to ensure a comprehensive and balanced assessment. It further noted that the financeability assessment should reflect the latest considerations and approaches of the credit rating agencies and have regard to the downside risks that are currently being monitored by them. It expressed concern that, without changes to Ofgem's proposed finance policy for ED3, the financeability assessment will likely identify issues. In its view, where financeability pressures arise, these should be addressed directly at source through the adoption of more appropriate policy approaches.
- 5.11 Responses to FQ17 ("What evidence, if any, should Ofgem consider in relation to expanding its assessment of financeability?"), largely echoed those to FQ16, with respondents suggesting that clearly defined target credit ratings should reflect the methodologies of various credit rating agencies and ensure that key metrics are assessed against sector specific benchmarks.
- 5.12 SPEN recommended expanding the financeability framework to include robust stress testing and risk modelling, such as Monte Carlo simulations, to capture correlated risks across totex, incentives and macroeconomic variables. It argued that ED3 will face heightened volatility driven by macroeconomic uncertainty, accelerated investment for net zero and supply chain cost pressures. SPEN noted that our own ED3 framework consultation and

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stakeholder responses highlight that the next price control will operate in a context of greater inflation volatility and heightened regulatory uncertainty compared to RIIO-2.

- 5.13 SSEN-D states that a financeable ED3 programme should be supported by a notional cashflow profile that maintains two investment-grade credit ratings at least two notches above the minimum threshold (BBB+/Baa1), supports a sustainable dividend yield of around 5%, and provides sufficient headroom to avoid undue funding pressure.
- 5.14 NGED suggested that the financeability assessment should be read in conjunction with investability. NGED also noted that although the move to a semi-nominal allowed return on capital initially improves credit metrics, this benefit would diminish over time and the long-term impact needed to be more fully understood. NGED stated that Moody's Adjusted Interest Coverage Ratio (AICR) threshold may need to be reassessed as a result. NGED was supportive of carrying out a long-term financeability assessment while recognising its inherent limitations. NGED noted that this would help ensure that policy choices made for ED3 do not undermine the future sustainability of raising debt and may also provide insight into intergenerational equity. NGED proposed that medium to long-term modelling across a range of totex and sensitivity scenarios should be carried out to test credit metrics against BBB+/Baa1 thresholds throughout the assessment period. Finally, NGED stated that there were issues around depreciation, referring to a NERA report commissioned by ENA to assess the depreciation gap. NGED stated that there were direct impacts on credit metrics, particularly Funds from Operations (FFO)/ Net debt, arising from the relative reduction in revenue caused by extending asset lives from 20 to 45 years.
- 5.15 ENA welcomed the proposal to incorporate long-term modelling into the financeability assessment, suggesting that it should cover at least three future price control periods. Separately, it stated that relying on assumptions that diverge from "natural" assumptions to support financeability could risk undermining investability, referring to gearing and capitalisation rates. It contended that investors could face the possibility that a future regulator may revise key financial policies for ED4, resulting in debt financeability deteriorating to below investment-grade credit rating levels. It therefore considered that priority should be given to adopting more sustainable solutions that address the underlying causes of any identified financeability concerns.
- 5.16 NPg argued that the formal financial assessment needs to expand beyond financeability and into investability. NPg also stated that the dividend yield should be 5% instead of 3%. NPg stated that the long-term return on book equity for a notional network company indicates that the status quo financial framework does not support healthy credit ratings and long-term investability.

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SSMD Decision and Rationale

- 5.17 We will retain an in-the-round financeability assessment. We will evaluate each licensee in line with the notional capital structure and assuming efficient performance, assessing their ability to achieve credit metrics in line with a strong investment grade (Baa1/BBB+) credit profile. We conclude that there remains strong consumer interest, supported by evidence, in calibrating a financial package that would help to support credit metrics associated with a strong investment grade rating.
- 5.18 We will continue to use the key elements of the Moody's methodology scorecard in our assessment, recognising it as a transparent and readily replicable methodology. In addition, we are considering expanding our analysis to include elements of the S&P methodology scorecard. We will consider the merits of this further ahead of Draft Determinations, taking account of the requirement for licensees to maintain two investment-grade ratings. We will also continue to model and analyse the key credit ratios utilised by Fitch as part of our broader financeability assessment.
- 5.19 We will continue to consider any updates to rating agency approaches, methodologies and credit metric thresholds when conducting our analysis of financeability.
- 5.20 In our modelling of implied credit ratios, where we calculate debt interest costs we will substitute the assumption that the cost of debt is equal to the allowed return on debt, with forecast efficient average debt costs utilised in the calibration exercise (as in RIIO-3). We consider that this adjustment will allow a more accurate assessment of network companies' ability to fund efficient debt costs (at the notional capital structure).
- 5.21 We will review the DNOs' business plans to assess whether it is necessary to adjust the complexity of capital programme score in our assessment. We will make a decision on any such adjustment in the Draft Determinations.
- 5.22 We will proceed with the proposal to incorporate long-term modelling into the financeability assessment, which was generally supported by the network companies and consistent with RIIO-3. We will also use the extended form of the PCFM approach, as we did in RIIO-3. We will also incorporate relevant elements of assessment used by the main rating agencies, Moody's, S&P and Fitch. This modelling will broadly extrapolate RIIO-ED3 price control policies and the current macroeconomic environment into future periods.
- 5.23 It is important to emphasise that the assumptions underpinning this long-term modelling are necessarily simplified and may not reflect the actual policies or allowances that will be adopted in future price controls.

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- 5.24 The limitations inherent in long-term modelling cited above mean that any apparent weakness in projected ratios should not necessarily be viewed as definitive evidence to prompt immediate action. Future policy developments or adjustments to allowances could materially alter the financial outlook, potentially mitigating any issues currently forecast. Moreover, financeability issues identified may be more appropriately addressed at the time of the relevant price control, when more accurate and up-to-date information will be available. Despite these limitations, the modelling remains a useful tool for identifying potential material long-term trends that may be best addressed within the RIIO-ED3 framework, rather than deferred to subsequent periods.
- 5.25 We note SPEN's suggestions to include further stress-testing and Monte Carlo simulations in our financeability assessment. We believe these measures would add further complexity to our assessment without clear consumer benefits, noting that our in-the-round financeability assessment considers the price control package as a whole and does not rely on any one metric.
- 5.26 We do not consider NGED's proposal of including an assumed scenario with no equity support to be realistic. Such an assumption represents a severe downside rather than a credible funding scenario, particularly given that many DNOs sit within wider corporate groups that have multiple channels through which equity-like support can be provided. We also consider this downside scenario to be unduly restrictive, as management can typically deploy measures like reducing dividend payouts or re-profiling capital programmes to offset periods of limited equity availability.
- 5.27 We do not see a clear rationale for further methodological changes based on NPg's response that our assessment should be expanded beyond financeability and into investability, given that our existing in-the-round financeability assessment already assesses the price control package as a whole.

Financeability levers

Summary of consultation responses

- 5.28 In response to FQ18 ("What evidence, if any, should Ofgem consider in relation to expanding financeability 'levers?"), respondents generally favoured the use of depreciation policy and/ or asset lives as financial levers to support financeability. Capitalisation rates were also acknowledged as a potential lever, though typically viewed as a short-term measure that can help to fine tune financeability rather than provide a structural solution. SSEN-D, NGED and NPg highlighted the perceived negative impact of extending assets live from 20 to 45 years in RIIO-ED1. There was limited support for reducing gearing or the dividend yield assumption.

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- 5.29 ENA explicitly disagreed that a reduction in the dividend yield assumption could be used to address financeability concerns, arguing that doing so would create equity investability issues. It referred to Oxera analysis⁵⁸ undertaken for RIIO-3, which concluded that such an approach would trade off the interests of debt and equity capital holders at a time when both debt and equity capital are required to finance the networks' investment needs. ENA stated that satisfying credit metric requirements should not come at the expense of incentivising the entry and retention of equity capital. ENA stated that, in assessing the requirements of an investable PR24 package, the CMA incorporated the continuation of a cash dividend yield, regardless of RCV growth. ENA argued that this further reinforces the principle that maintaining a sustained dividend yield remains a critical component of an investable regulatory package.
- 5.30 UKPN referred to the UKRN Guidance when arguing that lowering notional gearing would not represent an appropriate financeability position. It noted that if regulators choose to reduce notional gearing from one price control to the next, they must consider whether such a change is feasible, including assessing whether the allowed cost of equity is sufficient to support any required de-gearing. UKPN also stated that, when considering the use of capitalisation rates and depreciation policy as levers, a key constraint is how the credit rating agencies view these measures and whether they recognise them as genuine improvements in credit quality.
- 5.31 SPEN cautioned against improving financeability at the expense of investability. It stated that arbitrary changes to gearing could distort the balance of risk and reduce comparability across regulatory periods, and that lowering the dividend yield assumption would run counter to network investors' preferences for income and capital growth returns. SPEN reiterated its position to set the notional ILD portion of the capital structure at the sector average. However, it acknowledged that it may be reasonable to set ILD portion below the sector average to reflect financeability considerations and the practical limitations of the ILD market as DNO borrowing increases.
- 5.32 NPg argued that there were only two realistic financial levers available, depreciation and capitalisation rates. It considered depreciation to be the more appropriate lever for maintaining a healthy long-term financial profile, as both asset lives and the depreciation schedule can be adjusted. NPg stated that over the next three price control periods a reduction in depreciation allowances below their "natural" rate, caused by the transition to 45-year asset lives from ED1, would see credit metrics fall below investment grade thresholds leading to financeability constraints. It noted that that capitalisation rates may help with short-term fine-tuning but was not suitable for addressing the long-term decline in DNO cashflows. NPg stated that relying on adjustments to capitalisation rates

⁵⁸ Oxera, RIIO-3 risks and investability topics, 9 December 2024, section 3.1.4.

