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Transcription

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Speakers: Jonathan Brearley and Akshay Kaul and Martin Young

Presentation

Operator

Hello and welcome to the Ofgem Investor Call. Throughout the call, all participants will be in listen-only mode, and afterwards, there will be a question and answer session. And, just to remind you, this conference call is being recorded. Today I am pleased to present Jonathan Brearley, the Executive Director of Systems and Networks; Akshay Kaul, the Director of Network Price Controls; and Martin Young, Head of Investor Relations. I'll now hand you over to Martin.

Martin Young

Thank you very much, Jerry, and thank you to everybody for joining us today. Today marks another major step in the RIIO-2 process with the publication of our RIIO-2 framework decision. And it's my great pleasure this afternoon to introduce Jonathan Brearley, our Executive Director, Systems and Networks, and Akshay Kaul, Director of Network Price Controls, who will run through a brief presentation before moving on to Q&A.

You should have received the slides, but just in case, the presentation is available on our website www.ofgem.gov.uk, and you can navigate through to the presentation on the investor relations page by clicking on 'about us', followed by 'how we engage' and then finally 'investor relations'.

And with that, I will hand over to Jonathan.

Jonathan Brearley

Thank you, Martin, and depending on where you are in the world, thank you all for joining us, and good morning or good afternoon. Today represents the latest stage in the RIIO-2 journey, following on from the framework consultation that we published in March. Since then, we have continued to enjoy an active exchange of views from a wide range of stakeholders, and I hear from my team some of that's been fairly robust. Back in March, I commented that we do recognise the benefits to all from the regulatory regime for UK energy networks being both stable and predictable. This is a view that we continue to hold.

I also commented that it is equally important to recognise that we face a rapidly changing energy landscape, and that regulation needs to be increasingly flexible to adapt to this change. The continued pace of change in the broader energy sector means that this is of the utmost importance.

Although we have not updated the cost of equity today, we reiterate that this will be a tougher price control for network companies, but that also that we welcome outperformance against tougher targets, and where this results from genuine innovation or efficiency, we will reward companies for doing so. We are convinced that the environment for investors remains attractive as a result of the framework that we're setting out today.

Now I'm going to run you through a short presentation that outlines the key points of today's decision documents, and after this, we'll move straight to questions.

So, first of all, slide 1.

In March, we indicated that the decision document would make a set of decisions on a number of issues, and narrow the range of options in respect of others. These are all summarised in this first slide. In particular, I would just like to highlight a few things.

Firstly, some of the key decisions. We are having a five-year default length for the price control. We are continuing with the planned schedule for price controls, in particular, we are not aligning the electricity transmission and electricity distribution price controls start dates and end dates. We are separating out a price control directly for the electricity system operation reflecting the new governance of the system operator. We are extending the role of competition in all monopoly activities. We are making greater use of uncertainty mechanisms, and more up-to-date setting of outputs. We are not having an early settlement of the price controls for electricity transmission, gas transmission and gas distribution. Equally, we are confirming CAPM as the methodology for estimating the cost of equity, and we are shifting from RPI to CPIH in terms of calculating the RAV and allowed returns. Finally, we are retaining an economic asset life approach for depreciation.

In addition to those decisions, we have narrowed down our options in a number of areas. We have ruled out debt pass-through as a means of setting the cost of debt, but we will continue to examine recalibrating the existing model or moving to partial indexation. We have ruled out moving to a nominal RAV to ensure financeability, but we will continue to explore the two remaining options for financeability. Equally, we have ruled out a hard cap and floor returns adjustment mechanism, but we are continuing to explore other fair returns options.

Moving to slide 2. We do recognise the significant improvements made by companies in stakeholder engagement in RIIO-1 versus previous price controls, but in the framework consultation, we expressed a belief that the process can be improved. Today we are confirming our approach to enhanced engagement and introducing two different models for distribution and transmission. These are set out on this slide.

First of all, for transmission. We will require companies to establish an independently chaired user group to provide us with a public report on their views on the companies' business plans from the perspective of network users. At the distribution level, we will require each company to establish an independently chaired customer engagement group to provide us with a public report on their views on the companies' business plans from the perspective of local stakeholders.

We are also separately establishing a RIIO-2 Challenge Group that covers all sectors, and this level of enhanced engagement will help us to assess and scrutinise business plans effectively. However, the ultimate responsibility to make initial and final determinations remains with Ofgem. We will be updating our guidance for enhanced engagement in due course.

Turning to slide 3. The way that 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 investments.

Against this backdrop, we have confirmed some, and are seeking to further develop other, key proposals for RIIO-2 that we outlined in March.

(i) So, first of all, a reversion to a five-year price control with consideration to some allowances being set for a longer period where we have evidence of significant net benefits to consumers relative to the five-year baseline. We will use the sector-specific price controls to consider any issues that may span across multiple price controls.
(ii) No alignment of the start and end dates of the existing transmission and electricity distribution price controls.
(iii) A separate price control for the system operator in electricity with further work to be carried out on potential regulatory and remuneration models. At this stage, we do not propose a separate gas system operator price control.
(iv) The need for new investment to maximise long-term value for consumers, with a requirement that the company business planning processes subject new investment to higher hurdles.

Moving on to slide 4, innovation and efficiency have the potential to drive down costs and help enable transformation of the energy system, but to a degree innovation should be business as usual for network companies, with innovation stimulus funding provided for projects that demonstrate longer-term consumer value and are at higher risk of delivery. We are retaining an innovation stimulus package, but limited to innovation projects which might not otherwise be delivered under the core RIIO-2 framework. We will carry out further work on three core areas of reform.

So, first of all, increased alignment to energy transition challenges, for example, looking at the way the gas sector might change as a whole; greater coordination with wider public funding ensuring that ourselves, BEIS ,and other funding bodies are using their resources without overlap and to maximum effect. And thirdly, increased third-party engagement, including potential direct access by third-parties outside of the current network companies.

