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Presentation

Operator

Welcome to the Ofgem Investor Call. Throughout the call, all participants will be in a listen-only mode and afterwards, there will be a question and answer session. Just to remind you, this conference call is being recorded.

Today, I'm pleased to present Martin Young, Head of Investor Relations. Please begin your meeting.

Martin Young

Thank you, Sarah and thank you to everybody for joining us today. Today marks a major step in the RIIO-2 process with the publication of our framework consultation on the RIIO-2 framework. And it's my great pleasure to introduce Jonathan Brearley, our Senior Partner in charge of Networks who will run through a brief presentation before we move to Q&A. The presentation is available on our website, www.ofgem.gov.uk, and you can navigate to the Investor Relations page by clicking on About Us, followed by How We Engage, and then finally Investor Relations.

On that, I'll hand over to Jonathan.

Jonathan Brearley

Thank you, Martin and thank you to those who dialled in. Depending on where are you on the globe; good morning or good afternoon. Today represents the second major stage in the RIIO-2 journey. Last summer, we published an open letter and subsequently enjoyed an active exchange of views, some of it quite robust. I can assure you that we do listen and in setting out our initial thoughts for the RIIO-2 framework, we recognise the benefits to all, from the regulation framework for UK Energy networks being stable and predictable.

However, it is equally important to recognise that we face a rapidly changing energy landscape and that regulation needs to be increasingly flexible to adapt. This will be a tougher price control for network companies, but we will allow companies to an additional returns where this make sense – results from genuine innovation and efficiency and incentives will reward our companies for meeting their targets. Based on present conditions, the cost of equity in RIIO-2 will be lower than that in RIIO-1, and reflective of the low level of risk that investors face. We are convinced that the environment for investors remain attractive.

We have a short presentation that outlines the key points of today's consultation document. And we'll run through these before moving to questions. So, I will take you through this and I'll navigate you through them all.

So, going to slide one. Today's consultation makes a wide range of proposals, some of which are summarised on this slide. In particular, I'd like to highlight a few of these things.

So number one, a reversion from a five year price control that with the possibility of companies making the case to set some allowances for a longer period of time. Number two, no delay for the start of RIIO-2 for electricity transmission. Number three, a separate price control for the electricity system operator. Number four, an extension of competition across all sectors. Number five, improving our methodology for indexing the cost of debt. Number six, retaining CAPM and retaining the cost of equity, but with the possibility of indexing into the future. Based on currently available evidence, this suggest a range of around 3-5% RPI real. Number seven, the needs to address the financeability challenge as a consequence of these lower baseline returns. Number eight, a proposal to move away from RPI. And then number nine, mechanisms to ensure that returns are fair to consumers.

Moving to slide two in the presentation pack, I would like to highlight that in RIIO-2, we are seeking to deliver five overarching outcomes. First of all, we'd like to give consumers a stronger voice. Secondly, we'd like to respond to changes in how networks are being used. Thirdly, we would like to drive innovation and efficiency. Fourthly, we want to simplify the price controls. And then finally, we would like to ensure fair returns.

Now moving to slide 3, before we get into detail, I would like to have a few words on RIIO-1. RIIO-1 has generally worked well. By and large network companies are delivering well for customers, and providing the services they need. Over 25% of generation

capacity is distribution connected, reliability is improving, and customer satisfaction is at record levels. In some cases, we have seen systemic outperformance and not all of this has been delivered through innovation and genuine efficiency.

Benefit-sharing mechanisms from our performance has resulted in customers receiving over £5 billion via lower network charges and some network companies have agreed to make additional voluntary contributions. We welcome such moves and we will continue to do so. RIIO-2 needs to build on RIIO-1 but it does need to learn the lessons from RIIO-1 and address the balance of risk between network companies and consumers.

Moving on to slide 4, as mentioned, we would like to get consumers a stronger voice. Stakeholder engagement should be embedded in the DNA of the network operators, and we recognise the significant improvements made by companies in RIIO-1 versus previous price controls. However, we do believe the process can be improved and in RIIO-2, we plan to enhance engagement by introducing different models for distribution and transmission.

In distribution, we will require each company to establish an independently chaired Customer Engagement Group whose role would be to challenge companies on how consumer needs and energy system changes are reflected in business plans, and consider proposals for improving output performance, cost efficiency, and strategic issues.

In transmission, we will require companies to establish an independently chaired User Group to provide input and challenge to the business plan with a focus on outputs, incentives, expenditure, forecast, uncertainly mechanisms, and capital project needs.

In addition to these groups, we will also establish a RIIO-2 Challenge Group, covering all sectors, and this level of enhanced engagement will help us assess and scrutinise business plans. The way the energy networks are being used is changing, and the traditional boundaries between distribution and transmission in both electricity and gas are blurring. Our approach needs to be sufficiently adaptable to respond to changing needs but also to provide a framework that incentivises the delivery of required investment.

Against this backdrop, we are making some key proposals for RIIO-2. As mentioned, the reversion to a five-year price control, although we are challenging companies to demonstrate where they think a longer period of time can justify benefits for consumers; no delay to the start of the electricity transmission price control; separate price control for the system operator; and the need for new investment to be economic with a higher burden of proof regarding need, given the amount of change that there may well be within the sector.

Moving to the next slide, innovation and efficiency have the potential to drive down costs – so this is slide 5 for clarity – and to enable the transformation of the energy system, but to agree innovation should be business as usual for network companies. In essence, network companies need to mainstream a lot of the activity that we have been taking forward in RIIO-1. Innovation stimulus funding should be provided for projects that demonstrate longer term consumer value and are at higher risk of under-delivery. We're considering a reform of the innovation stimulus with increased alignment of funding to support critical issues, greater coordination with the public-sector funding, and increase third party access. In essence, we want to make sure that innovation is particularly targeted at some of the strategic challenges each of the networks face.

We have observed the benefit of competition in network provision through OFTOs, IDN's, interconnectors, etc. and have recently set out criteria for competition in onshore transmission in RIIO-1. In RIIO-2 we propose to continue applying this new separable and value criteria to transmission, and we have a preferred position to extend these across all network sectors. We also propose to develop models for early and late stage competition. We will also seek to simplify the price control, we will continue to use outputs and incentives to drive improvements, and where we are confident we can accurately forecast cost, we will reward outperformance. Where it is most difficult to estimate costs, we will use uncertainty mechanisms, such as indexation and volume drivers to protect consumers from paying costs that are not required.

Information asymmetry is always a challenge for regulators and in RIIO-1, we incentivised companies to deliver better business plans via both the IQI and fast tracking. We are not convinced that these have delivered all the benefits we expected across the board, and therefore are considering options for reform. Number 1, we are considering retaining but amending the IQI. Number 2, we are considering retaining fast tracking for distribution only. And number 3, we are looking to build, potentially, a single business plan incentive for distribution.

Turning to slide 6, I'd now like to talk about the cost of debt. As you know, our current approach uses indexation on a trailing basis and CEPA estimate that the latest yield is over 300 basis points lower than that expected at final proposals back in December 2012. In that respect, indexation has worked well, but there is evidence that network companies have outperformed the debt index, whether it be by outperforming on the day of issuance, through the tenor or via timing of issuance.