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in ED3 would simply defer the issue to ED4 and would not resolve intergenerational fairness concerns linked to the current depreciation issue, citing NERA's October 2025 analysis.⁵⁹ NPg argues that there are limitations of using gearing as a financeability lever, referencing the CMA's position on gearing assumptions and arguing that such an approach does not provide long-term stability. It also stated that dividend yields are not a viable financeability lever, noting that while reducing dividend yields may improve credit metrics, it would be detrimental to key equity metrics.

- 5.33 NGED argued that neither altering notional gearing nor modifying the notional dividend policy are appropriate levers for addressing financeability concerns. It stated that reducing gearing would not address underlying issues, could increase consumer costs through equity issuance charges, and could raise returns on a growing RAV. It characterised depreciation as a structural building block, linked to intergenerational equity, investability and value for money, rather than a financeability lever. It also did not view adjusted capitalisation rates to be the preferred long-term solution to support financeability challenges that they argue are caused by the depreciation gap, though it accepted that such adjustments may be necessary and justified to manage short-term cashflow profiling.
- 5.34 SSEN-D stated that presenting notionally financeable cash flows could undermine investability, returns should be set that reflect real financeability risks for DNOs and that DNOs should be fully compensated for the costs of raising new capital (they state that a 5% equity issuance allowance is the bare minimum required against their analysis indicating costs can be 7 - 10%). They also suggested adopting an optimal capitalisation rate that balances long-term investment recovery with sufficient cashflows to operate and fund capital. It also stated the need for a policy that protects intergenerational fairness and avoids unnecessary reductions in depreciation income arising from past decisions. It highlighted the perceived consequences of extending asset lives in RIIO-ED1, stating that this was acknowledged by Ofgem in the British Gas Trading Limited appeal.⁶⁰ SSEN-D stated that the revised depreciation approach created a long-term depreciation trough into the 2060s, implying costs are being unfairly shifted to future generations. It argued that longer asset lives have reduced operators' cashflows since RIIO-ED1, undermining financeability despite being presented as supporting intergenerational fairness, a justification it disputes. SSEN-D references analysis conducted by NERA, which it notes highlights emerging financeability challenges and lack of intergenerational fairness.

⁵⁹ [251021_NERA_ENA_Depreciation_solutions_for_ED3_FINAL.pdf](#)

⁶⁰ CMA (2015) 'British Gas Trading Limited vs GEMA, Final determination', September 2015, pages 125, 127-128

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- 5.35 Citizens Advice argued that the financeability of several network companies has been significantly strengthened by the RAV additions realised through elevated inflation during RIIO-2. It stated that we should demonstrate how these RAV additions affect financeability and confirm whether any changes to distribution policies have been made that influence this assessment. Citizens Advice suggested that we make a minimum expectation around how this 'windfall' should be distributed explicitly clear.⁶¹

SSMD Decision and Rationale

- 5.36 We will consider whether any adjustments need to be made to support financeability at Draft Determinations and will consider all levers accordingly. We believe it is appropriate to retain revenue advancement options, such as adjusting capitalisation or depreciation methodologies, to address financeability challenges. These measures can address short-term cashflow pressures in a way that is NPV neutral to the consumer. Other measures, such as increasing allowed returns on equity, would represent a permanent transfer of value from consumers to companies to address a short-term cashflow issue. As set out in Chapter 4, we will consider whether gearing ratios should be altered at Draft Determination.
- 5.37 We note responses from stakeholders which put forward various arguments on the relative merits and disadvantages of using different levers to help support financeability metrics. As discussed above, we will assess financeability at Draft and Final Determinations, taking an in-the-round assessment. If financeability issues are identified, we will then assess the most appropriate adjustments to make to the financial framework. It would not be appropriate to pre-judge which levers will be deployed at this stage of the determination process.
- 5.38 We acknowledge the Citizens Advice's observation regarding the impact of inflation-driven RAV additions during RIIO-ED2 and their effect on network companies' financeability. We have introduced semi-nominal WACC and RAV indexation to mitigate potential inflation-related shocks in the future. However, we will consider whether it is appropriate to adjust the notional level of gearing over the ED3 period to better support this phase of high investment - which would replicate the approach taken in the Transmission sector. Increases in equity capital gained over the ED2 period would be taken into consideration when assessing the merits of this approach. We will take a decision on the notional capital structure at Draft Determinations.

⁶¹ Ofgem, [Call for Input - Next Steps - Final.pdf](#), August 2023, Para 3.6

6. Financial resilience

Our financial resilience framework protects consumers by making company failure less likely and/or increasing the chance and quantum of recovery in the event of failure.

For ED3, we have decided to enhance the financial resilience framework and bring it in line with RIIO-3. This includes requiring more than one investment grade credit rating, adding a distribution lockup trigger at 75% regulatory gearing, and extending financial resources certificates to cover the full price control period or at least three years ahead.

We recognise that the wider Energy Networks Ringfence Review,⁶² which includes ED companies and has regards to matters related to financial resilience, is ongoing and awaiting decision. The outcome of the Review may provide an alternative or complementary route for implementing some of the financial resilience measures that we are adopting for ED3.

SSMC questions

FQ19. Do stakeholders have views on the proposed financial resilience measures?

Our approach for ED3

SSMC summary

- 6.1 Financial resilience refers to the ability of companies to maintain sufficient safeguards or headroom to prevent or manage the risk of financial distress in the event of adverse shocks. Our principal objective is to protect the interests of consumers and our requirements relating to financial resilience aim to shield consumers from the negative effects of financial vulnerability or failure. We constantly strive to do this by monitoring, enhancing provisions, and promoting a prudent and responsible approach to financial resilience by network companies.
- 6.2 Within the parameters set by the price control, licence and company law, network companies and their shareholders retain considerable discretion over decisions related to financing and capital structure. We expect companies to manage their own financial risks and for shareholders, rather than consumers, to bear the direct consequences, whether gains or losses, of those decisions.
- 6.3 Our 2024 Multi-Year Strategy⁶³ recognised financial resilience as a key aspect of the energy system's overall stability and a key element of consumer protection. It is therefore a priority for Ofgem that existing financial resilience measures evolve to ensure appropriate levels of protection are maintained for consumers.

⁶² [Energy Networks Ring-fence Review consultation | Ofgem](#)

⁶³ [Ofgem Multiyear Strategy](#)

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- 6.4 In the SSMC we recognised that our analysis undertaken during the RIIO-3 consultation stages⁶⁴ indicates a need for enhanced financial resilience measures across the regulated energy network companies, including the DNOs. Our ED3 Framework Decision⁶⁵ also highlighted the importance of a consistent approach to financial resilience across the sectors.
- 6.5 Our SSMC asked stakeholders for feedback on adopting three measures to enhance financial resilience that regard the licensees' credit rating, the distributions lock-up triggers and the availability of resources certification.
- 6.6 Measure 1 would amend current credit rating obligations to “require” licensees to maintain more than one investment grade credit rating at all times⁶⁶ rather than "use reasonable endeavours" or "take all appropriate steps" to maintain only one investment grade credit rating. This aims to ensure a consistent approach across the UK energy regulated sectors and remove ambiguity around the "reasonable endeavours" statement.
- 6.7 Measure 2 regards the amendment of the current distributions lock-up triggers⁶⁷ to include a trigger if the licensees reach 75% or higher actual regulatory gearing. This is supported by alignment with existing market expectations on gearing covenants and Moody's guidance for maximum gearing level for Baa1-rated energy network companies.
- 6.8 Measure 3 refers to extending the availability of resources certification obligations⁶⁸ to require company boards to state that, based on reasonable assumptions, they envisage sufficient financial resources to cover the entire price control period or a minimum of three years ahead. This aims to enable visibility of the long-term viability of licensees and provides early warning signals of risks to financial resilience to allow Ofgem to intervene more promptly if appropriate.
- 6.9 Additionally, certificates in relation to financial resources would require explicit references to stress testing, in line with our approach in RIIO-3. This refers to both the existing 12-month financial resources certificate and the new extended version of the certificate that we're introducing at ED3.

Summary of consultation responses

- 6.10 We had six responses to our SSMC question whether stakeholders have views on the proposed financial resilience measures. The responses ranged from

⁶⁴ [RIIO-3 SSMD Finance Annex](#)

⁶⁵ [Framework decision: electricity distribution price control \(ED3\) | Ofgem](#)

⁶⁶ [Standard conditions of the Electricity Distribution Licence](#), Condition 40: Credit rating of the licensee, paragraph 40.1

⁶⁷ [Standard conditions of the Electricity Distribution Licence](#), Condition 41: Restriction of Indebtedness and transfers of funds, Part C

⁶⁸ [Standard conditions of the Electricity Distribution Licence](#), Condition 30: Availability of Resources

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neutral to supportive for the overall implementation of financial resilience measures, with three stakeholders asking for further clarifications and suggesting changes to our proposals. NGED and ENA stated that the ED3 consultation stage is simultaneous with the Ringfence Review consultation, and stated that they preferred to respond to the latter where matters overlap. NGED and ENA's responses will be addressed separately in the Ringfence Review.

- 6.11 SSEN-D said that they consider ED companies financially resilient, but stated that any measures adopted should be applicable from the beginning of ED3. SSEN-D's view is that the proposed credit rating changes were neither tested nor compensated in the ED2 financeability assessments, so it is unreasonable to impose unaccounted costs and risks during the current price control.
- 6.12 SPEN agreed with the importance for a financially resilient sector and believe that measures beyond those proposed for RIIO-3 would not bring tangible benefits to consumers. SPEN also suggested an active monitoring framework of financial resilience that can be integrated with the Return Adjustment Mechanism to ensure that financial underperformance does not compromise long-term service delivery or investment capacity.