We have observed the benefit competition in network provision through OFTOs, IDNs, interconnectors, and other areas, and intend to extend the role of competition in RIIO-2 where appropriate, and where it provides better value for money for consumers. We propose to use the new separable and value criteria applied to competition in electricity transmission to identify projects suitable for competition in other sectors and we will carry out further work to develop models for early and late stage competition.

Now moving to slide 5. We will also seek to simplify the price control, but we will continue to use outputs and incentives to drive improvement that consumers' value. Where we are confident, we can actually forecast costs, we will reward outperformance, and where it is more difficult to estimate costs, we will use uncertainty mechanisms, including indexation to protect consumers from paying for costs that were not required. We will also establish outputs that are up-to-date when the price control begins, and remain current throughout.

Real price effects, RPEs, are a major contribution to outperformance in RIIO-1 and we will continue to explore their indexation. In March, we commented on the challenges of information asymmetry and set out a number of options to reform the IQI and fast-tracking components of business planning. We have decided to remove early settlement as an option for electricity and gas transmission, and gas distribution, given the degree of concentration in ownership, the lack of comparability between companies in electricity transmission, and an incompatibility with the enhanced engagement process we have set out. However, we recognise that that there may be a need for incentives on companies to submit higher quality business plans and we will consult on this at a sector methodology stage.

We are committed to improving the quality and transparency of financial reporting by the network companies, and we have previously consulted on introducing RIIO accounts. We have decided to defer the introduction of RIIO accounts to RIIO-2 at the earliest, but we will immediately move to strengthen the annual reporting process in RIIO-1, including a transparent assessment of network company performance on financial parameters, including tax and financing, based on both notional and actual gearing. We are convinced that this will bring about improvements in financial reporting.

Turning to slide 6, I would now like to talk about the cost of debt. In March, we presented three options for improvements in our approach to the cost of debt, and today we have ruled out one of these, the pass-through option, due to the poor incentives this creates, and potential cost to consumers. We will further develop the remaining two options, recalibrating the RIIO-1 approach, or moving to partial indexation. We will impose a high bar of evidence that needs to be met before we materially overcome our existing methodology, and will consult on our preferred way forward in December.

The other principal component of the allowed return is the cost of equity, and today we confirm the use of CAPM to estimate it, and the approach to the key parameters as set out in the March consultation. We will estimate the risk-free rate by using the current yields on long-dated index-linked government debt. We will estimate the expected market return by considering the historical long-run average of market returns as a best of objective estimate of investors' expectations of the future. We will estimate forward-looking betas by looking at historical correlations between the share prices of regulated utilities and a stock market index such as the FTSE All Share Index. We will cross-check the calculation against market to asset ratios, and returns bid by investors. Contrary to indications made in March, we are not providing an updated cost of equity range at this time. We will provide an updated range when we publish sector methodologies in December. In the meantime, we will continue to review the calculation of the equity beta and total market returns. We have not ruled out the possible of indexing cost of equity.

We have a duty to secure that efficient companies are able to finance their regulated activities and a lower baseline in RIIO-2 will make it more challenging for companies to meet standard financeability metrics. In March, we identified and consulted on three high level policy options for addressing this challenge. Today we have ruled out moving to a nominal RAV given the potential threat to the perceptions of the stability of the regulatory regime from such a marked change. We will carry out further work on the remaining two options as part of the next stage of the RIIO-2 process. Number one, putting the onus on companies to address through their business plans the issues that we've raised. Two, establishing the concept of a debt floor. There are also additional levers to address financeability including notional gearing and the fast/slow money split, and we will consider these at the same stage.

Moving to slide 7. There are a host of other financial issues that we will take into account as we move forward; and we've summarised these on slide 7.

(i) Number one, corporation tax. In our March consultation, we indicated that we intended to review a number of areas in respect of tax and we outlined three options. Given the complex nature of this area, we will conduct further work before we rule out any options in or out. This forms part of our ring-fence review and we will consult in December on any proposals arising from this work.

(ii) Number two, inflation. In March, we proposed a move away from RPI to CPI or CPIH, and our decision taken today is an intention to move to CPIH. CPIH is seen as the more comprehensive measure of inflation in the household sector, and also aligns us with Ofwat. We will carry out further work to determine whether phasing is necessary for the transition.

(iii) Number three, depreciation. We are maintaining our existing policy of using economic asset lives for depreciation but we will carry out further work on what this means for each of the sectors and set out any sector-specific proposals in December.

(iv) Four, capitalisation rates. We will continue to analyse our policy on capitalisation rates.

(v) Number five, return adjustment mechanisms. In our March consultation, we identified five options that could provide failsafe protection to guard against the risk of systemic higher returns across the sector. Today we have ruled out one of these options, a hard cap and floor given that it would eliminate incentives for the companies to continue efficiencies once the cap is reached. We are continuing to assess the impact of the four remaining options. First of all, discretionary adjustment; second, constraining totex and output incentives; third, examining the role of the RORE sharing factors, something we've called sculpted sharing factors; and four, anchoring returns at some level or at indeed at some cap level. We will consult on these in December.

Moving to slide 9. We've set out an indicative timeline for the RIIO-2 process. We intent to consult at a sector specfic level in December, arriving at the decisions in Q2 2019. Business plans are to be submitted in Q4 2019, and we expect to issue draft determinations in Q2 2020, with final determinations in November 2020.

Before we move to questions, I would like to repeat my concluding remarks of last March. We are facing a significant period of change in network usage, and although RIIO-1 has generally worked well, we have learnt lessons. We 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. However, this will be a tougher price control for network companies, and returns on average may well turn out to be different those in the existing price controls, but those who deliver great customer service at lower cost will be rewarded. We firmly believe that UK networks remain an attractive environment for investors, but returns should reflect a low level of risk of a stable and predictable regulatory framework. We remain very much open to dialogue with analysts and investors alike, and please feel free to reach out to us through Martin.

And with that, I will now hand back to Martin.

Martin Young
Thank you, Jonathan. And Jerry, if we could now poll for questions. We do only have until 4:30 pm, so if I could ask that those who wish to ask questions, limit themselves to a maximum of two questions of each. Jerry, please can we take the first question?