Slide 7 shows some of these in graphical form. We plan to analyse debt further, but we believe that there is scope for improvement in our method of indexation, and we are considering different approaches in RIIO-2. Three of these are recalibrating the RIIO-1 indexation policy, or a fixed allowance for existing debt, plus indexation for new debt only, or a pass-through allowance for debt.

Moving on to slide 8, the other principal proponent of the allowed return is a cost of equity. And in RIIO-2, we propose to continue to use the CAPM approach. We note the recommendations of the report by UKRN, and also those of CEPA who we appointed to consider the cost of equity in the CAPM terms. Considering the components of the CAPM approach to the cost of equity, there is evidence to suggest that both the risk-free rate and total market return are lower than in previous regulatory periods. This is shown on slide 9.

Based on current marketed evidence, a range of 1.8% to -0.6% RPI real for the RIIO-2 period can be assumed for the risk-free rate, although we will consider using indexation to ensure it remains in line with current market conditions. For the total market return, CEPA are proposing a range of 5% to 6.5% RPI real. Finally, for the equity beta, CEPA are recommending 0.7% to 0.8% although the UKRN study points through a lower range of 0.3% to 0.5%. This clearly points to a lower cost of equity of RIIO-2 than in RIIO-1, something that we believe is further supported by the premia to RAV achieved in network sales, competitive procurement of network assets, such as Thames Tideway and OFTOs, and the use of a dividend growth model.

We are also considering indexing the cost of equity. Our high-level proposal is to treat the cost of equity as a weighted average of the risk-free rate and a total market return, with the weight equal to the beta factor. Under this proposal, we will fix both the total market return, and beta, and index the risk-free rate. Our current estimation for the allowed equity return in RIIO-2 is 3% to 5% RPI real, should it be calculated on today's conditions.

Moving to slide 10, we have a duty to secure that efficient companies are able to finance their license activity, and a lower base-line allowed return in RIIO-2 will make it more challenging for companies to meet standard financeability metrics. Consequently, we have identified three high level policy options for addressing this challenge, and we are consulting on these. The first is adopting a nominal return instead a real return calculation; the second is putting the onus on companies to address this problem; and thirdly is introduce a license-backed revenue floor, targeted somewhere around notional debt. We are also proposing to look at other finance issues, including tax allowances and indexation, where we are proposing to move away from RPI, to either CPI or CPIH.

Moving to slide 11, high returns are justified – more justified – when companies innovate and demonstrate efficiency in operating their network, but in RIIO-1, it's clear that some underspend is down to factors outside the control of companies, such as real price effects, weaker economic conditions, milder winters, re-profiling expenditure, and high scope assumptions.

RIIO-1 contains a number of mitigation tools, but in RIIO-2, we will go further. We will index, where feasible, link cost of delivery of outputs of volumes, use uncertainty mechanisms to automatically adjust, wait until we have more certainty whether it's doubt over cost and scope, and revisit efficiency incentives to better reflect the balance of risk.

We are also of the view that it is important to guard against the risk of systemic high returns across the sector, and have identified five options that could provide this protection but still retain the benefits of incentive-based framework. This includes, first, a hard cap/floor; secondly, a discretionary adjustment; thirdly, constraining totex and output incentives; fourth, RoRE sharing factor that changes as performance changes; and five, anchoring returns where we index returns to a central point but

allow companies to spread above or below that point. We would welcome views on the benefits and impacts of each or any alternative approaches.

On slide 13, we set out an indicative timeline for the RIIO-2 process. This consultation remains open until early May, and we expect to make our decisions on the RIIO-2 framework in the summer before consulting other sector specific level in quarter 4. We remain very open to dialogue with analysts and investors alike, and please feel free to reach to us through Martin.

Finally slide 14, before we move to questions, I'd like to make a few concluding remarks. We are facing a significant period of change in network usage. And although RIIO-1 has generally worked well, we have learned lessons and will apply these in RIIO-2. We will continue to use the incentive-based RIIO framework to set price controls, and we will continue to welcome outperformance within our price controls. This will be a tough price control for network companies, but those who deliver greater customer service at lower cost will be rewarded. We firmly believe that UK networks remain an attractive environment for investors and our returns should reflect the level of risk of a stable and predictable regulatory regime.

I will hand back to Martin for questions.

Q&A

Martin Young

Thank you very much Jonathan.

Sarah, could you please now poll the questions? And as we only have until 17.00 this afternoon, please, can I request that those who wish to ask questions do limit themselves of a maximum of two questions each. Sarah, please, can we take the first question?

Operator

Ladies and gentlemen, if you do wish to ask a question, please press zero one on your telephone keypad now. If you wish to withdraw your question, you may do this by pressing zero two to cancel. And there will be a brief pause whilst questions are being registered.

And our first question comes from the line of James Brand from Deutsche Bank. Please go ahead, your line is open.

James Brand

I have two questions. The first is on the options to ensure fair returns. You didn't highlight any of those as preferred options in the document but I was wondering whether you could give us a bit of a steer, whether any of those were preferred maybe more than others. And secondly, when we should expect to have a clear view on that. Should we expect to have a clear preferred option being selected when you publish the final framework in the summer?

And the second question is I just wanted to clarify a comment that you made earlier in the presentation. I think you said that at current market conditions that the cost of equity implied by your modelling would be 3-3.5% RPI real. So you went on the indexing route, that could be the starting point based on current market conditions. Could you just clarify that's what you said? Because I only half caught that. Thanks.

Jonathan Brearley

So on fair returns, no, we don't have a preferred option right now. I think it's a difficult area for us and the companies themselves. And so what we've done is put out a range of options and we are welcoming feedback on those options. And equally, we are asking the question as to whether there are alternative ways in which we can manage this issue. I think what we are determined to do, though, is to make sure that were unexpected things to happen and the price control to drift off in an unexpected way, we

want something within the price control that would, in essence, bring that back to where expectations were in the first place. We will by July, though, be expressing a clear view on the way forward on fair returns. Just to clarify, current market conditions lead to 3-5% RPI real, not 3-3.5%.

James Brand
Great. Thanks a lot.

Operator
Thank you. And our next question comes from the line of Maurice Choy from the Royal Bank of Canada. Please go ahead. Your line is now open.

Maurice Choy
Hi. Good afternoon to everyone. Just two questions from me. The first question really is one of a big picture between, I guess, Ofgem's approach to power and gas networks versus Ofwat's approach to water. Honestly, if you look at RIIO-T1 versus AMP6, notwithstanding the fact that these were determined at different times but the ROE clearly had a proper 130 basis points difference. This analysis, whether by CEPA or even by your report, suggest this difference for logic or not, probably should be eliminated. I wondered if you could discuss a little bit more about how you see these two industries differing, whether by risk or by direction.

The second question is on one of the options about your returns, anchoring of returns, and that's on page 106 of your document. You mentioned that anchoring is meant to cap specifically the RAV return. I just want to know why RAV return, which I assume is WACC rather than ROE. Thank you.