SSMD decision and rationale

- 6.13 We have assessed the representations made by stakeholders and decided to adopt the financial resilience measures as proposed in the SSMC. We believe that these measures are consistent with our reasonable expectations for a financially responsible licensee. We also consider that these measures achieve the right balance between best practice on financial resilience across the regulatory landscape, but which do not introduce disproportionate incremental costs.
- 6.14 We acknowledge SSEN-D's view regarding current sector resilience. However, as regulators, we must ensure that licensees continue to remain resilient in the future and believe that financial resilience safeguards are more likely to be effective when such measures are put in place proactively to ensure consumer harm is prevented, rather than after the event.
- 6.15 The chosen measures achieve our intended objectives of robust financial resilience and enhanced safeguards, and we do not propose implementing an active framework of monitoring financial stress, as per SPEN's comment. However, as the sector evolves and challenges take new forms, we will constantly review and strive to improve financial resilience tools to ensure licensees obligations are fit for purpose to protect consumers.
- 6.16 We do not believe that the aim of a financial resilience framework should be to protect licensees from financial underperformance, as implied by SPEN. This removes the incentive for companies to manage their own financial risks and for

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shareholders, rather than consumers, to bear the direct consequences, whether gains or losses, of those decisions.

Measure 1 – more than one credit rating requirement

Summary of consultation responses

- 6.17 SPEN stated that an absolute requirement for two credit ratings could lead to inefficiency where credit rating agencies' opinions differ and "best endeavours" remains appropriate.
- 6.18 NPg suggested that financeability assessments should reflect the proposed requirements for at least two investment grade credit ratings.

SSMD Decision and rationale

- 6.19 We have decided that licensees will be required to ensure they maintain more than one investment grade issuer credit rating at all times. For the avoidance of doubt, this measure refers to an Issuer Credit Rating, a rating issued for the entity as a whole, rather than a debt instrument rating, and as defined by the existing licence conditions.⁶⁹
- 6.20 We do not believe that requiring more than one investment grade credit rating creates undue uncertainty or inefficiency, as pointed out by SPEN. The use of multiple ratings reduces reliance on any single methodology and provides a robust indicator of financial resilience. We note that licensees' actions are the primary driver of credit rating outcomes through their financial policy, operational performance and governance, rather than discrepancies between rating agencies. Additionally, we remain of the view that "best endeavours" is inherently subjective, difficult to enforce consistently, while also creating confusion as compliance with licence requirements cannot be objectively determined.
- 6.21 Regarding NPg's point on financeability, we do not consider that our financial resilience requirements should have any direct impact on the assessment of financeability. The additional three resilience measures discussed here represent outcomes that efficient companies with appropriate financing approaches should be able to achieve.

⁶⁹ [Standard conditions of the Electricity Distribution Licence](#), Condition 40: Credit rating of the licensee, paragraph 40.2

Measure 2 – distributions lock-up trigger at 75% gearing

Summary of consultation responses

- 6.22 UKPN asked for clarity on how gearing will be calculated for the purposes of the proposed distributions lock-up trigger.
- 6.23 SPEN views the successfulness of this measure as dependant on financeability targets not being reduced to ensure licensees maintain headroom before triggering the lock-up.

SSMD Decision and rationale

- 6.24 We have decided to proceed with Measure 2. This measure will add 75% actual regulatory gearing as a trigger alongside the existing triggers, such as when an issuer credit rating of the licensees falls to the lowest investment grade and is put on negative watch or outlook for downgrade. For the avoidance of doubt, the 75% gearing trigger will have the same effect as the current triggers and, therefore, lock-up transactions as delineated by the current licence conditions.⁷⁰
- 6.25 To address UKPN's request for clarification on how gearing will be calculated for the purposes of Measure 2, we note that the 75% actual regulatory gearing trigger will have both a backward-looking and a forward-looking test. The backward-looking test means licensees will consider their actual regulatory gearing ratio as reported at the closing of the last reporting year, using nominal figures for net debt and RAV. The forward-looking test will be based on projected gearing for the end of the current reporting year, using reasonable assumptions and forecasts made by the licensee.
- 6.26 Regarding SPEN's view, and as noted above in the case of the credit rating requirements, we do not consider there to be a direct link between our financial resilience requirements and our assessment of financeability. In the assessment of financeability we consider metrics associated with efficient licensees structured in line with the notional capital structure. The assessment of financial resilience is based on relevant financial metrics under companies' actual financial structures. Within the range of our resilience requirements, licensees have discretion over their individual financing strategies. It is important that the risks and rewards of financing decisions remain with the companies and their investors, and not consumers.

⁷⁰ [Standard conditions of the Electricity Distribution Licence](#), Condition 41: Restriction of Indebtedness and transfers of funds, Part B, paragraph 41.3 limbs (a) to (g)

Measure 3 – extended financial resources certificate

Summary of consultation responses

- 6.27 UKPN requested further clarification around the assumptions to be included in the extended financial resources certificate to demonstrate compliance.
- 6.28 NPg asked for the company board to retain discretion over these assumptions. NPg also said that stress testing should be proportionate and tailored to sector-specific risks.
- 6.29 SPEN viewed this measure as unnecessary and challenging from an audit sign-off perspective, although took comfort in our assertion that the measure does not require increasing liquidity levels.

SSMD decision and rationale

- 6.30 We have decided to proceed with Measure 3. Licensees will have to submit to Ofgem an annual certificate attesting sufficiency of financial resources for the whole price control period or a minimum of three years ahead.
- 6.31 For the avoidance of doubt and to respond to UKPN's request for clarifications, licensees must use any relevant assumptions in relation to financial markets availability for any financing or refinancing needs or around equity injections. We reiterate that for the purposes of compliance with this certificate requirement, assumptions are sufficient and licensees do not need pre-funding or maintaining more liquidity than necessary to cover the timeframe required by the certificate.
- 6.32 We recognise that company boards are best placed to assess their financial plans and assumptions, and so we expect them to take the ownership of this process and use assumptions specific to their situation, as called for by NPg. However, at a minimum, we expect assumptions to refer to:
- access to and availability of financial markets for financing, refinancing or equity injections
 - assessments of forecast financial standing, including assessments of downside scenarios
 - credit facilities, financial covenants and compliance with these
- 6.33 We note that the assumptions that licensees consider should be presented in a statement of factors accompanying the certificate. This is similar to the existing process of issuing the 12-month financial resources certification.
- 6.34 We understand NPg's view that stress tests should be proportionate and tailored to sector-specific risks. We may provide guidance in the Regulatory Instructions and Guidance (RIGs), but ultimately we expect companies to ensure stress testing is reasonable and relevant to their individual context.

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- 6.35 We believe there are no challenges in issuing the certificate as mentioned by SPEN. While the new certificate will require company board approval and sign-off from a licensee director, it will not require an independent auditor opinion or sign-off.
- 6.36 We disagree with SPEN's view that this measure is unnecessary. The extended financial resources certificate enables stronger visibility over the long-term and provides earlier warning signals in case of financial deterioration. Moreover, this measure is based on our view that financial resilience measures are more effective when they are preventative rather than reactive.

7. Depreciation

Section summary

Regulatory depreciation policies establish how consumers repay licensees for the investment they make in the network, representing a key component of licensees revenues. We will continue to assess depreciation policy options at Draft Determinations.

SSMC questions

FQ20. Do stakeholders have views on our application of asset lives for ED3?

FQ21. Do stakeholders have views on depreciation methodologies that could be adopted for ED3?

FQ22. Do stakeholders have views on our use of capitalisation rates?

FQ23. Do stakeholders have views on technical asset lives and depreciation periods?

FQ24. Are there new methodological approaches that could be considered for ED3?

Our approach to ED3

SSMC summary

- 7.1 When networks incur expenditure, some of it is earned as revenue in the same year as the spend is incurred, and the remainder is added to the company's RAV. These assets are then paid back to networks over a period of years, which we term depreciation. Depreciation is a significant component of overall network allowed revenues. It is also commonly referred to as 'RAV depreciation' or 'allowed depreciation'.
- 7.2 Our key aims in setting regulatory depreciation policies are to:
- allocate costs fairly between current and future consumers (sometimes referred to as intergenerational fairness)
 - ensure that company revenues reflect the licensee's need to make sustainable economic investments
- 7.3 The key principle for intergenerational fairness is that the rate of depreciation should be set so that different generations and types of consumers pay network charges broadly in proportion to the value of network services they receive. Simultaneously, networks should be able to recover their costs over a reasonable period that allows them to operate efficiently on a notional basis.
- 7.4 Our main levers for regulatory depreciation policies are:
- setting the number of years over which the RAV is paid back to networks (also referred to as asset lives)
 - setting the method of how depreciation is calculated

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- setting the capitalisation rates which determine how much expenditure is earned as in-year revenue and how much is added to the RAV and paid back over a number of years
- 7.5 Within the SSMC we consulted broadly on asset lives, depreciation methodologies and capitalisation rates.
- 7.6 In the following sections, we cluster responses to our consultation into key themes and address each in turn.

Asset lives

Summary of consultation responses

- 7.7 In FQs 20 and 23 of our SSMC, we asked “Do stakeholders have views on our application of asset lives for ED3?” and “Do stakeholders have views on technical asset lives and depreciation periods?”.
- 7.8 DNOs did not directly challenge the assumption of 45-year technical lives in their responses.
- 7.9 SSEN-D stated that it aims to continue assessing the alignment between technical lives and depreciation periods as they gain greater certainty on the investment in ED3.
- 7.10 SPEN stated that they are comfortable with Ofgem's 45-year asset life assumption. However, SPEN stated that it would expect Ofgem to acknowledge the depreciation gap and address any intergenerational fairness issue which it creates. SPEN stated that asset life assumptions should also be considered with reference to financeability issues. SPEN stated that if asset life assumptions are too short then it creates a burdened asset class in the future that there is little assurance for. SPEN stated that if asset life assumptions are too long then there may be issues with short-term financeability, and how much the recovery period actually corresponds to the useful life of the asset. SPEN stated that it supports exploring depreciation options (as flagged in a report from NERA and discussed below) as a means to do this.