Q&A

Operator
Thank you very much, and our first question comes from the line of Chris Laybutt of JP Morgan. Please go ahead. Your line is now open.

Chris Laybutt
Good morning, everyone, or good afternoon should I say. Just a question on the return adjustment mechanisms. You've dropped one of the five suggested mechanisms, and I think it's fairly clear which options are preferred by the networks, but could you provide a sense for what the pecking order might be in your initial discussions internally, please?

Jonathan Brearley
So, look, I think it's too early for us to give any indication of where our preferences lie. We understand that this is a controversial issue for the industry itself. We have highlighted what we think is our worry about the next set of price controls, which is this issue, that no matter how hard we work, we may end up systemically not only with outperformance but underperformance as well, and what we're saying here is we have four options on the table remaining to do so. The reason we ruled out the hard cap and floor is simply we cannot see how that works, because it simply dulls incentives right at the point that where you want companies to work the hardest.

Chris Laybutt

And just one quick follow-up, please. In terms of the factors that are listed on say Page 7 of the slide deck, you're consulting in December on a range of issues. Does that mean that we will see a decision on those during 2019 which will relate to electricity distribution as well, and can you just run through how that process will work given you actually will be sort of combining those processes together?

Akshay Kaul

Yes. So, I think as you rightly say in 2019, we will make sector-specific methodology decisions on the first three sectors that are gas transmission, gas distribution and electricity transmission. In general, for something like fair returns mechanisms, what we're seeking to do, when we do make those decisions, is to set out the design principles on the basis of which those decisions have been taken, because it is possible that some sector characteristics may mean that the application of those design principles varies between the sectors. So, to take just an example, early settlement is a good example of something where we have a general design principle that we should only apply early settlement in those cases where there is sufficient comparability and competition between the companies. Those conditions are not satisfied in the electricity transmission sector, but we think they are satisfied in the electricity distribution sector.

So, when we make the decisions, and we consult on them in December, and when we make the final decisions in 2019, we will be careful to set out the common design principles based on which those decisions have been taken. And, when we come to the sector methodology for electricity distribution, which will probably be sometime 18 months or so later, we will reassess the application of those principles taking account of what we have learned in the meantime through the implementation of RIIO-2. And the decision for ED2, the final decision for ED2, will be taken as part of its sector-specific methodology which will be, as I say, sometime after the first three sectors.

Chris Laybutt

So, in terms of the design principles, I mean, specifically the ensuring fair returns elements, will there be a separate decision published on those issues, or that particular issue, or will that be form part of the various decisions for the various different sub-sectors?

Akshay Kaul

So, I think we will have a common cross-sectoral design principle and then that will see applications across the sectors based on their specific characteristics.

Chris Laybutt

Great. Okay, thank you. Very clear. Thank you.

Operator

Thank you. Our next question comes from the line of Maurice Choy of RBC. Please go ahead, your line is now open.

Maurice Choy

Thank you and good afternoon. Two questions from me. The first question goes back again to the backstop mechanisms. If I'm not mistaken, you are somewhat alluding to the potential that all four sectors may have different backstop mechanisms. Would you confirm that that is a possibility, and if so, I guess how could you justify that to be true if they are facing similar risks and perhaps similar returns?

And, then the second question is really backing to the CPIH conversion. Obviously, you're not looking to align the key sectors in terms of regulatory periods, but if you're giving the CFOs just a few years in terms of information of what type of phasing you may look at from RPI to CPIH, how do you then see their ability to raise similar or matching debt especially given the CPI debt as well as RPI/CPI swaps are quite illiquid these days? Thank you.

Jonathan Brearley

Okay, I'll take the first one and I'll hand the second one over to Akshay. I mean, on fair returns, it's pretty clear that some of these are about comparability between different companies. So, some of the options are about your position relative to others for example. And so, therefore, you do have to look at the different sectors and what the benchmarks might be within those sectors. So, all I'd say at this stage is that we are looking to find an answer to the problem that I highlighted. That is the common problem across all of the network sectors and there is a common risk there. There may well be a differential approach simply because you have different circumstances in different parts of the network and therefore you might end up with a combination, or a very different combination of things in different areas. But again, just to emphasise, right now we are not ruling that out or ruling that in. We are simply saying that we are looking further about this and we'll come forward with a position in December.

And on CPIH and debt?

Akshay Kaul
Yeah, so I think the question was about the phasing of the approach and how company financial CFOs would take that into account in raising debt in the future. So, I think at the moment, our decision is to indicate a clear direction of travel towards CPIH. We haven't yet decided whether we make that transition in one go at the start of RIIO-2, or whether we phase it in as Ofwat have done in their control, PR19 control. I think one of the things we recognise is the difference between the water sector where there a much higher proportion of debt is index-linked, compared to the energy sector where a much lower proportion of debt is index-linked. That probably gives us and the companies comparatively greater room for manoeuvre if you wanted to move faster towards the CPIH index, we potentially could do so.

I think I should also mention in the slide that we got to look at the issue of the cost, the CPIH transition, and the cost of debt financeability in the round, because we think that one of the effects of moving from RPI to CPIH, particularly moving immediately to CPIH, will be to, all other things being equal, to increase the cash flow to companies over the RIIO-2 period, which in the context of a potentially lower cost of equity compared to the RIIO-1 settlement should help with sustaining their credit metrics, and sustaining their financeability positioning. But as I say, we'll be working with the companies and the CFOs between now and December, trying to understand what challenges, if any, the transition from RPI and CPIH may pose for them, and we will take a decision on phasing accordingly.

Maurice Choy
Just to follow-up on that. Can I just get your confirmation again that whatever phasing that you do choose will still be one where you make the companies whole, or NPV neutral?

Akshay Kaul
Yes.

Maurice Choy
Thank you.

Operator
Thank you. Our next question comes from the line of Deepa Venkateswaran of Bernstein. Please go ahead. Your line is now open.