Jonathan Brearley
Okay, thank you. On the first question, clearly the analysis representing here suggests that water and the energy networks are roughly in line. And that's what the CEPA analysis sets out. We are consulting on that so we'd welcome your views. But clearly, we're not aiming up in the same way perhaps as has been done in the past.

On anchoring returns, the concept there is slightly more complex in the sense that what I really said is that the average remains the same, wherever we would peg that. But companies can still do a lot better. But if they do, that will be a spread of companies, some of whom will be doing worse as a result. We're open to the sorts of metrics that we would use to apply to anchoring. But the main concept there is sort of a way in which you can limit the overall returns in the sector but make sure that our performance can do better than those who are not performing as well.

Maurice Choy
Just one follow-up, if you don't mind, on the first one. Obviously, that's a comparison of power or energy networks to water. Is that also true for other regulated industries within UK, such as rails and other regulated industries?

Jonathan Brearley
That's probably not for us to comment on. I mean, what we're trying to do here is look at the market evidence around the energy sector and apply that to that. So, I don't think we can get into a discussion of the relative risks between different sectors on this call.

Akshay Kaul
And honestly, you have to keep in mind that there can be timing differences and then we make our determinations. Water runs broadly a year ahead of us.

Maurice Choy
Thank you.

Operator
Thank you. And now our next question comes from the line of Iain Turner from Exane. Please go ahead, your line is open.

Iain Turner
Thanks. Could I ask just a couple of questions? You mentioned on slide 8 that competitive procurement of network assets has influenced this thing, and also that it would be in a Hinkley-Seabank decision. Just point out that you've never actually published those OFTO returns. And it will be quite nice if you're going to rely on them, for you to actually be a bit more transparent on that. That was my first point.

And then secondly, just on having a negative risk-free rate. Does that actually make sense? I mean, obviously, that's where indexed yields are at the moment. That's being driven by QE, a risk-free – philosophically, can you actually have a negative risk-free rate?

Akshay Kaul
Yes, I think the academic team, which was advising us about the UK regulated networks, took a look at this issue. And in their view, there's a sort of price-of-tomatoes argument here that the price to index link yields is whatever the price to index link yields in a relevant market. And that is what we follow in terms of our capital asset pricing model methodology.

We are completely alive to the risks that the yields can change over a price-controlled period. And I think that is one of the reasons why we have put forward a proposal for indexing the calculation. But we are not, in any sense, thinking that there is something irrational about the fact that there is a negative yield. It is just what it is.

Martin Young
And I think, Iain, on your first point/question, there are some documents out there that evaluate the benefits of OFTO rounds 1,2 and 3. I think in terms of OFTO round 4, it's just a reference from CEPA in the documentation that accompanied the HSB announcements earlier this year. But I will make a note and endeavour to dig out the documentation that pertains to 1, 2, and 3 and send that across to you.

Iain Turner
You do also have one running at the moment, I suppose, which is also fair to say. So perhaps if you could be a bit more transparent when that one's concluded, and you might have -

Akshay Kaul
We can't share confidentially sensitive information from live bids, but when the tender rounds are concluded, then, yes, definitely, we want to be as transparent as possible.

Iain Turner
Thank you.

Operator
Thank you. And our next question comes from the line of Fraser McLaren from the Bank of America Merrill Lynch. Please go ahead Fraser, your line is open.

Fraser McLaren

Hello. Good afternoon. This is Fraser McLaren here from BAML. Just on the extension of competition, just wondering if you can outline whether or not this is contingent on legislation eventually being passed or indeed if you seek to rely on your rather controversial approach in Hinkley. Thanks.

Jonathan Brearley

So, our preferred approach is to do this with the backing of legislation. However, as we've already demonstrated within the transmission sector, we will explore ways in which we can do this within the current framework.

Operator

Thank you. And now our next question comes from the line of Ali Agha from SunTrust. Please go ahead, your line is now open.

Ali Agha

First question, coming back to the part about potentially capping returns, given that there is so much focus and the points you've made that some companies are earning excess returns, wouldn't it be better to set a framework where the focus is on the earned return and not on the cost of equity, similar to the US model to some extent? And if the companies end up earning above that perhaps that can be shared with customers? I'm just, first of all, wondering about your thoughts on return on equity focus versus cost of equity.

Jonathan Brearley

Okay. I'm going to, over -

Akshay Kaul

And so, I think the fair returns mechanisms that we have described, the majority of them do work on the basis of realised return on equity, not the ex-ante cost of equity. And essentially the idea is that there is some threshold over which the realised return becomes something that then has to be shared with consumers or capped in some way. And we proposed doing it in a number of different ways. There could be company-specific caps at a particular threshold level. There could be sharing factors, so you can cross – a company can cross the threshold level but have to hand back increasingly larger portions of the savings to consumers. Or there could be a sector level cap so if the entire sector is going beyond the level than the sector is capped at that level. But it's all connected with the realised returns, not the ex-ante estimates.

Jonathan Brearley

I think what I'll just like add is just to be clear that we are operating an ex-ante regime here, whereas US is primarily ex-post. And so, what we're not targeting is the rate of return in the same way the US will. It's just around where things aren't expected and returns go away from where we thought they may go in the first place.

Ali Agha

Right. Right. And just to – I mean, following up, I mean, just to comment. Given that your own comments that based on the parameters, companies ended up earning excess returns, I think one way to address that politically or otherwise would be to ensure that returns are capped at a certain level.

My second question, just a clarification. This process, I think, it's going to take a few years to play out, 2021 and 2023. I just wanted to know, in case over that three-to-five year period, if there is a change in government, does that have implications for RIIO-2, or does RIIO-2 happen regardless of the government in power?

Jonathan Brearley

So, what a regulator does never happens regardless of what government is in power. And clearly, if parliament legislates, then we are a creature of parliament and we have to follow that legislation. However, our clear expectation is that we will go with this price control and run this price control in the same way we have previously.

Ali Agha

Thank you.

Operator

Thank you. And our next question comes from the line of Ashley Thomas from Millennium. Please go ahead. Your line is open

Ashley Thomas

God afternoon. Two questions from me. On returns, PPL said in its full year results call that its indications from Ofgem suggest a good performing network should still be able to achieve double-digit returns in RIIO-2. If we look at RIIO-1 and your Ofgem eight-year forecast, the best performing ED is forecast to have a 500 bps outperformance versus its cost of equity in RIIO-1. So to get up to double-digit in RIIO-2 given the cost of equity sort of spread that you've given, suggests that the scope for outperformance would be higher in RIIO-2 than RIIO-1. Is that sort of your view that a best performing network could outperform more in RIIO-2 than has been the experience in RIIO-1?

Jonathan Brearley

Yeah. So first question, thank you.

Ashley Thomas

Should I go on with the second?

Jonathan Brearley

Yeah.

Ashley Thomas

Okay. Yeah, great. Second, just on slide 3 and the lessons learned from RIIO-1 and the sort of systemic outperformance, it's sort of quite striking that the line on the incentives return on EDs. So I guess, sort of, are you confident that those incentives have been set at the right level and still actually act as an incentive sort of going forward, given that a number of the networks are sort of likely to have maxed out on interruptions incentive?