SSMD decision and rationale

- 7.11 We have decided to retain a 45-year economic asset life assumption in ED3.
- 7.12 The 45-year asset life assumption was adopted in the ED1 price control, drawing on analysis from expert economic consultant, CEPA.⁷¹

⁷¹ cepa-econ-lives.pdf

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7.13 No evidence was presented by stakeholders to suggest that the 45-year assumption is wrong or inappropriate. We assess issues relating to the impact of the historical decision to transition to a depreciation policy based on 45-year asset lives in further detail in the sections below.

Depreciation methodologies

Summary of consultation responses

7.14 In FQ21 we asked “Do stakeholders have views on depreciation methodologies that could be adopted for ED3?”

7.15 We received eight responses to the consultation question noted above. Five responses were received from DNOs, two were received from energy industry bodies, and one was received from Citizens Advice.

7.16 SSEN-D stated in their response that a depreciation policy should seek to achieve the following outcomes:

- promote a fair intergenerational balance of charges by avoiding the artificial deferral of costs into the long-term solely to reduce current customer bills
- support financeability and investability requirements of the sector, taking into account investor expectations around payback periods
- reflect the average actual economic lives of new assets as the transition to net zero progresses

7.17 DNO responses put forward a broadly consistent view, largely focused on three technical reports prepared by external consultants, NERA, on behalf of the ENA.⁷² The first report argued that the impact of the RIIO-ED1 decision to transition from a depreciation policy based on 20-year asset lives to one based on 45-year asset lives leads to a 'depreciation gap' or 'depreciation holiday'. The report estimated this difference in revenues between the current and previous depreciation policies as approximately £2.1bn in 20/21 prices over the period between the commencement of ED3 and the late 2060s on an average DNO basis.⁷³ They stated that this reduction in depreciation revenue creates a long-term, structural financeability issue for the DNOs at the notional capital structure. This is illustrated in NERA's analysis of FFO / Net Debt shown in Figure

⁷² 250115_NERA_ENA_Depreciation for ED3.pdf

251021_NERA_ENA_Depreciation solutions for ED3_FINAL.pdf

251021_NERA_ENA_Depreciation solutions for ED3_cap rate adj supplement_FINAL.pdf

These reports were published within the responses to our [SSMC](#). The depreciation solutions and cap rate supplement are discussed in the New methodical approaches and Capitalisation rates sections of this chapter.

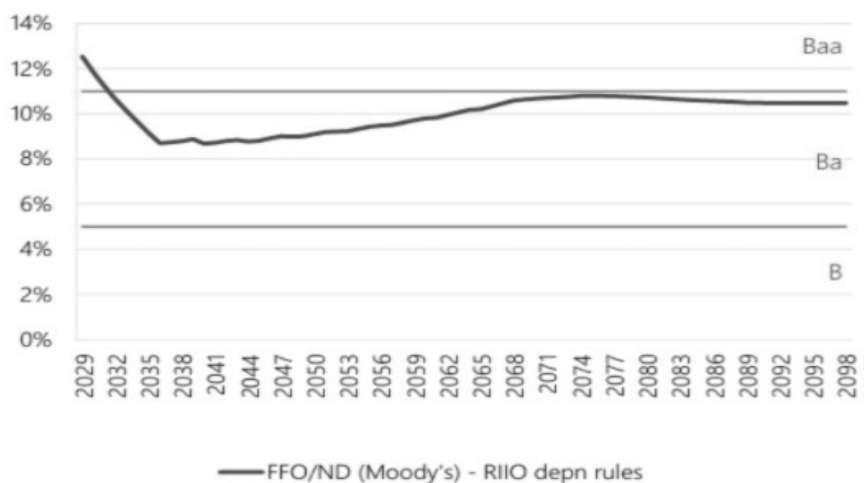
⁷³ 250115_NERA_ENA_Depreciation for ED3.pdf page 14

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1 below. The NERA report also stated that revenues should align with totex; with regulatory depreciation aligning with capex.

Figure 1: NERA analysis of FFO /NET DEBT

Moody's FFO/ND falls below 11% threshold required for Baa sub-rating in 2032 (ED3), and remains below 11% in the long-run



Source NERA 2025⁷⁴

- 7.18 The DNOs stated that the impact of the depreciation policy transition results in current consumers benefitting from lower depreciation costs at the expense of future consumers, who pay returns on higher RAV in perpetuity. The DNOs stated that this exposes future revenue to political risk. They also argued that this is intergenerationally unfair and stated that Ofgem should consider the depreciation policy proposals put forward by NERA. The January 2025 NERA report stated that due to the differential between the Green Book Social Time Preference Rate and the WACC, consumers prefer to pay higher depreciation charges and that this supports changing the depreciation methodology.⁷⁵
- 7.19 The ENA stated that it is important that Ofgem reach a policy conclusion in its SSMD, to give investors early visibility of cashflows and potential equity injection. SSMD stated that delaying action until ED4 would leave financeability challenges unresolved. NGER stated that the financeability impact does begin to arise in ED3 and that it would be inappropriate to address this as through a temporary financeability measure, when the issue is structural.

⁷⁴ 251021_NERA_ENA_Depreciation solutions for ED3_FINAL.pdf - page 19

⁷⁵ 250115_NERA_ENA_Depreciation for ED3.pdf - page 24

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- 7.20 Citizens Advice stated that that depreciation policy should not primarily be used as a liquidity tool, rather it establishes how consumers repay licensees for investments made in their networks. Citizens Advice state that Ofgem should confirm how the impact of high inflation during the gas crisis, which led to a higher-than-expected increase in the RAV, has improved financeability and whether this offsets any issues arising from the 20–45-year transition.
- 7.21 The Independent Networks Association made a general comment that changes in regulatory policy should be reflected in the charging methodology to avoid prejudicing independent operators.

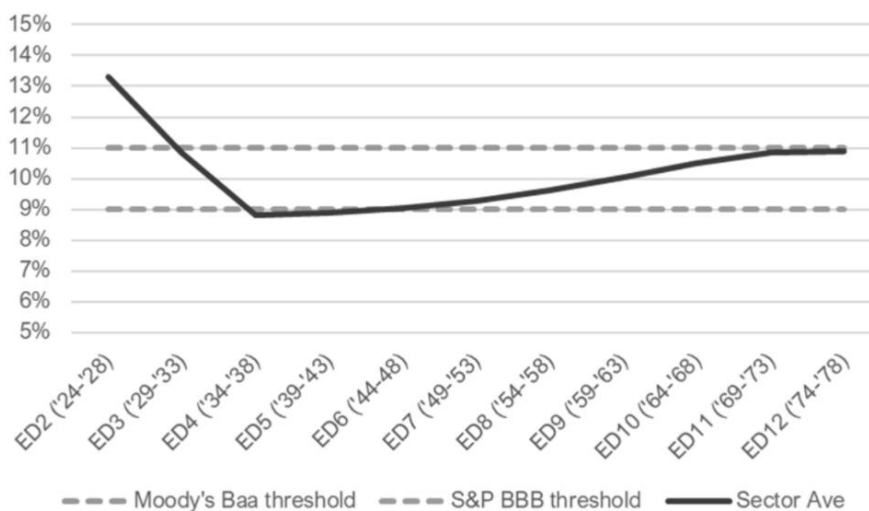
SSMD decision and rationale

- 7.22 We note stakeholder concerns that the transition from a policy based on 20-year asset lives to one based on 45-year asset lives leads to a potential impact on financeability for ED companies. It is not currently evident that the current depreciation approach is wrong on a first principles basis, nor that changes to the depreciation policy would be the most appropriate response to any financeability constraints in ED3 or future price control periods.
- 7.23 We will make a decision on any changes to depreciation policy at Draft Determinations, taking account of the evidence considered and assessing financeability in the round. We do not agree with the ENA's view that Ofgem must make a decision on this issue at the SSMD stage of the price control setting process. While we understand that the DNO's primary concern with the depreciation policy relates to the impact on financeability across future price control periods (ie, that the greatest impact is currently expected to occur during the two control periods following ED3), it would still be premature to make policy decisions ahead of taking account of company business plans and ED3 policy decisions in the round. For further information on our approach to financeability, including the assessment of long-term financeability, please see Chapter 5.
- 7.24 For the purposes of business planning, companies should assume that the current approach continues, with depreciation calculated a straight-line approach and a 45-year asset life assumption.
- 7.25 The transition from a depreciation policy that assumes 20-year asset lives to a depreciation policy that assumes 45-year asset lives in RIIO-1 leads to a period of lower depreciation revenue. This arises because as the depreciation of RAV additions with a 20-year life tail off, assets with a 45-year life have not built up to the level required to generate the same depreciation revenue. We acknowledge that this dynamic, alongside other factor such as periods of increased capital expenditure, can put strain on the financial metrics of licensees, particularly cash-based measures such as FFO/Net Debt. This is shown in CEPA's analysis (see Figure 2 below), which considers the long-term FFO to Net Debt ratio of an average DNO under Moody's methodology. However, we do not believe that it is

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automatically the case that the depreciation policy should be adjusted as a result.

Figure 2: CEPA analysis of FFO / Net Debt



Source CEPA 2026⁷⁶

- 7.26 We consider the characterisation of the transition effect as a structural problem to be misrepresentative. The transition effect is a consequence arising from the change in the depreciation policy that was signalled in advance of ED1 with an eight-year adjustment period, throughout that price control. Since publication of the SSMC, we have commissioned a report by CEPA which considers the appropriateness of the existing depreciation policy.⁷⁷ This report has been published alongside the SSMD.
- 7.27 CEPA's report concludes that the existing depreciation policy of straight-line depreciation over 45 years is rational in seeking to align regulatory depreciation with economic lives. It also concludes that the decision to transition to this policy can be viewed as intergenerationally fair and equitable for both current and future consumers, as it more broadly aligns the cost of network investment with higher future usage of the network. CEPA have found that reversing the current depreciation policy does not appear justified on intergenerational equity grounds.
- 7.28 We also agree with Citizens Advice who stated in their response that depreciation policy should not primarily be used as a liquidity tool, rather it establishes how consumers repay licensees for investments made in their networks. In addition, we note that any changes to notional gearing may impact

⁷⁶ Ofgem CEPA depreciation - FINAL Report.pdf - page 15

⁷⁷ Ofgem CEPA depreciation - FINAL Report.pdf - this report has been published alongside the SSMD.