Deepa Venkateswaran
Thank you. I had a question on the Hinkley-Seabank. I appreciate this conference call is not entirely around that, but given that it is quite moot. So, one question I had is that your blended WACC, so if I take a blend of the construction and operation, it comes out really low at around 1%. I presume National Grid shareholders will not be too happy with that. So, I want to understand at what stage can National Grid challenge this decision. Is it kind of 30 or 60 days from today or is it later when you will come up with a precise point estimate on WACC?

And I guess the second question I had was related to I think what you talked about on RPI-CPI, because I think in the consultation document, you say that if you phase it in immediately, that's like a £15 increase, and I think overall the cost of equity reduction was quantified at £15 or £25. So, to me, it feels like RPI-CPI would eat away most of the savings to customers from a lower cost of equity. So, surely, that should drive or do you think that that's actually not very relevant in how you set the final decision on phasing? Thank you.

Jonathan Brearley
I think on the first question, sorry to not give you a perfect answer, but I think you need to talk to National Grid about when they feel they can challenge and under what circumstances. So, therefore, I'd advise you to speak directly to them about that. Suffice

to say, we are trying to find a balance for the Hinkley consultation to make sure that we can reflect the benefits of competition which is what we set out today.

On the second question, I'm going to hand over to Akshay in terms of the relative impact of customer bills.

Akshay Kaul

Hi Deepa. So, I think your question was about the extent to which to move from RPI to CPIH will offset the reduction of the cost of equity. I think you're right that in cash terms over the RIIO-2 period, there will be an offset, which is what I was referring to when I said if you take a look at the financeability of companies, you have to look at it in the round, keeping both the reduction in the cost of equity and the increase in cash flow both [inaudible] switch to CPIH in your mind. Over the longer term, consumers and companies are in fact NPV neutral. So, in terms of the overall bill impacts from the cost of equity going down, that will remain value positive for consumers, but the only difference will be the timing of when they see the cash savings. The charges will be higher in relative terms in the RIIO-2 period than they would have been had we persisted with RPI, but they will be lower in the RIIO-3 and RIIO-4 period than they would have been otherwise. I believe we think it's overall a very value-positive thing to consumers to move to a more comprehensive inflation index. We think it also helps in the RIIO-2 period in terms of cash flows and financeability metrics; and, obviously, we will take into account the speed of transition when we talk with CFOs and the companies between now and December.

Jonathan Brearley

I think the other thing I would emphasise on the overall impact on consumers in the RIIO-2 period, there are a number of moving parts of the price control, of which we have highlighted two. Once we have a more comprehensive set of effects as a whole, we'll update our assessment what the impact might be for consumers even in the RIIO-2 period.

Deepa Venkateswaran

Okay. Thank you.

Operator

Thank you. We'll now go to our next question, which is from the line of Lakis Athanasiou of Agency Partners. Please go ahead. Your line is now open.

Lakis Athanasiou

Hi guys. Two questions from me. The first one is on notional gearing. I know you said you're going to come out with final decisions in December, but can you give us an idea at this stage about the things that will drive your decision on notional gearing, and maybe even the kind of direction of travel if possible at this stage?

And my second question is on financial reporting. I see that you've dropped the idea of detailed RIIO accounts, which I think is an excellent thing to do, but you're still not indicating that you're going to do the thing that you really do need to do which is to provide the linkage between IFRS accounts and the numbers within the price control financial models and the license-driven revenue adjustments. And frankly, without something like that, the IFRS accounts/regulatory accounts are pretty much a un-analysable. Water sector have been doing this for years. I don't see why you guys can't do it. It's something that would be so easy to do and actually make the financial accounts that have been reported now actually useful.

Jonathan Brearley

Okay. I'm going to say a little bit on notional gearing, but actually I'm going to hand over to Akshay for both questions to comment. There is a balanced judgment on how we set the notional gearing. I don't think we can give a direct of travel right now I'm afraid. There are number of factors that drive our assessment, but actually, I will hand over to Akshay to give you the details of that, and he will update us on RIIO accounts.

Akshay Kaul

Allright. Well, thank you for those two questions. So on notional gearing, I think we will keep the approach we've had in the past, to look at the size of the equity wedge in relation to how much risk is carried by the companies in their business plans, and we ultimately will make a decision on notional gearing only in the initial determinations in 2020. I think in December, we will set out general principles for how we approach notional gearing, but I'm not expecting them to be dramatically different. The equity wedge, as I say, should reflect the underlying degree of risk that the companies face in the price control.

To the extent that we materially offer some more risk protections to companies in the design of the framework between now and December, we obviously will take that time into account in deciding whether the level of notional gearing should be higher or lower. But that would be the basic design principle.

On your question on RIIO accounts, I think that's an excellent observation. And indeed, the team here is absolutely going to work with stakeholders to improve our annual reporting product so that we get a much more transparent link with the IFRS accounts, and stakeholders such as yourselves can actually analyse the information that we have put out there. I think the key thing for us is we want to do what is effective for stakeholders. We want to produce a comprehensive, accurate, transparent and accessible set of accounts. We think that this is much better achieved if we have a single authoritative source of those figures coming out of Ofgem in a consistent way that is reported by the companies, and we will indeed be asking the companies to reconcile those numbers with their IFRS accounts and publish those openly. So, please do engage with the team over the next few months to ensure that we make the necessary improvements. As you say, this is not difficult and effectively [inaudible] doing a lot of this, we used to do quite a lot of this, and we would very much like to set the gold standard in transparent financial [inaudible].

Speaker
I actually see no reason why you can't get them to do something for this year published as a separate sheet. It's one sheet of paper. It isn't anything more, and would actually make the regulatory accounts useful. I really don't understand this blind spot that you guys have on this.

Martin Young
I think if we can direct you to page 9 in the framework decision Lakis, there is reference to an open letter which is in the offing. It's been promised for August, so hopefully sooner than that rather than later with the sort of the next steps that we'll be taking in respect of financial reporting. So, hopefully when that comes out, you'll agree that there are improvements that are being proposed and improvements that will hit the ground in a timely manner.