Jonathan Brearley

So first of all, just for clarity, we have not said that companies can necessarily make double-digit returns in RIIO-2. What we have said is that we're running an incentive-based regulation and companies that perform well against certain incentives can do better. So I'm afraid we haven't made the assurance in those terms that have been described, but we are saying very clearly, we want to ex-ante regime, and we would like something where a company has performed well, clearly there should be rewards to do that.

On your second point, we are consulting at the moment on ED in the MPR around the structure of existing incentives. So probably through process, we'll have a discussion about what we do about that.

Ashley Thomas

Okay. Thank you.

Operator

Thank you. And our next question comes from the line of Mark Freshney from Credit Suisse. Please go ahead. Your line is now open.

Mark Freshney

Yes. Can I please ask two questions? Firstly, on the gearing, I mean, returns for the companies as a whole, the gearing ratio is almost is important as the allowed return on equity. I think the report that you commissioned mentioned 50 to 65. And I think you even mentioned in your 153-page document, potential deleverage is something the companies may need to do. So what are your thoughts to the overall amount of equity within the business? Because that's important for buffering against some of the risk. And secondly, the revenue floor to ensure financeability, that kind of looks to me like extra revenue that could well increase returns. Is that likely to be clawed back in an NPV neutral way or is it going to be like the water companies got up until 2010, which is extra revenue because the base ROEs weren't enough for the credit ratios?

Jonathan Brearley

So, I'll ask a couple of team members to jump in. But just to cover things from me, first of all, we are reviewing the gearing level within the regime and the notional gearing level. And so that is part of the consultation that we welcome your views on where that should be. And, to answer your second, yes, this will be – the revenue floor will be ultimately NPV neutral.

Is there anything else we would like to add?

Akshay Kaul

Well, just to say that according to our normal practice, we look at the gearing in the light of the riskiness of the price control settlement as a whole at the sector level. And that's what determines, in our view, the size of the equity wedge. So, we will continue to do that. We've done a number work so far, broadly assuming, the range of gearing that you're describing in the CEPA document.

And secondly, in terms of the revenue floor, we see it essentially as a way of providing liquidity to companies when they face cash flow shortfall in relation to being able to pay bond holders. But, as Jonathan was saying, we do it and envision it being NPV neutral for consumers. So, it will be paid back overtime when the trading position of the company has improved.

Mark Freshney

Okay, thank you very much.

Operator

Thank you. And our next question comes from the line of Roshan Patel. Please go ahead. Your line is open.

Roshan Patel

Hi. A couple of related questions on the cost of equity indexation approach. I just want a bit more details on the mechanism for that? Are you talking about an annual adjustment based on spot yields? And with that, obviously, you're potentially introducing quite lot of volatility. Are there any protection mechanisms which you might introduce to protect investors there?

The other part relates to that, so if you're introducing volatility, how appropriate do you think the historical betas are in terms of equity risk? Will it be an upwards adjustment to the beta under the indexation approach?

Akshay Kaul

So I think what we are thinking to do is, in fact, remove risk from investors. I mean, the choices for us would be to either make some kind of forecast of how this portrait is going to move over the price control period or to index them. And our experience from RIIO-1, in general, across the ranges of these sorts of situations has been that trying to forecast things like interest rates is not a very sensible thing to do. And so in a sense, we're taking that risk away from investors.

In terms of causing volatility, the proposal in the condoc is, in fact, to assume that the betas and the total market return are broadly stable over the course of the price control period. So we'll only be transmitting the changes in the risk-free rate times the beta factor, one minus the beta factor. So we're not expecting to see a huge amount of volatility, but we are trying to create a price control settlement that is adaptable in case risk-free rates to do move in unexpected ways.

Jonathan Brearley
I think all I'd add is that indexation cost of equity is a choice at the moment. So, it's something we're considering rather than definitely going to do.

Roshan Patel
Okay, thank you.

Operator
Thank you. And our next question comes from the line of Lakis from Agency Partners. Please go ahead. Your line is now open.

Lakis Athanasiou
Hi, guys. Thanks for the conference. Two questions from me as well. One is, how seriously should we take your proposal for going to a nominal return or is it really just a stalking horse to make going to a 100% CPI more palatable?

Second question on CATO. Again, how serious are you going to be in applying this? Operation and maintenance, we already get competitive procurement by the companies. Construction, you are putting in mitigating factors. The finance, you're sorting out. But you're going to be locking stuff in for 25 years, which is okay when rates are low, but what happens when rates are high? We will end up with the same PFI debacle? And just an observation, you did make an error in defining the PMICR in section 7.7 which you repeated in slide 10.

Jonathan Brearley
Okay, thank you, Lakis. I'll say a couple of things. But then, again, I'll hand over to the team to cover it in more detail. So, we are serious about all of the options there in the document. Clearly, you'd expect me to say that, at this stage. If you have concerns around issues, such as nominal return, then please make your feelings known through the consultation.

Lots of questions, Lakis, on how we bring competition into the sector. But I think what's missing from the list of mitigations we have already in place that you gave us is clearly a competitive dynamic we think does drive good outcomes for consumers and make sure that consumers benefit as much as possible from a competition that occurs. And so, what we are doing is looking to make sure that we can secure as much as benefits as possible for consumers. And, yes, we are serious on both points, but, yes, lots to do in terms of that line. Anyone else want to jump in? No? Andrew?

Andrew Stone
Thank you for the spots on PMICR, we'll put it right in future.

Operator
Thank you. Our next question comes from the line of Paul Winston from Keybanc Capital Market. Please go ahead. Your line is now open.

Paul Winston
Just looking for a clarification on an earlier question regarding cost of equity indexing, would that be changed annually or not? I was unclear from your response. I have a follow up as well. Thank you.

Jonathan Brearley
Annually or not for indexation?

Akshay Kaul
Yeah. Our thinking was that this will be an annual indexation process.

Paul Winston
Okay, thank you. And then I've heard some concern from investors about a mid-period price change. Is that now off the table?

Jonathan Brearley

So I think that's a separate process to the one we're talking about today. So there is already a consultation around a mid-period review for the electricity distribution sector. That is something that we are looking to conclude in the coming weeks.

Paul Winston

Thank you very much.

Operator

Thank you. Our next question comes from the line of Sam Arie from UBS. Please go ahead. Your line is now open.

Sam Arie

Hi, good afternoon and thank you, a very helpful presentation [inaudible] recently on UK Energy Network. It seems like very sensible set of proposals so you make and very fair questions that you ask. So, thank you for that.

My question is just firstly on the five-year timeframe, I think that has been discussed before, so perhaps not a surprise. But when I look at your timeline for the consultation process, which starts from 2017 with the open letter and ends in 2021, so four years sort process end to end, then we're going to have a five-year RIIO period. So, it almost seems like the consultation process for RIIO-3 will start before we've even had any experience in RIIO-2. So just maybe you thought that through and can explain how that's likely to work.