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the extent of any financeability challenges related to the transition of depreciation policies.

7.29 When considering the overall long-term financeability of the ED3 price control and the range of financeability levers available, we will consider whether amending the current depreciation policy is necessary. The CEPA report considered the options available to Ofgem if it requires to support licensee financeability to be:

- retain the current depreciation policy and support DNO financeability via lower gearing
- lower capitalisation rates below natural rates during peak network investment, and adjust gearing as required
- accelerate the rate of depreciation either temporarily or permanently to achieve a targeted level of depreciation, and lower gearing where required
- facilitate a third-party financing solution that allows DNO investment to be funded as fast money, but paid for by consumers as slow money

7.30 With regard to the implication of differences between Green Book and WACC discount rates raised in the NERA report, we consider this to be an oversimplification and not compelling evidence that consumers would support paying higher depreciation charges in earlier control periods. Regulatory depreciation exists to help to spread the cost of investment in the network across the period that consumers benefit from the investment.

7.31 With regard to NERA's arguments that depreciation should align with capex, this correlation holds true in a steady-state system where investment is stable in perpetuity. It does not hold true where levels of investment vary, or where investment is front-loaded or deferred. This is why regulators use depreciation to spread the cost of investment in the network over the time period where consumers benefit from such investment. Otherwise, consumers would simply pay for investment on a pay-as-you-go basis.

7.32 Additionally, provided the cost of capital is appropriately set, changes in depreciation policy should be NPV neutral.⁷⁸ Changes to depreciation policy to accelerate revenue should theoretically not impact the underlying credit quality of the DNO using the notional capital structure.

With regard to the depreciation revenue 'gap' suggested by NERA, it is important to understand that a significant portion of any 'gap' would relate to accelerated RAV repayments made by consumers in pre-RIIO periods in order to support licensee financeability in early price control periods.⁷⁹ It should be noted that immediately post-privatisation, depreciation lives for new investments were 40 years, with 20-year lives

⁷⁸ Ofgem CEPA depreciation - FINAL Report.pdf - page 14

⁷⁹ DPCR 3 Final Proposals para 8.10, page 94

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being introduced in DPCR3 to assist licensee financeability. We note that whilst NERA propose amending the depreciation policy for ED3 they do not propose reverting to a 20-year life.

New methodological approaches for ED3

Summary of consultation responses

- 7.33 We asked in FQ24 “Are there new methodological approaches that could be considered for ED3?”
- 7.34 The NERA depreciation solutions report put forward four alternative depreciation methodologies for Ofgem to consider:
- reducing asset lives to 35 years (which NERA discount as failing to achieve the objective)
 - moving to a 45-year sum-of-digits depreciation policy
 - using a run-off rate similar to the water sector
 - using a depreciation 'adder' to increase the depreciation revenue
- 7.35 The NERA report stated that maintaining the status quo or adopting a 35-year asset life would not, in its view, be appropriate but does not express a preferred approach from the other options presented stating that these alternative methods are potential solutions to the depreciation gap.
- 7.36 NERA's report stated that a 45-year sum-of-digits depreciation profile could be adopted for ED3 and later additions. Sum-of-digits depreciation significantly front loads the depreciation charge in comparison to straight line depreciation.
- 7.37 Whilst all DNOs advocated considering the three preferred NERA options, NGED, UKPN and NPg, along with the ENA, stated a preference for moving to a 45-year sum-of-digits approach. The ENA, NGED, UKPN and NPg cited regulatory precedent in the Gas Distribution and Gas Transmission sectors, alongside the relative simplicity of the methodology as reasons to adopt this approach.

SSMD decision and rationale

- 7.38 At this stage, we do not consider the alternative depreciation approaches suggested by NERA to be superior to the current approach based on straight line depreciation over 45-years. As noted above, we will consider alternative approaches at Draft Determinations if we conclude that there is a financeability challenge to be addressed and that depreciation changes are an appropriate tool to meet this challenge.
- 7.39 We note that the NERA report on this issue stated that in its view none of sum-of-year-digits, run-off rate and depreciation adder is clearly superior, and that there would be pros and cons of Ofgem adopting one of these policies.

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- 7.40 For each of the NERA options there are challenges which would have to be addressed prior to implementation. We will continue to engage with stakeholders and will consider these alternative approaches in more detail at Draft Determinations, if necessary.

Capitalisation rates

Summary of consultation responses

- 7.41 We asked in FQ22 “Do stakeholders have views on our use of capitalisation rates?”
- 7.42 NPg and UKPN proposed using a single capitalisation rate for all licensees across the ED sector in ED3. UKPN stated that given that the focus for ED3 is to fund more of the expenditure on an ex-ante basis, it believes that Ofgem should consider returning to a single capitalisation rate for ED3 - which would have the benefit of simplifying the price control.
- 7.43 SPEN stated that Ofgem should consider whether the natural capitalisation approach adequately reflects the step change in investment within the sector. SPEN stated that it is important that capitalisation rates, while not an optimal choice as a financial lever, can be used where depreciation policy fails in allowing the distribution sector to maintain financeability.
- 7.44 SSEN-D stated that Ofgem should be open to setting the capitalisation rate below the natural capitalisation rate, where justifiable, to support cash requirements and ensure the DNOs remain financeable and investable (measured at the notional capital structure).
- 7.45 Although the ENA did not provide any specific response to the consultation question on capitalisation rates, an additional report prepared by NERA on behalf of the ENA was submitted.⁸⁰ This report focused on the use of capitalisation rates as a method for reducing the impact of the depreciation transition. The report argued that lowering capitalisation rates from the natural rate to improve financeability metrics, as was undertaken in RIIO-3 for the ET sector, pushes the depreciation gap into future periods when the capitalisation rate returns to the natural rate.
- 7.46 An additional NERA report assessed the use of capitalisation rates as a method of supporting licensee financeability, arguing that this does not represent a permanent solution to reduced revenue.

⁸⁰ 251021_NERA_ENA_Depreciation solutions for ED3_cap rate adj supplement_FINAL

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SSMD Decision and rationale

- 7.47 In line with the ED2 approach, we will use a guiding principle of setting bucket-1 and bucket-2 capitalisation rates to reflect licensees' anticipated natural capitalisation rates during ED3, whilst at the same time setting rates that are reasonably consistent within each sector. To inform our views, we will consider licensees' reported forecast rates alongside historical rates. In line with the ED2 approach, capitalisation bucket-1 will be for ex ante allowed totex and bucket-2 for re-openers. The two-bucket approach allows the overall capitalisation rate to change as additional re-opener funding is approved as the price control progresses.
- 7.48 The range of responses received on capitalisation rates is an indicator of its utility and its importance as a financeability lever. On balance we believe that the two bucket, ex-ante approach to capitalisation remains the optimal way to provide certainty around the split between fast and slow money, whilst also flexing for uncertainty at the start of the price control around the extent of capital intensive projects.
- 7.49 Capitalisation rates within ED1 and ED2 were set at the natural rate. Within RII0-3 for the Electricity Transmission sector, we decided to reduce the capitalisation rate for bucket-2 capex from the natural rate to 85%. The impact of reducing capitalisation rates in such a way is that the licensees receive a greater proportion of their totex as fast-money, meaning consumers repay a larger proportion of the investment immediately, and a smaller proportion of the investment is repaid over time (45-years straight line). This accelerates the cashflow of the licensee and can improve credit metrics in the short term whilst degrading these metrics in future years.
- 7.50 During our financeability assessment, we may consider modifications to capitalisation rates. If capitalisation rates are set lower than the natural rate this increases revenues to licensees and reduces RAV growth, whilst higher rates reduce revenues and increase RAV growth. Alongside other financeability policy measures, we may choose to set capitalisation rates at levels that differ from natural rates where it can help us to achieve the right balance of financeability, current consumer bills, and intergenerational fairness.

8. Corporation tax

Section summary

We have decided that the approach to Corporation tax in ED3 will align with the approach to Corporation tax in RIIO-3. This provides an allowance as a proxy for efficient tax costs. This is fundamentally the same approach as ED2.

SSMC questions

FQ25. Do stakeholders agree that the approach to corporation tax should be foundationally aligned with the principles set out in our RIIO-3 Draft Determinations?

Our approach to ED3

SSMC summary

- 8.1 Within the ED3 SSMC we set out our proposal to align the ED3 approach to Corporation tax with RIIO-3. A financial model is used to calculate a tax allowance based on licensees operating efficiently and on a standalone basis, in line with the notional capital structure.⁸¹ This is as a proxy for efficient tax costs. The approach is supplemented by additional protections. The additional protections are the tax review, tax clawback and tax trigger event mechanism.
- 8.2 Providing an allowance on this basis enables companies to recover amounts required to cover their tax costs while incentivising them to manage their tax affairs efficiently thereby keeping costs lower for consumers. The additional protections reduce the risk of consumers providing an allowance for tax costs which are not ultimately borne by the licensee.

Summary of consultation responses

- 8.3 In FQ25 of our SSMC we asked whether stakeholders agreed that the approach to corporation tax should be foundationally aligned with the principles set out in our RIIO-3 Draft Determinations.
- 8.4 Five responses were received in total. Responses were received from all of the ED licensees or their respective parent company.
- 8.5 All DNOs with the exception of SSEN-D were supportive of the proposal to align ED3 with the RIIO-3 approach.
- 8.6 SSEN-D stated that they consider that Ofgem should move to a pass-through approach for tax allowances.