Lakis Athanasiou
Okay. Thank you.

Operator
Thank you. Our next question comes from the line of Ali Agar of SunTrust. Please go ahead. Your line is now open.

Ali Agar
Thank you. Good afternoon. My first question was just to clarify, I think, a point you had made earlier in response to the previous question. So, in the notion or in the context of financeability, if, as we expect, the cost of equity will be lower for companies in RIIO-2, which presumably increases their risk profile, should we assume that, conceptually, one way to mitigate that would be to have a higher equity layer authorised for the [inaudible] companies? Is that a fair way to be thinking about balancing the risk and the financeabiity for these companies?

Akshay Kaul
Not really. I think the size of the equity wedge should reflect the riskiness of the price control settlement for companies and how much equity buffer they need to have to withstand the variation in revenues caused by, for instance, our incentive mechanisms. I think, certainly, if we were increasing the power of those incentive mechanisms and increasing the extent to which there could be downside penalties, we would look again at the equity wedge and consider whether it should be higher than we have proposed in the past.

But equally, to the extent that we are limiting the range of those mechanisms and providing other risk protections for the companies, such as the indexation of the equity, or the concept of the debt floor that Jonathan mentioned, we will again consider whether there is merit in going in the other direction, to have a lower equity wedge because there is less risk in the price controls for investors. And, be the case that there's less risk in the price controls for investors, we will generally seek to associate that with a lower cost of equity than we otherwise be the case.

Ali Agar
I see. So, the…

Jonathan Brearley
So, one thing I would add is, you know, we are taking a fresh look at some of these issues. So, you know, there is not an assumption that everything is right in the existing framework. So, we will be looking at the overall risk and then matching our assessment of equity, equity returns and debt returns as a part of that.

Ali Agar
I see. So, just the concept of a lower cost of equity in your minds would not equate to a higher risk profile for the companies.

Akshay Kaul
Yeah. So, it's the other way around I think in some ways.

Ali Agar
Yes. And my second question, just to also be clear on the process, you know, this is still a couple of years out, and for the electric distribution companies until 2023. So, is it fair that the mechanisms or the process is now set, and regardless of if there is a change in government, for example, in the UK, that this process would continue or is that subject to change if there is a political change over the next, you know, three to five-year period?

Jonathan Brearley
So, we are a regulator. We are a public body and we are a creature of statute. So, what we, you know, what controls Ofgem business as a whole is run by parliament. So, if there is a change in government and there's a change in parliamentary decision making, then that could lead to a change in this process. However, I continually point back to the very, very strong record the UK has, not only in the energy sector, but across all sectors in providing stable and predictable regulation, and we think that's something that we'll continue to build on.

Ali Agar
Thank you.

Operator
Thank you. Before we go to our next question, may I remind everyone that if you wish to ask a question, please press zero one on your telephone keypads. If you wish to withdraw your question, you may do so by pressing zero two to cancel.

And our next question comes from the line of Dominic Nash of Macquarie Securities. Please go ahead. Your line is now open.

Dominic Nash
Yes. Good afternoon. I've got a couple of questions. Firstly, on equity indexation, which I think is quite an interesting approach that you've adopted here. Is it possible to give us, have you actually explored that in more detail, and what you're sort of leaning towards as your preferred options here, or have you decided to sort of park all of this?

And my second question. There seems to be quite a lot of non-decisions still, and were you expecting to be sort of slightly more advanced on your decisions at this stage or are we at risk of having to run through decisions each time for electricity transmission, electricity distribution, and gas transmission or gas distribution as we go forward from here? Thank you.

Jonathan Brearley
And so, let me take the second question, and I'll hand over to Akshay to add something if he wants to, and answer the first one on equity indexation. We've always envisaged setting up a framework as a whole at the end of the year, this year. So, there are a number of different parts of this framework that are quite [inaudible] together, and I think we felt at this stage that what we wanted to do is give an indication of direction of travel, but until we have the framework as a whole set out, I don't think it will make sense to go further than we have gone today, but we are intending to give ourselves a good basis for making more detailed decisions as part of the sectoral strategies.

And I will hand over to Akshay on equity indexation.

Akshay Kaul

Yeah, thanks [inaudible]. So, on equity indexation, essentially our approach to this is informed, really, by the same approach we're taking to other aspects for the price control where we face the choice between making a forecast of parameter, or indexing it. So, for instance, we've talked about real price effects, I think where we can index those, we would probably prefer having learned the lessons from RIIO-1, to index them, rather than trying make a forecast of them.

Now, on the cost of equity side, I think if you just very simplistically break it down into a risk-free rate and a risk premium, I think that it will not be unreasonable for investors to expect – if you are fixing the cost of equity without any indexation – to expect some assessment of how risk-free, underlying risk-free rates, might move in the economy over the RIIO-2 period. And again we face similar choice there, between whether we should try and forecast how those rates might move, or indeed whether if we have a relatively simple and transparent way of indexing to a [inaudible] credible index, whether we simply just index, and on a year to year basis, we allow the index to move. And so, investors are protected, but also consumers are protected because we don't have to then make a forecast of how those rates might change.

That's essentially the choice. I think we put forward a method of indexation, a specific method of indexation, in the consultation document. I think it was so terse and so brief that not that many stakeholders paid that much attention to it. We didn't get a lot of reactions to it. So, you know, in our decision document today, we have again directed the attention of stakeholders to that proposal. It's a relatively simple proposal to index the cost of equity to the risk-free rates, but with a recognition that the beta factors should be taken into account, and we look forward to engaging on that.

We make a final decision on this, obviously, as far as the sector methodologies as Jonathan said, but we will consult in December again on our preferred approach. But, as I said, just go back to our first principles, which is where we have choices between making forecasts and making a link to an index, in general, we will be seeking to explore the links to an index.