And then my second one, it's just on your comments about the tax issue. I mean, if I understand you correctly, it seems to be you're concerned that some companies may have had an unintended outperformance because of tax situations that they have. And I just want to check if you've quantified that and have a sense of size of that benefit where it's been a benefit, and therefore how much it would be at stake if you were able to iron that out, so to speak. So those are my two questions. Thank you.

Jonathan Brearley

So RIIO-3 versus RIIO-2? I mean, all I'd say is there's always going to be a trade-off between having a shorter price control and the admin burden of doing so. So, obviously, we will need to work that through as we start the planning for the price control after this one. But, clearly, that's something we would consider. I mean, on tax, I don't know if any of the team want to…?

Andrew Stone

It's too early to say at this stage on tax. What we're proposing to do is to review the existing circumstances and see what's going on and take views from stakeholders as to what should be going on. It's really a very open field at the moment.

Sam Arie

So, thank you. Yes. So on tax, mind if anybody – you said that there was a problem that needed to be fixed. But actually you're saying, there might be a problem, there might not; you haven't decided -yet.

Marcia Poletti

So, I think we're observing differences between what we are calculating as a company's tax allowance and what they're actually paying to HRMRC, and these are all probably legitimate. But there is a question around whether we should just match that level of payment and that you'll find in the consultation document.

Sam Arie

Right. And did you say somewhat – did you quantify those differences for us? Apologies, I only saw this morning, so I just had a quick look. But have you quantified the extent to which you see differences there?

Marcia Poletti

There's nothing quantified in the consultation document. We'll be undertaking our review and we will be publishing more information as we go.

Sam Arie

Okay, perfect. Thank you very much.

Operator
Thank you. And our next question comes from the line of Greg Orrill from UBS. Please go ahead, Greg. Your line is open.

Greg Orrill
Yeah, thank you. Just to follow up on the idea of an earnings sharing mechanism, how you would think about structuring that.

Jonathan Brearley
So we have already – we already have within the price control – in essence, we have a sharing of either cost outperformance or cost underperformance. And those have been set in a variety of ways in the existing price control through some of the incentive-based mechanisms. We're not setting levels. But in essence, what we are saying is we want a sharing factor that shares back in any of outperformance in terms of cost reduction. Equally though, we're saying there's two ways that could be effective. One is that can be impacted by our assessment of the quality of the business plan, and that may change according to that. But secondly, when we look at fair returns, clearly, one of the options is to say that as returns get higher, however you measure them, more of that earning goes to consumers. So your sharing factor to consumers get bigger as returns move away from some sort of central point or some sort of cap.

Greg Orrill
Thank you.

Operator
And our next question comes from the line of Timothy Ho from Morgan Stanley. Please go ahead. Your line is open.

Timothy Ho
Hi. Good afternoon. Two questions from me. The first is you stated that the lower returns will mean that an investment grade credit rating will be harder to retain, in the document. Can you give us some colour around what Ofgem sensitivity and also showed in that regard? And number 2, you say in the document that the equity injections to reduce actual gearing to notional levels might well be appropriate than option B in addressing financeability issues, and that rating agencies will discount approaches involving modifying capitalisation rate. So I wanted to ask if Ofgem has tested the appetite for equity injections under this lower cost of equity environment. Thank you.

Jonathan Brearley
So in terms of the general point, I'll just say that we're now consulting on this now. So, this is part of the conversational we'll be having, both with investors and with the industry itself. Does anyone would comment on either sensitivities we've carried out or any calculations we've done?

Akshay Kaul
So at this stage, it's too early because we have to consider ultimately these things in the context of the company price controls and the sector specific packages that we set out, including the risk of the incentive regime. But all we have done so far is thought about the effect of the metrics, assuming everything else being equal, of a lower cost of equity going through the system. And we think that all else being equal, that will have a dampening effect on some of these credit metrics. And that's the reason why we are, in a sense, being proactive. You don't necessarily think that there will definitely be a problem in terms of financeability when we get to each of the sectors. But in the event that these metrics come under pressure, we think that it is prudent to have some mechanisms there to tackle the situation, and we have proposed three such options on the table.

Timothy Ho
Thank you.

Operator
Thank you. And our next question comes from the line of Maurice Choy from the Royal Bank of Canada. Please go ahead, Maurice. Your line is open.

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Maurice Choy

Thank you. Just one follow-up question and this is kind of following up on Ashley's questions on incentives. In the water sector, Ofwat kind of gives a 1% to 3%, plus/minus potential ODI. Obviously, there's uncapped ODI incentives. But, if they are going to introduce a lower ROE, at least it seemed quite balanced to help the market quantify the upside from incentives. So, for today's announcement for Ofgem, if you are going to suggest a lower return without giving an idea of what is acceptable level of incentives, it kind of seems quite one sided in my view. So would you say a plus/minus, 1-3% of additional ROE is reasonable for energy networks?

Jonathan Brearley

I don't think we can quantify that for you now, I'm afraid. That is something we consider as part of the consultation.

Akshay Kaul

And it's still early at this stage. I think we will look at the incentives packages for each of the sectors in the context of the characteristics of each of the sectors. And it may be that in some cases there is a case for higher powered incentive – more higher powered incentives than others. You should also keep in mind that we very much want this time around to differentiate these incentive rates between companies based on the quality of their business planning. And we'll be giving quite a lot of attention to that.

In general, I think the message that you should take away is that we very much believe in incentive regime-. Although we can't give you any specific numbers now, I think there's unquestionably going to be the potential to outperform the baseline allowed returns if companies deliver good service and they do so at lower cost. But the specific incentive rates will only be settled at the sector-specific methodology stage.

Maurice Choy

And when can we get clarity on that? And specifically, what I'm asking is the power of incentive.

Akshay Kaul

Yes. So, I think we aim to publish a consultation on the sector specific methodologies towards the close of this year. And then the companies themselves will be putting proposals in their business plans back to us on service targets and potential incentive regime back in the autumn, towards the backend of 2019. And the final determination of that will really be the end of 2020 when we make our final determinations.

Maurice Choy

Okay, thank you.

Operator

Thank you. And our next question comes from the line of Abe Azar from Deutsche Bank. Please go ahead. Your line is open. To the line from Aip Aza, your line is open to ask a question.

Abe Azar

Sorry, I was on mute. Good afternoon. Have you calculated what a change to the nominal cost of equity would mean to the current period customer bills?

Akshay Kaul

Yes, I think, we think that all else being equal, the effect of the cost of equity reduction would be of the order of about £15 to £25 on the household bill.

Andrew Stone

I think the question was on real as nominal.

Jonathan Brearley

Yeah, I think we haven't calculated that yet.

Andrew Stone
And we know, yeah.

Jonathan Brearley
So that is something that we'll look at as part of [inaudible]. We haven't published anything on that today.

Marcia Poletti
But obviously, there'll be an offsetting factor as you reduce the cost of equity. If you move to a nominal right, those two factors offset each other somewhat.

Abe Azar
Right, thank you.

Operator
Thank you. And our next question is a follow-up question from the line of Lakis from Agency Partners. Please go ahead. Your line is open.