⁸¹ Referred to in [RIIO-3-final determinations](#) and [ED2 final determinations](#) as a 'notional allowance with additional protections'

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- 8.7 SSE, SPEN and NPg requested further guidance from Ofgem on how PCFM variable values should be updated.
- 8.8 NGED and UKPN advocate excluding Fair Value movements from the definition of Tax Deductible Net Interest.

SSMD decision and rationale

- 8.9 We have decided to align the approach to corporation tax with the approach taken in RIIO-3. This is fundamentally the same as the approach taken in ED2. We do not consider that moving to a pass-through approach would benefit consumers. We have not identified any clear evidence that a change to a pass-through would provide better value for the consumer and furthermore, we consider that it would introduce inconsistency in the calculation of the allowance, which may be to the advantage of some networks and the disadvantage of others. The existing approach to taxation is neutral to corporate structure. A pass-through approach would not incentivise licensees to act efficiently.
- 8.10 In line with RIIO-3, we intend to allow licensees to amend tax pool allocation variable values retrospectively during the ED3 price control period, for the regulatory years within the price control. We consider this to be required due to the higher capital allowance rates available as a result of full-expensing and first year allowances. This is to allow licensees to reflect the tax profile of the actual spend undertaken, where this varies from the initial forecasts.
- 8.11 In RIIO-3 we decided not to include a tax forecasting penalty, and in ED3 we do not propose to include a tax forecasting penalty, as we consider that the risk of manipulation of tax variable values should be sufficiently mitigated by mirroring the changes made in RIIO-3. We may revisit this decision if it becomes apparent that licensees are using tax variable values to manipulate allowed revenue, or other financial outcomes.
- 8.12 Instead of implementing a tax forecasting penalty, we will make minor changes to the Price Control Financial Handbook (PCFH), and to the Tax Review licence condition, mirroring the position taken in RIIO-3. These changes make it explicit that the licensee must populate the tax variable values (eg tax pool allocations and rates) PCFM on an efficient, stand-alone company basis, and not use these values to optimise the tax position of any wider corporate structure that the licensee may be part of, regardless of the filing position taken in its tax return.
- 8.13 We will also update the definitions of Adjusted Net Debt and Tax Deductible Net Interest in line with RIIO-3, to reflect changes in accounting standards and tax

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legislation which have arisen since the introduction of the tax clawback, in line with our earlier call for input.⁸²

⁸² [Tax clawback review call for input.pdf](#), [Tax-Clawback-Review-CFI-response.pdf](#)

9. Return Adjustment Mechanisms (RAMs)

Section summary

The purpose of RAMs is to provide protection to consumers and investors in the event that network investor returns, as measured by return on regulated equity (RoRE), are significantly higher or lower than anticipated at the time of setting the price control.

SSMC questions

FQ26. Do stakeholders have views or evidence as to why RAMs should or should not continue?

FQ27. Do stakeholders have views or evidence as to whether the RAMs methodology should be amended, such as recalibrating the threshold or rates or including financial performance?

FQ28. Do stakeholders have views or evidence as to whether there should be separate RAMs for 'BAU' parts of the business and specific programmes?

Our approach to ED3

SSMC summary

- 9.1 In the SSMC, we considered retaining RAMs to ensure the fairness of ED3 by protecting consumers and investors against ex post overall returns from network price controls deviating greatly from ex ante expectations. We proposed rolling over the existing methodology from our RIIO-3 Draft Determinations unless evidence emerges that merits an alternative approach.
- 9.2 In the SSMC we outlined the ED2 RAMs methodology, where we decided to introduce sculpted sharing factor RAMs. We decided that the RAMs will take into account combined performance under the Totex Incentive Mechanism (TIM) and Output Delivery Incentives (ODIs), and that adjustments under the RAMs will be implemented as part of the close out of RIIO-ED2. We also decided that we would apply symmetry to the upside and downside application of the RAMs thresholds. We also set out the following RAMs threshold trigger levels:
- primary threshold level - 3% plus or minus the baseline allowed return on equity
 - primary adjustment rate - adjustment of 50% applied to returns above or below the primary threshold level
 - secondary threshold level - 4% plus or minus the baseline allowed return on equity
 - secondary adjustment rate - adjustment of 90% applied to returns above or below the secondary threshold level

Inclusion of RAMs in ED3

Summary of consultation responses

- 9.3 Question FQ26, asked “Do stakeholders have views or evidence as to why RAMs should or should not continue?”.
- 9.4 Three DNOs (NGED, SPEN and UKPN) agreed with Ofgem’s rationale for retaining RAMs as a protection mechanism that should operate only as a backstop in extreme scenarios where returns diverge materially from expectations, rather than an active tool in normal price control operation.
- 9.5 NPg were not supportive of the use of RAMs, stating that if the price control is designed and calibrated correctly, then the overall package should make sense without the need for RAMs. They stated that applying RAMs on top of calibrated mechanisms could switch off carefully designed incentive mechanisms and risk curtailing the incentive for leading firms to keep driving performance forward in customers’ interests. NPg stated that performance bands would need to be suitably wide, otherwise best practice discovery could be hindered at a potentially significant cost to all consumers. They also stated that RAM thresholds should only be considered after setting the cost of equity and the incentives package, as sequencing matters to ensure that RAMs do not distort the overall framework.
- 9.6 SSEN-D stated that it did not believe the upside adjustment should exist, and that having RAMs, particularly the upside adjustments, adds little value because the likelihood of triggering an upside RAM is low given the risk asymmetry in the incentive profile. They argued that the incentive structure already places greater downward pressure than upward potential and expect that this asymmetry will intensify in ED3.
- 9.7 Citizens Advice supported maintaining a form of protection against sector performance diverging materially from expectations and asked Ofgem to consider adopting an Outturn Adjustments Mechanism (OAM) similar to that used by Ofwat in the water sector. Citizens Advice argued that an OAM may offer advantages over RAMs by helping to ensure returns remain aligned with expectations and thereby maintaining public confidence. Citizens Advice stated that RAMs limit the exposure of both consumers and companies to a poorly calibrated price control, which should ultimately benefit consumers. Citizens Advice also noted that, because RAMs alter the companies’ risk profile, they can be expected to reduce equity beta to some extent and emphasised that this should be reflected explicitly when determining beta or taken as further justification for adopting values towards the lower end of the range when setting the cost of equity.

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SSMD decision and rationale

- 9.8 We have decided to retain the use of RAMs within the ED3 financial framework. We consider RAMs play an important role in protecting companies and consumers alike from unexpected or extreme gains or losses.
- 9.9 In response to the concerns raised by NPg, we note that the primary purpose of RAMs is to help protect both customers and companies from price control packages that are subsequently found to be misaligned, either through design or due to unexpected future developments. This approach ensures that returns do not exceed or fall through reasonable expectations for efficient companies operating as regulated monopolies. Well calibrated RAMs with appropriate thresholds will not limit incentives to drive efficiency or establish new best practices.
- 9.10 We also disagree with SSEN-D's argument that RAMs offer little practical value. RAMs protect customers and investors against unusually high or unusually low levels of RoRE. Their value is not negatively impacted if the RAM thresholds are not triggered.
- 9.11 While RAMs are an example of the regulatory protections that network companies face, we do not agree with Citizens Advice that we should adjust our beta estimates as a result. Our beta estimate is based on the observable betas of comparator companies who operate in regimes with significant protections, and so this effect should be broadly 'priced in'. While not all comparators operate under exactly the same regime as in GB energy networks, we consider them suitable close for our beta analysis purposes. As a result, further adjustment would risk double-counting the impact of regulatory protections for networks.
- 9.12 We note Citizens Advice's argument that Ofgem should adopt the OAM approach to managing outturn returns. We will monitor this new approach by Ofwat and the associated outcomes for companies in the water sector. For now, we continue to consider it more appropriate to focus on the calibration of incentives within the RIIO framework to ensure that they drive improved outcomes for consumers. Further information on incentives within the package can be found in the business plan, delivery and efficiency incentives section in the ED3 SSMC overview document (Chapter 7).
- 9.13 For note, any adjustments under the ED3 RAMs will be made following the closeout of the ED3 price controls and reflected in company revenues in the following price control. We believe this to be the simplest approach, which correctly measures the performance over ED3.

RAMs methodology

Summary of consultation responses

- 9.14 Question FQ27 asked “Do stakeholders have views or evidence as to whether the RAMs methodology should be amended, such as recalibrating the threshold or rates or including financial performance?”
- 9.15 NGED and UKPN stated that they do not believe that the RAMs methodology needs to be amended, stating that the current approach remains appropriate and that further changes are unnecessary. They argued that RAMs already function as a backstop mechanism and cautioned that altering the methodology could increase complexity without clear additional benefit.
- 9.16 NGED, UKPN, SPEN and NPg stated that financing performance should not be included within RAMs. They argued that transparency around debt costs and the use of external benchmark indices mean there is limited information asymmetry in relation to financing, reducing the justification for including it. These DNOs added that incorporating financing performance could amount to introducing a cost of debt sharing mechanism and that a five-year price control period does not provide a robust timeframe for measuring financing outcomes. Others also noted that including financing performance could expose customers to the financing strategies of the individual businesses.
- 9.17 SPEN proposed that the lower bound should be the allowed cost of debt, as allowing returns to fall below this level only serves to increase financial risk and worsen customer outcomes.
- 9.18 Citizens Advice agree that consumers should not have to bear any risk associated with company financing decisions, however, argued that Ofgem should specifically include regulatory-induced financial performance, or systematic out-performance rather than individual deviations. They noted Ofgem’s previous rationale for excluding financing performance, namely that debt allowances are based on external indices and that financing risks should sit with companies, but stated that past windfalls did not arise from company risk-taking, but from features of the debt-allowance methodology.
- 9.19 Citizens Advice acknowledged that whilst the introduction of RAV-weighting improves alignment with deployed capital, it does not completely eliminate the potential for the notional allowance to over or under-estimate actual market debt costs. They highlighted areas where the notional cost of debt can misalign with actual market costs, including index choice, timing and lag structures, historic and inflation-linked debt treatment, and the CPI/CPIH mismatch. Citizens Advice encouraged Ofgem to consider an approach similar to Ofwat’s OAM, introduced in PR24. The OAM adjusts equity returns for systematic over/underperformance of (ODI) if the median company’s realised RoRE falls

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outside a ± 50 bps deadband around the baseline allowed return on equity. Ofwat then applies an adjustment to all companies equal to the difference between the median.