Dominic Nash

Okay, thank you. Quickly to follow-up on something, just a point of clarity. Did you say earlier that the cost of equity will be fixed on a risk-free based on current forward rates, and then you're going to be using historical averages and forward looking rates for the interest premium in the beta? And, if that is what you said, do you think that is actually a consistent methodology; because I kind of feel it isn't?

Akshay Kaul

Sorry, could you just repeat the question.

Dominic Nash

Yeah, sorry. Earlier in the, earlier on this call, you mentioned that you're calculating the cost of equity based on the current risk-free rate on the forward looking rates, and then you're going to be using a mix of historical forward-looking for equity risk premiums and betas. And the question I've got is, is that actually a consistent way of doing it or are you going to actually try and – I mean, it's just seems wrong to me.

Akshay Kaul

You know, I wanted to [inaudible] to the risk-free rates. I think we do the same method to estimate the risk-free rate on a forward basis. All I was saying was is that when you do that for the cost of equity calculation, we have a choice about whether we use the spot forward rate as it was at the beginning of the RIIO-2 period and then make some forecast about how that rate would move over the RIIO-2 period, or whether in fact we just index the calculation, assuming a relatively stable beta and a relatively stable total market return.

So, the proposal we made at the decision document was to think about using a stable beta and a stable total market return, and allowing one minor [inaudible] change in the risk-free rate to pass through into the calculation. So, we don't think there's any inconsistency in the methodology. It's just that there is a choice between simplicity and accuracy. There's always a choice in price control between simplicity and accuracy.

We think the consumers will be better off, in general, if the price control if we avoid making forecasting errors, but equally we recognised that introducing indexation brings with it, its own complications. So, it's a balanced judgement, but we would be looking to engage again with stakeholders on the question of cost of equity indexation, and then set out a fresh set of proposals for December.

Dominic Nash
Thank you.

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

Mark Freshney
Hello, good afternoon. Could I please come back to the Hinkley-Seabank consultation, or decision document, and how that fits into RIIO-2 because it would seem to me that if the large, chunky parts of capex are taken out and put in another lower returning project finance type company or RAB, if you like, that will reduce asset based growth, increase cash flows of the remaining core RAB, if you like, and we'd start to get a business which looks more like something between a company that maintains pipes and wires, and is run-off of historical investments, than something which, from a management viewpoint, is exciting, where there's a scope to get substantial cost out on large new assets. So, have you thought about how competitive tendering and your approach to competitive tendering is actually changing the risk profile of, you know, the core RAB if you like?

Jonathan Brearley
So, when we – when we have thought through the Hinkley-Seabank consultation process, yes, we have thought about the interaction between the existing price controls, and, in essence, the existing assets that are under the price control framework. And we have had substantial evidence that where you put new assets, or indeed new-built assets into the competitive framework, that net-net does give significant benefits to the consumers.

I would challenge the idea that there is not an exciting business outside of simply one transmission link to Hinkley and other network – new pieces of network – that might be made. And I would, sort of, quite vigorously, sort of assert that there is a huge amount of cost reduction work that the existing companies can do, particularly in the light of the sort of transition we're going through, the sort of changes we're seeing on the network.

If I can personally have to highlight one of the biggest challenges we'll face over the next ten years, it's the efficient use of the assets we have, and that is, at the heart of what makes us and other companies what are doing.

Mark Freshney
Okay. Thank you very much.

Operator
Thank you. Our next question comes from the line of Ashley Thomas of Millennium. Please go ahead. Your line is now open.

Ashley Thomas
Yeah, hi there, good afternoon. I had two follow-ups on prior queries. Actually, one is on Hinkley. I don't think we're actually at a stage of competitive tendering, so my query was actually on the competition proxies to Hinkley. On EDMPR, you estimated that

there was scope for up to 680 million of consumer savings from reviewing incentives, but you concluded that that will be more than offset by 50bp increase in the cost of equity for all networks due to higher regulatory uncertainty. For Hinkley, you've reduced your consumer saving estimate from over 100 million to 50 to 100 million, but in the impact assessment, there was no reference made to any offsetting costs from higher regulatory uncertainty. So, I just wanted to ask – so, the two questions.

One, why was sort of regulatory uncertainty considered for one decision and not the other? And do you really think there hasn't been any regulatory uncertainty introduced by pushing through sort of the competition proxy decision, when it could be argued, you know, that wasn't really in the initial RIIO framework? So, that was my first question.

And the second was actually really just to echo Lakis' comments on reconciliation on the regulatory accounts in IFRS. You know, if we could have something akin to the segmental statements, pretty much as soon as possible, but could they then be policed, because we have an issue on retail that for the companies, they are not on the same accounting basis you know, sort of some capitalise DCC costs, some expense them. So, those are the two queries.

Jonathan Brearley

In terms of the first, we are very clear with the document we have published that we have flagged the issue of competition throughout the RIIO-1 process, and therefore, we think that this was clearly signposted. Clearly what hasn't happened is the legislative framework hasn't changed, so the competition proxy is taking advantage of what we think a competitive framework would bring. So, I think that's very different to the EDMPR decision. But really, we we're saying, look, if we were to expand the scope beyond the stated rules in the price control, what impact would that have on regulatory uncertainty? And that's what drove that impact assessment. We have two very, very different sets of circumstances and that's why the comparison is very different in terms of how we do them.

And again, on segmented statements.

Ashley Thomas

Okay. Sorry, Jonathan. So, unlike the sort of investor analysis feedback you've had even on this call, you don't think there's been any higher regulatory uncertainty?

Jonathan Brearley

So, I'm not going to give definitive statements on this call, particularly given the sorts of discussions we're having right now. But we've set a set our position out very clearly in the Hinkley document we published today, and we do believe we flagged that this could be under some kind of competitive regime very early on in the RIIO-1 framework.

Ashley Thomas

Okay.

Akshay Kaul

So just on IFRS and segmental accounts, yes, I think the intention is very much is to get the companies to produce a reconciliation with IFRS. I just want to be a little cautious in terms of the speed at which we can get consistent reporting with the companies. We certainly will get them to improve this for the current annual reporting product. So, my sense is the team will do a bit of work with the companies to make sure that the accounting is being applied and the costs are being calculated in exactly the same way.