Lakis Athanasiou
Hi, guys. Two questions again. First one on cost of equity and renationalisation risk. Now, as a matter of principle, what is your attitude to taking into account things like the renationalisation risk, which have clearly had an upward push on the cost of equity in recent months?

My second question is really the past question seemed to have an expectation. The lower returns could be compensated by higher incentive rates. And my expectation is that your incentive rates would be one-sided, as really they have been in the past. Could you comment on that? I mean, are you expecting genuine plus and minus, whereas in the past you always seem to have a plus?

Jonathan Brearley
I'll answer the first one and I'll do a bit on the second, but the rest of the team, do jump in. I mean, I think that we set our methodology, Lakis, on how we look at cost of equity. There is probably no more I can say now about how we do with the sorts of risk for the companies will come back and claim will have an impact on that calculation.

On the second point, I think, we haven't fixed the incentive regime but clearly I think if you look at the RIIO-1, the intention at the start is that they would be quite two-sided and that the reality is it turned out to be somewhat different. So, we would be looking at that. But certainly, on the table is exactly sort of more symmetrical and balanced incentives that don't mean that everybody is necessarily going to do better.

Marcia Poletti
So, like you said in particular, some of the fair-return mechanisms look at having, for instance – looking at relative performance of companies which would imply that potentially 50% would benefit and 50% would be penalised. So, we are looking at ways to introduce greater symmetry or greater automatic symmetry.

Lakis Athanasiou
Thanks. That seems a great departure from previous price controls?

Jonathan Brearley
Well, still to be worked through, but certainly that's on the table.

Lakis Athanasiou
Right, thank you.

Operator
Thank you. And ladies and gentlemen, just as a reminder, if you do wish to ask a question, please press 01 on your telephone keypad. And we have another question from the line of Mark Freshney from Credit Suisse. Please go ahead. Your line is open.

Mark Freshney
On CMA challenge, I recall that one of the features of RIIO is that interested parties would also – so long as they had a valid case, there was a process for them to ask for CMA referral of the price controls, which I think happened actually at the last electricity distribution review. Given you've now got this Challenge Group and these Consumers and User Groups, is it now the case that – will CMA challenge still be open to interested parties as well as the companies? Or following those two groups being introduced, would you close off the right of CMA challenge to them?

Jonathan Brearley
So just to say that it doesn't affect the CMA challenge process so they can still challenge that in the end of the process.

Mark Freshney
Okay, thank you.

Operator
Thank you. And our next question comes from the line of Verity Mitchell from HSBC. Please go ahead. Your line is open.

Verity Mitchell
Hi, it's Verity from HSBC. It's just an observation really and a question. I mean, one of your key objectives for this price review is simplifying price controls, but you've thrown in a whole range of a very interesting and innovative possibilities for changing the way we think about things. How are you going to, I suppose, simplify the range of options that you put and what's the process of that? So you don't end up having actually a very complicated price control, but with all your innovations.

Jonathan Brearley
So I think – yeah, no, I accept that sometimes when public servants innovate, things get really complicated so that's a familiar problem. This is a partly frankly a symptom of the stage we're at in the process. So what we're trying to do here is to get the range of possibilities out there so we're going to have a proper discussion with yourselves and the industry about it. But the aim is once we begin to make some firmer decisions, this outlook will look a lot simpler and we expect overall the price control to be simpler as a result.

Operator
Thank you. And our next question is a follow-up question from the line of Fraser McLaren from Bank of America Merrill Lynch. Please go ahead, Fraser. Your line is open.

Fraser McLaren
Hello. It's Fraser McLaren here again. Just a question on CPI, please. Can you elaborate on why you don't think that a phased approach to CPI may be necessary? And is the impact on the profile of cash recovery in that instance included in your £15 to £25 bill saving estimate? Thank you.

Marcia Poletti
So the answer to the second part of your question first, no, we aren't. The £15 to £25 saving does not include any impact of any movement to CPI. And then why we think a phased transition is not necessary. I think in the sense that relates to the previous caller's question around complexity in the price control. However, this is question that we are open to consultation on and it would be good to hear views.

Fraser McLaren
Thank you.

Operator
Thank you. And our next question comes from the line of Florence Taj from MFS Investment Management. Please go ahead. Your line is now open.

Florence Taj
Yes, hi. Thank you very much for the presentation. I guess, my first question is a question of observation, but I guess from the RIIO-2, or RIIO-1 rather, we had a framework that seemed to be innovative, a large CAPEX budget, significant opportunity for the companies to outperform in delivering this budget which led to the low cost of equity that you observed in the market, along with the large transaction premium that were being paid for the asset.

As I looked at what you're proposing for this price review, essentially, an extremely low cost of equity, a reduced ability to outperform. And when the company do outperform, a clawback, no ability or limited ability to outperform on the cost of debt, which you will tighten further, no ability to outperform on the tax side, plus now, a political environment, which is such that any kind of outperformance essentially lead to a threat of nationalisation.

So my question to you is, basically, why should equity investors continue to fund this sector with that kind of regulatory framework?

Jonathan Brearley
I mean, our aim throughout the price control period is to make sure we get the right balance between maintaining fair cost for consumers, and making sure that these companies are financeable, and we can get the necessary equity and debt investment in place. This is our first view of how we might go about assessing that, and we've given you an indication of what that might mean.

A couple of things on what was mentioned in the list, I think what we're saying our intentions at the moment actually is, is that there is further work to do on the scale of incentives. We're not making any judgement at all about what scale of outperformance can be made. What we are saying is that we are supporters of ex-ante regulation, which by its nature, does build in incentives for good performing companies.

All I would say is, we set out here what we think is a fair balance between consumers and shareholders, but there is a long way to go, and that's why we're consulting with you.

Marcia Poletti
And I think the other aspect of RIIO-2 in the period it's set it, is, we are looking at end key transition in the UK and the need for increased CAPEX in response to the de-carbonisation challenge and response to the DNO DSO switch. So, I think there are still opportunities there, and they will remain there for high performing companies. Maybe the challenge then becomes not all companies will be high performing, which maybe makes your job a lot more difficult.

Florence Taj
But even the ones that are performing well, it seems will have very low returns.

Jonathan Brearley
Well, as I say, we set out our view here, we welcome your views. This isn't a final decision, this is our first step in the process, so please do come back to us.

Florence Taj
Can I ask one more? Just on the idea of a nominal regulation, are you actually talking about doing away completely with the inflation adjustment? Or am I not understanding what you're trying to do there?

Marcia Poletti

Yes. So one of the reason why you see the potential for challenge around financeability is the way the price control provides value for companies. And part of it is providing the operating cash flow upfront, and part of it is provided through the indexation of the regulatory asset value. The metrics, however, concentrate primarily on the forma.

So one arithmetic solution to the problem is to start paying nominal returns. Now where we are interested in this point about views on that approach, and have no defined positioned on this.

Florence Taj

Okay. Thank you.

Operator

Thank you. Our next question comes from the line of Michael Lapides from Goldman Sachs. Please go ahead, your line is now open.