SSMD decision and rationale

- 9.20 We have decided that the current RAMs methodology remains appropriate for ED3. We will assess evidence on the ED3 package in the round before confirming RAM threshold levels in Draft Determinations.
- 9.21 We note that no respondents argued that individual company financing outperformance should be included within RAMs. We maintain the view that companies should bear the risks and rewards associated with financing decisions. In relation to Citizens Advice's comments on the potential for miscalibrations of debt estimates - we continue to believe that these are best addressed at source via improved methodologies rather than captured through RAMs. For example, for ED3 we have updated our estimate of CPIH inflation (see Paragraph 2.39) and will introduce a nominal allowance for fixed rate debt (see Paragraph 2.34), both of which should improve the accuracy of our cost of debt allowance and reduce the risk of miscalibration.
- 9.22 Ofgem does not consider an OAM type mechanism to be appropriate within the ED3 framework at this stage. As noted above, we will monitor this approach and the associated outcomes for companies in the water sector. For now, we continue to consider it more appropriate to focus on the calibration of incentives within the RIIO framework to ensure that they drive improved outcomes for consumers.
- 9.23 We note Citizens Advice's argument that the financing outperformance observed in RIIO-2 largely reflected systematic features of the debt allowance methodology during a period of higher-than-expected inflation, rather than company-specific financial choices. Ofgem is considering how the benefits of higher-than-expected inflation during ED2 may be used to support investment and financeability in ED3 and beyond. This may include changes to the gearing levels assumed in the notional capital structure. We will make further decisions on this at Draft Determinations.
- 9.24 We do not agree with SPEN's proposal to set the lower bound at the level of the allowed cost of debt. This would reduce the extent to which companies bear the risks associated with financing decisions and we consider that such the associated out or underperformance should not be included in RAMs.

Separate RAMs for specific programmes

Summary of consultation responses

- 9.25 Question FQ28, asked “Do stakeholders have views or evidence as to whether there should be separate RAMs for 'BAU' parts of the business and specific programmes?”
- 9.26 No stakeholders called for the introduction of separate RAMs for different business areas. NGED and NPg argued that separate RAMs would make the price control more complex, with NPg adding that multiple RAMs could create perverse outcomes, such as out-and under-performance in different areas not cancelling out, while providing no overall benefit.

SSMD decision and rationale

- 9.27 We have decided that separate RAMs for specific programmes are not required for ED3. We have neither identified nor received any compelling evidence to support separate RAMs.

10. Other finance issues

Section summary

This section covers other key finance topics, such as our DRS and Disposal of Assets methodology. We have decided to roll forward our ED2 methodology on DRS and Disposal of Assets, while incorporating targeted PCFM improvements.

SSMC questions

DRS

FQ29. Do stakeholders agree with a continuation of our existing DRS approach and methodology?

Disposal of assets

FQ30. Do stakeholders agree with a continuation of our existing Disposal of Assets approach and methodology?

Other financial modelling issues

FQ31. Do you agree with our proposal to seek improvements to the PCFM, and do you have suggestions for further improvements?

FQ32. Do you agree with our proposal to continue with the self-publication approach to annual updates?

FQ33. Do you agree with our proposal to continue with nominal WACC as the single interest rate for prior year adjustments?

Pension scheme established deficit funding

SSMC summary

10.1 Our current policy sets a commitment to consumer funding of deficits in defined benefit pension schemes, which were generally in existence before the energy network sector was privatised. To reflect this commitment, our price controls provide a form of pass-through funding by consumers of pension deficits in respect of those attributable to service before certain specified cut-off dates.⁸³ We last updated our policy on this in April 2017.

10.2 The allowed revenue that network companies can recover under this policy is reviewed on a triennial basis as a 'reasonableness review'. We performed this review and set a new established deficit pension allowance effective from 1 April 2024.⁸⁴

⁸³ This is known as the Pension Scheme Established Deficit (PSED), for electricity distribution the cut-off date was after 31st March 2010

⁸⁴ [Ofgem Revised pension allowance values and completion of 2023 reasonableness review](#)

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10.3 At this review we noted that most schemes are now over 90% funded, with some schemes in surplus. We flagged that we consider that this may be an appropriate time to carry out a review of the policy for funding of established deficits and who should bear the relevant risk in the future. While we have not carried out a review to date, we do not discount doing so in the future.

Summary of consultation responses

10.4 No stakeholder presented evidence on this issue.

SSMD decision and rationale

10.5 For the business plans, we expect network companies to assume pension allowances for the relevant portion of pension deficits during the ED3 period that reflect their submission for the 2026 pension reasonableness review.⁸⁵

Directly remunerated services (DRS)

SSMC summary

10.6 Directly remunerated services are specific activities of the network companies that are settled outside of the normal regulatory price control. Companies are allowed to charge their customers directly for certain services performed. For instance, a network company may enter into a commercial agreement with a third party such as a telecoms provider to lease out unused space on its grid infrastructure for the placement of satellite dishes or pylons. The telecoms provider would then pay a rental fee directly to the network company, according to the terms of that agreement. These services are “directly remunerated” by the customer rather than through Ordinary Transportation Charges.

10.7 The policy intent is to avoid consumers paying for a service for which the network companies have already been remunerated. Costs associated with these services are paid for directly by the specific party (or parties) requiring the service. As such, these costs should not be factored into the network companies’ cost allowances, to avoid double-counting.

10.8 In our RIIO-3 Final Determination and ED3 SSMC we highlighted that DRS has not been reviewed for some time and we may consider carrying out a broader review of DRS during the RIIO-3 price control period.

10.9 We proposed a continuation of the existing DRS policy and methodology for ED3.

⁸⁵ This will be updated following the outcome of the 2026 pensions reasonableness review that will be published in November 2026.

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Summary of consultation responses

- 10.10 In FQ29, we asked whether stakeholders agree with a continuation of our existing DRS approach and methodology.
- 10.11 NGED, SPEN, SSEN-D and NPg generally supported continuing with the existing DRS approach and methodology. SPEN were comfortable with maintaining the current framework, and SSEN-D also raised no objections, noting they would comment further once Ofgem undertakes its wider DRS review. The other DNOs suggested some specific changes.
- 10.12 NGED suggested allowing networks to retain a proportion of profit for non-statutory DRS activities to strengthen incentives to participate and generate benefits for consumers. NGED also raised concerns that deducting DRS10 and DRS16 (Value Added Services and Distribution Network Voltage Control Services) proceeds from both allowed and actual totex reduces incentives and exposes DNOs to forecasting risk. NGED further requested clarification in the ED3 SSMC regarding suggestions that Ofgem may undertake its own forecasting of DRS activities, noting that they do not believe this would be practical given the operational nature of these activities and their reliance on company-specific asset data.
- 10.13 UKPN proposed moving small service connections from DRS into the price-control totex framework, noting that these costs are comparable to fuse upgrades and unlooping, which are already within totex. NPg recommended introducing benchmarking of DRS10 and DRS16 forecasts to improve transparency and comparability across DNOs, arguing that the absence of benchmarking under ED2 led to unnecessary variation and weakened incentives.
- 10.14 UKPN and NPg cautioned against Ofgem undertaking its own DRS forecasting, stating that such activities rely on company-specific data. NPg asked Ofgem to clarify its position on whether Ofgem would undertake its own forecasting of DRS.

SSMD decision and rationale

- 10.15 We have decided that the current treatment of DRS activities remains appropriate for ED3. We will consider specific amendments should we decide to undertake any review of this area.
- 10.16 We confirm that it is not our intention to undertake our own forecasting of DRS activity. Our view is DNOs remain best placed to assess local market conditions and asset utilisation. Ofgem will continue to assess the reasonableness of submitted forecasts, informed by sectoral benchmarking or comparative analysis, to ensure forecasts reflect efficient capability.

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- 10.17 Our position on non-statutory DRS is that the benefit derived from assets funded by consumers should flow primarily back to those consumers. Allowing full or partial retention of these revenues risks double remuneration and would weaken consumer protection. Therefore, we are not minded to introduce enhanced profit retention for non-statutory DRS.
- 10.18 NGED also argued that deducting DRS10 and DRS16 proceeds from both allowed and actual totex reduces incentives and introduces forecasting risk. We think deducting forecast proceeds from allowed totex and netting actual proceeds from actual totex ensures consumers are protected from paying twice and that the Annual Iteration Process keeps revenues aligned with real-world performance.
- 10.19 We note the arguments that some smaller service connection activities share characteristics with work already included within the core totex framework. Any review of DRS could therefore consider whether certain services should be reclassified, taking account of consistency and comparability across funding mechanisms.
- 10.20 We see merit in improving transparency and consistency in DRS forecasting, however, we note that DRS activity is influenced by company-specific assets and local market conditions. Any benchmarking considered in a wider review would therefore complement, not replace, company-specific evidence.

Disposal of assets

SSMC summary

- 10.21 Where network assets are no longer required, network operators may dispose of or relinquish operational control, subject to consent. They may also recover from third parties any costs in respect of damage to their network. Some of these transactions can include the disposal of land. Consumers should benefit from receiving a share of the proceeds from the sale of assets no longer required.
- 10.22 We have considered a general continuation of the existing disposal of assets policy and methodology for ED3.