I should just say that in terms of the improvements we are seeking to put through this year, the most basic set of improvements we want is for the annual reporting to include an assessment of the performance on finance and tax alongside the performance on totex and incentives, which they currently do, and to produce a relatively transparent account of the effects of notional versus actual gearing. And then I think we want to consider if they can move one step beyond that to also bring into play the effects on cash flows from the various MODs and reopener mechanisms that we operate, and to give a relatively transparent account of what effects they think closeout mechanisms are likely to have on their cash flows in a kind of enduring value adjustment.

I think that latter one very, very hard to do because it means making a forecast of where the companies might end up at the end of the RIIO-1 period. So, I'm going to be a little realistic about the expectations on that front. But certainly, in terms of having a much, much better sense of finance and tax and notional versus actual gearing and a full reconciliation of the data which they provide us with their IFRS accounts, I don't see any problems with that.

Ashley Thomas

That would be great. That would be very useful. Thank you.

Operator

Thank you. Our next question comes from the line of Orlando Finzi of M&G Investments. Please go ahead, your line is now open.

Orlando Finzi

Good afternoon, gentlemen. I just wanted it to pick-up on the RPI-CPIH transition. I'm sort of curious there, I mean, you've obviously made quite a firm decision it's the right route to go down on CPIH, but you are probably aware also that the House of Lords is still consulting at the moment on the road of RPI and future inflation indices. And you know, I guess it sounds like you're a bit like Ofwat making a decision, you know, ahead of any government decision as to which index will actually be formally used. I'm just curious if, you know, they come out with something that's a bit more definitive or steering towards later on this year, will that alter your opinion or are you wedded to CPIH even if we ultimately never have a CPIH bond, a government bond curve, which if we don't obviously will make funding in CPI efficiently quite difficult. I'm just sort of curious on your perspective around this, so I guess the lead from government on all of that.

Akshay Kaul

Yeah, thanks, Orlando. You're right that there's quite a lot of work going on in government in terms of looking at different inflation indices. I think what we're doing [inaudible] is responding to two things. First of all, the ONS itself has adopted CPIH as its preferred headline measure of inflation. And since our principle in applying indexation to price control is to use an accurate measure of inflation to index the RAV, so that there is a measure of inter-generational equity between different groups of consumers, we think it makes logical sense to move to CPIH because it is the more comprehensive measure of inflation seeing as it includes [inaudible] housing costs.

Having said that, in the decision document we published today, we have made note of the fact that we won't actually be implementing this until 2020 at the earliest. And between now and then, I think we'll be looking at a number of factors that will affect the final-final decision when we do implement this, including the data sets that the ONS produces, including where the government, indeed as you say, might move in terms of inflation targeting, and including whether or not the financial markets start to move towards more CPI/CPIH linked product.

At the moment, the distinction between CPI and CPIH is minuscule, vanishingly small. So, we don't see that there's that much in it. But if the financial markets for instance may have a marked preference in favour of CPI linked products over CPIH, and that is obviously something we would need to take into account in 2020.

Orlando Finzi

And just to check on that, I mean, if government did actually decide that maintaining RPI was the right way forward, from a British perspective in a Brexit world, i.e. an RPI that's perhaps better managed, possibly closer to CPIH in its value through a clearer management of indices, would you reverse back to RPI or are you wedded for other reasons to CPIH? I'm just sort of curious on the sort of pull or push just as to sort of stress that point.

Akshay Kaul

I think our primary driver is the ONS and where they go in terms of the preferred headline measure of inflation. As long as they maintain CPIH as the preferred headline measure of inflation, we're going to stick with CPIH as a method of indexing the RAV. What could cause us to reconsider is if, for instance, there becomes a marked deviation between CPI and CPIH and financial markets have a marked preference one way or the other, then I think we would be at least pause to reconsider before going fully forward. But as say, at the moment, the data indicates that the difference between them is vanishingly small. And so, what we have highlighted today is just our current direction of travel is to move in favour of CPIH.

Operator

Thank you. Our next question comes from the line of Matthew Lacutra of KPMG. Please go ahead. Your line is now open.

Matthew Lacutra

Thank you very much. I have two short questions. One question is in regards to WACC, whether you're considering or planning to consider any differentiation in the WACC across the companies due to leverage for within a particular control. Obviously, what I had in mind is any mechanism similar to what Ofwat are proposing to introduce in financial outperformance consultation.

And the second question, in relation to indexation, can you confirm that subject to any decision on the transition period, you're going to be using the same types of mechanism that Ofwat has introduced and whether you're going to be publishing the model to illustrate that? Thank you.

Akshay Kaul

Okay. Thanks, Matt. So, I think your question was about differentiation due to differences in actual vs. notional leverage. So, at the moment, I think that where we are going with this is that we're looking, first of all, at the cost of debt method, allowance setting method itself to make sure that is something that is in the interest of consumers, and protects consumers over the long-term.

We have indicated in the decision document that we are exploring whether there is a case for introducing a sharing factor into the financial performance, and whether those financial outperformance and underperformance should be shared in some way between companies and consumers in the way that protects outperformance and underperformance is shared. And that's I think what we see as the principle means of thinking about the legitimacy issues around this space.

I think as far as the gearing is concerned, Ofwat has a particular [inaudible] on that in their sector, there are particular issues in their sector which has caused them to look at it in a particular light. I think what I would say at this stage is where we are going with it is at this stage is simply to collect the facts on how companies are financing themselves, how they've organised their tax structures, how they are setting out intra-group arrangements and the way that they finance themselves within and outside of the ringfence.

The only thing we're doing at the moment is fact finding, and if that reveals to us that there is some reason for us to be concerned about the price that the consumer pays for network services, for instance, because our notional gearing levels are set artificially low or artificially high, then we will, of course, consider that as part of our December package. And equally, we will take a look at whether the way in which we set tax allowances is adequate to protect consumers in the same light. So, for instance, if there are systematic deviations between tax allowed and tax paid and the reasons for that are something to do with defects in the way that our price control framework operates, then we will seek to fix those, but we are not at this stage seeking to create differentiation in terms of the leverage position of the companies in the way that Ofwat has done.