Michael Lapides

Hey guys, thank you for taking my question. Just would love some more clarity on how indexation – in the document you talk about indexation at a high level, both for some of the components and the cost of debt, but also for things like the risk-free rate. Can you give a little more detail on how you think that would actually work, meaning, would that true up and lead to adjustment every year during the five or eight year regime? Would it be less frequent than that? Would it look historically at kind of trailing 12 month actuals for things like either the beta or the risk-free rate? Or would it look at the futures market and see how the futures market has changed over a 12-month period or at a specific point in time? Can you just kind of talk about how you're thinking the process would actually work for indexation, both on the debt and the equity side?

Marcia Poletti

So that's a very wide question. I think I'll give you a wide answer, and then you can follow up if that's not enough detail. But where there are established indices out there, we would be looking to use those. We are exploring, as part of this consultation, what approaches make sense. In the cost of debt, we are already indexed, and we obviously use that trailing average indexation, and one of the consultation options is around continuing and refining that approach. So I think it's very much dependent on the particular aspect we are trying to index.

Jonathan Brearley

Well, I think broadly, the pen portrait is you would expect roughly once a year for the cost of equity to be upgraded?

Marcia Poletti

Yes.

Michael Lapides

Got it. Thank you, guys. Much appreciated.

Operator

Thank you. Our next question comes from the line of Sam Arie from UBS. Please go ahead, your line is open.

Sam Arie

Hello again. Yes, thank you. I wanted to come back actually on the question asked earlier about timing and RIIO-3. And I remember from previous conversations that RIIO-3 is potentially a really important period and many of us have expectations about where renewable penetration would have got by then and the electrification of transport. And certain other megatrends that need a bit of time but by RIIO-3 will be really impacting what we need energy network operators to deliver. And yet, if we come back to the timing point, if we've got a five-year period in RIIO-2, and a full year for the consultation process, doesn't it follow that this framework is really the framework for RIIO-3 as well? Because by the time you kick off the process for RIIO-3 consultation, you won't have any experience or assessment of RIIO-2 yet, almost by definition. So how does that really work? Can you talk to us, please? Thank you.

Jonathan Brearley

So I'm happy to give you our views on this, and then I would welcome the team to jump again, if there's anything else they want to say. I mean, clearly, Sam, the point we – the issue we will always have is how we are going to do sort of update the price controls within a shorter period of time. The trade-off we are making, though, is, as you said yourself there, we have a rapidly changing sector. We have a number of different things which are extremely hard to predict upfront. Therefore, in timing what we're trying to do, if you like, is almost balance three things. One, that admin burden you're describing, how do we make sure we set price controls up and can do so in a robust way in a short space of time. Two, how we give sufficient stability to yourselves as investors and to the companies. And three, how do we manage in a world where things are changing, and changing in ways that are very difficult even to design something that adapts within a price control.

Our view that we set out today is that we think that five years is a sufficient compromise for that. And just remember, when we consult on a price control and when we design it, we don't say the rules are fixed on day one, as we haven't done, for example, with RIIO-2, but we can adapt as we move. And indeed, as the evidence comes forward in RIIO-2, then we can use that to adapt and change the design of RIIO-3 as we go along. So, although it is a long progress to set it up, we may do it more quickly, I don't know. But either way, we adapt as new evidence emerges and comes through. And bear in mind, it wasn't that long ago that Ofgem was doing five-year price controls as have Ofwat been doing for a long time.

Marcia Poletti

I think the other thing to remember is a lot of the key final decisions are being set within the last year or the last two years. And that's the material that's decided at sector-specific level. And so yes, the time tables look long. That's partly because we're talking about £100 billion of consumers' money. But those hard decisions are being made much closer to real time.

And then the last point, I think all price controls build on those price controls that were run previously. That's why we talk about these stable regulatory regimes. But we still need to examine the performance of previous price controls.

Sam Arie

That's very clear, and it's straight answer so I'm not challenging your need to do diligent work. I'm very appreciative of that. I just think that unless you guys can communicate that somehow the RIIO-3 process will be done much faster and half the speed of the RIIO-2 process. And I think on our side, there will be a tendency for people to assume whatever comes out of RIIO-2 is then the framework for 3 as well, basically.

Jonathan Brearley

Noted.

Sam Arie

Okay. Thank you.

Operator

Thank you. Ladies and gentlemen, once again, if you do wish to ask a question, please press zero one on your telephone keypad.

Our next question comes from the line of Iain Turner from Exane. Please go ahead, Iain. Your line is open.

Iain Turner

Just one comment and one question. I think you talked about simplification and CPI/RPI. I would just agree with you, if you can avoid the approach Ofwat has taken, that will be a really good idea because what they've done is a complete dog's dinner. My question though is about financeability. On slide 10, you talk about putting the onus on the companies, but you also point out that you've got duty to secure that companies can finance themselves. Aren't those two statements somewhat contradictory? What do you actually have in mind about putting the onus on the companies?

Marcia Poletti

So, I think there's two parts to that. The first part is that we need to design a price control in which an efficient firm can meet its financeability criteria. That doesn't necessarily mean all the firms out there have the same level of gearing that we are setting the price control on. So, if that's true, firms may need to make adjustments. But that's obviously only one of the options we're consulting around financeability.

Jonathan Brearley

So, what we're saying is yes, we do have a duty for financeability. That is a fundamental part of Ofgem's framework and the framework that we work within price controls. When we look at the issue that we're highlighting here, which is specifically the relationship between the baseline cost of equity and what people might do in terms of rating debt, one way that that can be addressed is companies themselves adjusting their gearing levels. That's not something we would need to do. That needs to be traded off against some of the other options which are much more interventitive from an Ofgem perspective, and, clearly, would carry additional risk for consumers.

Iain Turner

Does that mean though, using a notional company, you could be setting a cost of equity, which, for the notional company, would mean they weren't financeable?

Jonathan Brearley

I think it's hard to imagine we can do that. We'd need to take that way and think about exactly what that would mean. I think the point being that whatever we do, and we'll be judged on this by through any appeals mechanism, we have to ensure that an efficient company can finance its activities to deliver suitable services for consumers. That's going to be one of the tests that that's going to be applied at the end of this.

Ian Turner

Okay, thanks.

Operator

Thank you. And our next question comes from the line of Deepa Venkateswaran from Bernstein. Please go ahead, Deepa. Your line is open.

Deepa Venkateswaran

Thank you and apologies for the voice. I think my question really is two-fold. One is there's a lot of evidence on market multiples, transaction multiples, etc., also bids you place reliance on. But in one of the levers that some of the infrastructure funds employed is why a high amount of leverage. And I see a disconnect between what the government wants, say, the government sector, where Michael Gove is calling out highly leveraged structures, the review Ofgem are using, evidence from highly leveraged structures to justify a lower cost of equity. So how do we actually square the circle on the points? Do you want companies to have high leverage or not? And then are you actually setting that?

And secondly, in terms of, again, observable returns and transactions, there is an assumption that all investors of all categories have the exact same returns expectation. It is possible that a category of investors, such as an infrastructure fund, genuinely have a different threshold of what returns they require versus public market investors. Have you considered this difference as well? Thank you.