Summary of consultation responses

- 10.23 In FQ30, we asked whether stakeholders agree with a continuation of our existing Disposal of Assets approach and methodology.
- 10.24 All DNOs broadly supported continuing with the existing Disposal of Assets approach and methodology, with some highlighting that it ensures consumers benefit from residual value recovery while maintaining incentives for DNOs to optimise asset use.

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- 10.25 NGED proposed waiving forecasting errors associated with asset disposal from the forecast-penalty calculation, arguing that the current treatment exposes DNOs to unnecessary forecasting risk.
- 10.26 SPEN suggested reviewing the procedure to ensure partial asset reuse or repurposing is clearly defined and consistently applied across DNOs and highlighted the need to consider how digital and non-physical assets should be treated as these become more significant.
- 10.27 NPg asked Ofgem to clarify whether the current treatment of forecast and actual disposal proceeds would continue into ED3, noting that the upfront deduction of forecast proceeds means only variances between forecast and outturn are shared through the TIM. NPg considered that clearer articulation is needed to avoid the impression that all disposal proceeds are shared with customers.

SSMD decision and rationale

- 10.28 We note the supportive feedback and we confirm our proposal that networks will be incentivised to dispose of redundant assets.
- 10.29 To clarify, asset disposals proceeds will be treated as negative Totex and networks will retain a share of the proceeds via the Totex Incentive Mechanism. This is the approach adopted for other sectors in RIIO-3. Though we propose a change in the treatment in PCFM between ED2 and ED3, networks will continue to be incentivised to dispose of redundant assets and consumers will continue to benefit from receiving the remaining share of the proceeds from the sale of assets no longer required.
- 10.30 We note NGED's proposal to exclude forecasting errors associated with asset disposal to be excluded from penalties and we acknowledge the challenge of forecasting disposal values several years ahead. However, retaining the forecasting accuracy incentive is important to prevent information asymmetry and the risk of inflated or overly conservative forecasts. We will therefore retain the penalty mechanism.
- 10.31 We note the request for clear and consistently applied rules regarding partial reuse or repurposing of assets and comments on digital assets. We will continue to consider our rules and whether there are opportunities for providing further clarity or consistency, while recognising the varied nature of current and future assets.

Transparency through RIIO-3 reporting

SSMC summary

- 10.32 We recognise that it is important that investors in the networks sector can achieve a reasonable return on their invested capital, and dividends are

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considered an important component of the equity return. As companies adapt to a variety of challenges over the coming years, most obviously the changes required to help meet net zero targets, maintaining best practice in corporate governance measures is likely to become increasingly important.

10.33 During the development of both RIIO-ED2 and RIIO-3 we identified several areas where we considered there could be improved transparency through reporting. These included:

- executive pay/remuneration
- dividend policy
- corporate governance and ownership

10.34 Our focus on these issues reflected a recommendation to Ofgem from the January 2020 National Audit Office report⁸⁶ on electricity networks. This recommended that Ofgem should ensure network companies make it clear how much tax they pay; how executives are rewarded and how this links to quality of service for customers, and how dividend policies ensure companies remain sustainable. Around a dozen authoritative commentators (such as Citizens Advice) had also drawn attention to high levels of returns and made suggestions for reform.

10.35 In our RIIO-2 Final Determinations⁸⁷ we introduced new reporting requirements for the disclosure of executive remuneration to a similar level to that required for UK-listed public limited companies and publication of sustainable dividend policies. These new reporting requirements which were brought in for ED via ED2, were practically introduced via a new section on Corporate Governance, contained within the RIGs and RFPR template.

10.36 It is important that companies demonstrate with transparency how the decisions they make in declaring and paying distributions, and in awarding executive performance-related pay, take due account of matters that include long-term financial sustainability, delivering for customers and other stakeholder obligations. Fundamental to this is the principle that shareholder distributions and executive performance-related pay should fairly reflect performance, something which is key to helping ensure the legitimacy of the sector.

10.37 In this light, Ofgem has a clear expectation that the requirements of the RFPR corporate governance section are met in full and that remuneration and decision making in the interests of consumers and other stakeholders are an integral component of licensees annual reporting.

⁸⁶ See paragraph 22d here: [NAO report Electricity Networks](#)

⁸⁷ [RIIO-2 Final Determinations - Finance Annex](#)

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10.38 Our Ringfence Review highlights the importance of financial resilience reporting and ensure we have a comprehensive suite of early warning indicators for financial resilience issues. We believe that at a minimum we need to have greater scrutiny over the decision making around distributions and licensee groups' financial structures. We are also open to views and suggestions on how we should think about and manage the risks of high levels of leverage at MidCo and HoldCo companies that could negatively impact decision making and the resilience of the licensee.

Summary of consultation responses

10.39 No stakeholder presented evidence on this issue.

SSMD decision and rationale

10.40 We have decided to retain the existing requirements, and we continue to have a clear expectation that the requirements of the RFPR corporate governance sections are met in full.

Annual iteration process and other financial modelling issues

Improvements to the PCFM

SSMC summary

10.41 We will continue to develop and improve the PCFM for ED3. It will be developed first as the 'business plan financial model' for the purposes of business plan submissions and Draft and Final Determinations and will then be converted into an enduring PCFM model for use after the commencement of ED3.

Summary of consultation responses

10.42 All the DNOs responded to this question, with no responses from other stakeholders.

10.43 Respondents were generally supportive of the changes made to the ED2 PCFM. Where suggestions for improvements were made, these focussed on either updating certain calculations, or structural and functional changes to improve usability.

10.44 Regarding updating calculations, SSEN-D and UKPN suggested updating the tax allowance calculations to take account of new government policies on capital allowances.

10.45 Regarding structural and functional changes, suggestions were to: restructure input tabs to align more closely with other Ofgem reporting templates such as the Cost and Volume Regulatory Reporting Packs; enable the model to calculate

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results for multiple licensees to the same time; expand the PCFM to show financial statements and ratios; add a summary of key outputs with the possibility of saving results from previous model versions; and splitting the k correction term into its component true-up elements.⁸⁸

SSMD decision and rationale

- 10.46 We intend to implement the update the PCFM's capital allowance calculations in line with SSEN-D and UKPN's suggestion, as this will better align the model to current tax legislation. For other structure and functional changes, we will consider these further as we develop the PCFM and its related model, the Business Plan Financial Model (BPFM), which is used during the Draft and Final Determinations process. We will incorporate other changes ahead of Draft Determinations where we feel that they provide a benefit to model users without adding undue complexity. We will rely on ED3 BPFM Working Group meetings as the forum for testing and implementing these changes.
- 10.47 We have started regular working group sessions to discuss the BPFM and PCFM development. These are primarily attended by network companies, but we invite other stakeholders to attend.

Licensee self-publication of allowed revenue

SSMC summary

- 10.48 We proposed to continue the self-publication approach to annual updates taken in RIIO-ED2.
- 10.49 This approach requires licensees to update and publish the PCFM themselves in ED3, in accordance with the licence, PCFM handbook, and related guidance. Licensees are responsible for calculating their own allowed revenue values and publishing the PCFM on their websites with charging statements.
- 10.50 Ofgem will continue to publish a consolidated version for the sector annually and incorporate any modifications to the PCFM and all updates to variable values.
- 10.51 We believe that the self-publication approach taken in RIIO-ED2 has led to efficiencies for networks and Ofgem in the administration of the price control and has enabled licensees to more easily reflect changes to their variable values where those are subject to volatile fluctuations.

⁸⁸ The k correction term is the mechanism for trueing-up mismatches between the revenue collected via network charges and the revenue allowances.

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Summary of consultation responses

10.52 Five stakeholders responded to this question, representing all the five DNO groups. All respondents supported continuing the self-publication approach. NPg requested that we review the timeline associated with this obligation and NGED noted the requirement for a framework through which charge setting and revenue determination can be established for the first two years of ED3.

SSMD decision and rationale

10.53 We have decided to continue with the self-publication approach from ED2. The current system is working well, and we have received no evidence to support a change. We intend to review Annual Iteration Process timelines as part of ED3 RIGs development and in collaboration with network companies, we are actively discussing options for charge setting and revenue determination for the first two years of ED3 with a decision expected in 2026.

Interest on prior year adjustments

SSMC summary

10.54 We proposed to maintain the approach taken in RIIO-ED2, in which we use a single true-up mechanism with a uniform Time Value of Money (TVOM) for all types of prior year adjustments and true-ups, using nominal WACC as the rate.

Summary of consultation responses

- 10.55 All the DNOs responded to this question, with no responses from other stakeholders.
- 10.56 Four of the responses were supportive of our proposal. SPEN was the only network to state a preference for two separate TVOM rates for different types of true-ups, as had been used in RIIO-ED1. SPEN added that should Ofgem proceed with a single rate, the nominal WACC remains the best solution.

SSMD decision and rationale

10.57 At this stage we propose to maintain using a uniform TVOM for all types of prior year adjustments and true-ups, using nominal WACC as the rate. We believe the simplicity of this approach is advantageous, and that under the self-publication approach to allowed revenue a single rate is more robust to possible gaming of forecasts and true-ups than is the case with two separate rates. However, we consider it appropriate, ahead of Draft or Final Determinations, to keep under review whether we should revisit this approach should new evidence or relevant policy developments arise. Alternative approaches could include using more than one TVOM, or using a single alternative to nominal WACC. We do not

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consider that keeping this open will have any material impact for companies' business plan submissions and is only relevant for when the ED3 price control is in place.

Send us your feedback

We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this decision. We would also like to get your answers to these questions:

- Do you have any comments about the quality of this document?
- Do you have any comments about its tone and content?
- Was it easy to read and understand? Or could it have been better written?
- Are its conclusions balanced?
- Did it make reasoned recommendations?
- Do you have any further comments?

Please send your feedback to stakeholders@ofgem.gov.uk.