Matthew Lacutra

Okay. Thank you. My second questions was in relation to the indexation mechanism and the model for that. Thank you.

Akshay Kaul

Yes. So, I think we've said if we move to a transition period, I think we will be looking to do roughly what Ofwat has done which is to think about keeping RPI indexation for the embedded capital and moving to CPIH linked indexation for new additions to the RAV, and yes we will be very transparent about this in terms of how we modelled the issue.

Matthew Lacutra

Okay. Thank you.

Operator

Thank you. Our next question comes from the line of Verity Mitchell of HSBC. Please go ahead. Your line is now open.

Verity Mitchell

Good afternoon. I've just got one question which is about the transfer. I'm just looking at your bullet points about network utilization stranded and investment risk, and new investment to high hurdles. Is there a feeling that there should be further investment risk transferred over to the companies in this methodology?

Akshay Kaul

Well, I think there are a couple of things to say in respect of new investments. Firstly, I think we would like to think about testing new investment against non-traditional options, what you might call non-wire options with the electricity side. We want the companies to fully work through whether there are demand side responses and more flexible, storage-based solutions for instance that might remove or reduce the need for network reinforcement as solutions to network constraints.

And secondly, I think we are quite keen to think about a slightly more flexible approach in terms of how these decisions are made across the sector. So, if there is a network constraint in one sector, we are quite interested in thinking about how that might be notified across the whole system and give other stakeholders a chance to participate. For instance, a DNO might have a solution to a constraint in the transmission system, and we want to just work through whether there are any particular barriers that prevent us from enabling that DNO from proposing solutions to that transmission network constraint or vice versa.

More broadly, I think there is a question mark about new investments in sectors which face a significant amount of demand uncertainty in the future. And this is particularly true I think for the gas sector. And where the gas sector is proposing significant new investment, I think we'll be looking to think about that quite carefully in the context of what kind of stranding risks consumers might be exposed to.

And as you say, one of the solutions – I'm not saying this is necessarily the right solution, the best solution, but one of the solutions to something like that could well be to think about creating slightly different allocation of risk for those sorts of investments where we say to the companies, well you might take more risk of stranding and in exchange you might get a higher return.

So, all we highlight at this stage is that is a possibility but we certainly want to be a lot more careful in those sorts of sectors before we allow significant new additions to feed through into the RAV because we face a degree of demand uncertainty in the future.

Jonathan Brearley

So Verity, all I would add is that this is another component of trying to manage a price control in what is a very fast changing sector. So, this will be an element of that.

Verity Mitchell

Thanks.

Operator

Thank you. Just to remind participants again, if you would like to ask a question, please press zero one on your telephone keypads now. And our next question comes from the line of Greg Orrill of UBS. Please go ahead, your line is now open.

Greg Orrill

Yes, thank you. What does the document conclude about depreciation with regards to electric distribution?

Akshay Kaul

It doesn't make any conclusions about depreciation with respect to electricity distribution. I think we say that we are going to essentially maintain our current approach, which is to depreciate the RAV over the approximate useful life of network assets. And in RIIO-1 we did accelerate depreciation in the gas sector. We will again revisit the issue of the rate of depreciation in the context of each of the sectors for their methodologies in December. We don't expect to change the principle, but it is something that we will look at in December in terms of how do we look at the useful economic life of the assets in the context of each of the sectors.

Greg Orrill

And does that apply – would you make a decision on electric distribution in December?

Akshay Kaul

No.

Greg Worrall

Okay. Allright, thank you.

Operator

Thank you. Our next question comes from the line of Nicholas Campanella of Bank of America Merrill Lynch. Please go ahead, your line is now open.

Nicholas Campanella

Hey, thanks for taking my question. Sorry if you already mentioned it, but could you just talk about the ruling out of the hard caps and floors, and just expand on your decision there? I just wanted to get some more information about how you're thinking about the remaining return adjustment mechanisms. It just seems that there were several contrasting arguments as to why or why not they should be included in the price review. So, I just wanted to be clear on your expectation to include the remaining four RAMs or not.

Jonathan Brearley

So, just sort of take us back to the issue we are trying to address with the returns adjustment mechanisms. What we always said I think throughout this process, is that even with the best will in the world, these price controls may systemically be out of line with actuals. And therefore, companies may be under or indeed over [inaudible], under-rewarded. Therefore, we were looking at different ways in which we might address this.

The one we have ruled out is the one that says we have a hard cap and a hard floor on returns. And the reason we ruled this out is because when you hit either of those two things, you instantly dull all of the incentives for those companies to further increase efficiency. And this may well be at the time you want them to work the hardest, a time when they want to be really pushing to continue to drive cost out for consumers. Therefore, we think there are other better mechanisms within the list of the remaining four. However, we have not yet come to conclusion about which out of those four we might use.

Nicholas Campanella

Is it clear at this point that nothing else can be introduced in terms of the incentive and RAM metrics?

Jonathan Brearley

I think we are still working on all of that, and so I would say, you know, this is an indication of where we are now. We're not absolutely ruling out a further option should it come up when we design the incentives, for example.

Nicholas Campanella

Thank you.

Operator

Thank you. As we have no further questions on the line, I will hand the call back to our speakers for closing comments.

Martin Young

Thanks very much to everybody for joining today. I did want to point out that the call has been recorded. There will be a transcript. So, when those are both available, we'll make those available via our website for people to go back through if they so wish. What I did want to say, though, was a big, big thank you to everybody, both on behalf of myself and the team here. We very much look forward to continued constructive dialogue with you all. If you do have any follow-up, please feel free to get in touch whenever.

And with that, thank you very much and good afternoon.

Operator

This now concludes our call. Thank you for attending. Participants, you may disconnect your lines.