Jonathan Brearley

Look, I mean, the leverage of different companies is a matter for them, and it's not something that we're get in, other than to examine what we consider to be a notional company. And ultimately, that is the judgement for the investors themselves. I would just flag that without wanting to interpret the Secretary of State's comments, I think his concerns are broader than leverage and go into a number of issues around financial structuring.

In terms of the observable transactions, so in terms of where we want to leverage, I think that that's as far as we can go. Now, in terms of – sorry, the second question was on observable transactions?

Deepa Venkateswaran

Yes, the different categories of investors having different..

John Brearley

Look, what we're trying to do here is, ultimately, to make a judgement about what the market, as a whole, will accept to deliver the sort of investment that we need. So, in a sense, we're not trying to target with our current investors. But, ultimately, our judgement is an approximation for what market demands might be, and therefore, what consumers would need to pay. As a regulator, we're relatively neutral about which fund, to invest where.

Operator

Thank you. Our next question is a question from the line of Dominic Nash from Macquarie. Please go ahead. Your line is open.

Dominic Nash

Hi there, everyone. I've got two questions, please, if I may. The first one is on the true-up for out- or underperformance on the revenue number. What's your current sort of options available for that as to whether it's still going to be continuing under the similar – the same rate as current which is sort of a two-year lag revenue uptick and the associated really difficulty in modelling and earnings impact there.

And the second question is on return range, 3-5% on real RPI. I mean, that's pretty banging in line with Ofwat's return range. And Ofwat justified their return range by saying that they're using a shorter-term total, sort of equity return than a longer term. So, sort of Part A of this question is I understood that you are moving to a similar shorter-term view on total returns.

And then secondly, I want to get to your range that we're currently at. What is your length of market return and asset betas that you'll be using to calculate the new numbers, please?

Marcia Poletti

So on the first question around true-ups, I think this is not a question that we have addressed specifically in the consultation. If you have any views, we would be interested in hearing it. My guess is we'll continue the same process that we have in RIIO-1 unless people are raising strong objections.

Dominic Nash

I would rather it would be a bit more simple, personally. But it's one of the hardest things to model in these companies.

Marcia Poletti

Okay. And then may there be an interaction with RIIO accounts, if that simplifies life at all.

And then the question was calculation around the cost of equity and what timeframes, I think there are a number of approaches that have been taken. And I think, as you say, Ofwat is looking more to contemporary evidence. We're currently looking at longer term levels of total market return. They currently get broadly with the same sorts of numbers. Ofwat is forward-looking, we're backward-looking.

Jonathan Brearley

We're both forward and backward-looking.

Dominic Nash
Okay. So wouldn't you – your annual true up, though, if we were trying to predict what they're going to be, would it be five-year view or two-year view, so backward looking?

Marcia Poletti
So are you talking about a true-up if we go to indexing the cost of equity?

Dominic Nash
Yes, that's correct. I mean, sort of what sort of historical data links do we need to be – do you think we need to be looking at to work out what the progression is through the review?

Marcia Poletti
Right. So I think we haven't determined the mechanisms for the true-up around cost of equity. It may be that you make the adjustment every year, but you don't then do any sort of recalculation until the final end. We don't know.

Dominic Nash
Okay. Thank you.

Operator
Thank you. Our next question is a follow-up question Ali Agha from SunTrust. Please go ahead. Your line is open.

Ali Agha
Thank you. And this may have been in the slide and I apologise if I've missed it. I just wanted to clarify, what is currently in your thinking the appropriate sort of return for these companies and above that sector or a range of sectors you think paybacks kick in, etc. So, what would be that appropriate return sector right now?

Jonathan Brearley
We don't have that laid out yet. So, we're consulting on the broad framework now. And two things we need to understand better is how incentive regime might work. And therefore, where any sort of fair returns mechanism or failsafe mechanism will kick in after that? I think that's a matter primarily for the sectorial strategies which will start running through the end of this year.

Ali Agha
Okay, and certainly also clarify, as you mentioned, the companies will start giving you their plans sometime later this year. So as it relates to the distribution companies, given that their price control runs to 2023, is this something for them that's comes up in 2022? Is that we should think about for the distribution, electricity distribution companies?

Jonathan Brearley
So in essence, what we're saying, just to give you the timeline, which is on page 126 on the consultation, what we will have at the end of this year is a question around how we conduct the sector's specific methodology. We will then set out that sector's methodology in Q2 of 2019. But we'll expect the final business plan to be submitted to Ofgem in Q4 2019 and then we'll go into the determination process. That is for gas and electricity transmission. And a similar process roughly, with perhaps a little bit longer, will be for gas distribution. For ED, that will map into what I guess will be sort of late 2021, towards 2022, for 2023 determination.

Ali Agha
Understood. Thank you.

Operator
Thank you. Our next question is another follow-up question from the line of Lakis Athanasiou from Agency Partners. Please go ahead. Your line is open again.

Lakis Athanasiou

Hi guys, me again. Generally speaking, I agree with everything Dominic says. However, I'd like to put my vote in to keep the annual adjustments in. It makes what's happening in the network exceptionally transparent, exceptionally easy to model, particularly compared to the obfuscatory approach of overnight adjustments that Ofwat uses. And in the last review, Ofwat, even they screwed up their adjustments to the tune of £2 billion. So please keep the ongoing revenue adjustment. It's very easy to follow what's happening from that.

Jonathan Brearley

Can I ask you and Dominic to arm wrestle and come out with a joint view?

Lakis Athanasiou

Well, generally, I agree with everything he – nearly everything he said. It's just this one particular point.

Jonathan Brearley

That comes as quite a shock to the team here.

Speaker

That was all.

Jonathan Brearley

Thank you.

Operator

Thank you. And our next question comes from the line of Aip Aza from Deutsche Bank. Please go ahead. Your line is open once again.

Abe Azar

Thank you. Your consultation correctly points out there are few pure-play UK utilities. How do you consider other investment opportunities available to these companies to ensure that they'll continue to focus on investing in the UK?

Jonathan Brearley

Well, just to give a perspective on this, ultimately, the companies that invest in the UK networks do so under a particular regime where they invest in r ring-fenced dedicated companies towards the networks. What other investments those companies take forward – and indeed some of them do – is really is a matter for them. And so a matter for them to ultimately make their own trade-offs, as long as they work within the rules and within the ring-fencing arrangements that we have.

Abe Azar

Okay.

Operator

Thank you. And one last time, ladies and gentlemen, if you do wish to ask a question, please press 01 on your telephone keypads now. And as there are no more questions registered, I'll hand the conference back to you speakers.

Martin Young

Thank you very much, Sarah. A big, big thank you to everybody that's joined the call today, particularly to those who asked the questions. If you do have any further questions, I'm available for follow up. And I know that I speak for all of us, when I say that we very much look forward to continue constructive dialogue with all of you during the RIIO-2 process. So with that, thank you very much, and a good afternoon to everybody.

Jonathan Brearley
Thank you.

Marcia Poletti
Thank you.

Operator
This now concludes our conference call. Thank you all for attending. You may now disconnect your lines.