

RIO-2 Framework Decision Investor Call

30 July 2018

ofgem

- **Firm decisions**

- Enhanced engagement model for RII0-2; open hearings to focus on areas of disagreement/contention
- Five year default length for the price control
- No alignment of electricity transmission and electricity distribution price control start and end dates
- Separate Electricity System Operator price control
- Retention of an innovation stimulus package, albeit reformed
- Extending the role of competition
- Greater use of uncertainty mechanisms, and more up-to-date setting of outputs
- No early settlement for electricity transmission, gas transmission, and gas distribution
- CAPM to be used to estimate cost of equity
- Shift from RPI to CPIH in calculating RAV and allowed returns
- Economic asset life approach retained for depreciation

- **Narrowing down options**

- Debt pass-through ruled out; examining recalibrating the existing model, or moving to partial indexation
- Ruling out nominal RAV; exploring the two remaining options to address financeability
- Ruling out hard cap and floor returns adjustment mechanism; continuing to explore other fair returns options

Giving consumers a stronger voice

- **Confirmation of approach to enhanced engagement**
 - Transmission companies to each establish a User Group to report their views on company business plans
 - Distribution companies to each establish a Customer Engagement Group to report their views on company business plans
 - Ofgem to establish a RIIIO-2 Challenge Group covering all sectors to further scrutinise business plans
 - Each group to be independently chaired
 - Open hearings to be held before final determinations
 - Focus on areas of disagreement and contention
 - Invite further evidence in support of, or against, company proposals
- **Ofgem retains ultimate responsibility to make initial and final determinations, but evidence from enhanced engagement will be one of the key inputs**
- **Guidance Document for Enhanced Engagement to be updated in due course**

- **Default length of the price control set at five years**
 - Consideration of proposals from companies to set allowances for a longer period for certain activities, but evidence of significant net benefits to consumers relative to a five-year baseline needed
- **No alignment of the start and end dates for the electricity transmission and electricity distribution price controls**
 - Further work to be carried out to investigate if reforms of the price control framework are needed to support delivery of whole system outcomes
 - We intend to clarify the term 'whole-system' in a way that is meaningful in the context of the next price controls, and the appropriate role of companies in supporting the energy transition
- **Separate price control for the Electricity System Operator**
 - Further work to be carried out on potential regulatory and remuneration models
 - Engaging with industry on options in summer 2018
 - At this stage, we do not propose a separate Gas System Operator price control
- **Network utilisation, stranding and investment risk**
 - Company business plans to subject new investment to high hurdles

Driving innovation and efficiency

- **Retain an innovation stimulus package linked to projects which might not otherwise be delivered under the core RII O-2 framework**
 - Further work to be carried out on increased alignment to energy transition challenges, greater coordination with public funding, and increased third party engagement (including potential direct access)
- **Extend the role of competition in monopoly activities**
 - Use of the electricity transmission criteria of new, separable, high value (>£100m capex) in other sectors
 - Further work on how competition might be applied in a given sector
 - Developing the range of models for late competition, and consideration of early models
 - Further work to be carried out on the net benefits of competition in each of the sectors

Simplifying the price control

- **Continued use of outputs and incentives to drive improvements that consumers value**
 - Where we are confident we can accurately forecast costs, we will reward outperformance
 - Arrangements to enable automatic consumer refunds if outputs/deliverables for which funding has been provided are no longer required for reasons beyond the licensees' control
 - Further exploration of the indexing of Real Price Effects
 - Establish outputs that are up to date at the beginning of the price control, and remain current throughout
 - Relative output targets and uncertainty mechanisms to be considered in the context of each sector
- **Information revealing devices**
 - Ruling out early settlement (a component of fast-tracking) for electricity transmission, gas transmission, and gas distribution
 - The option to use early settlement will remain on the table for RIIO-ED2 and will be considered as part of the process of setting the methodology for that sector
 - Business plan incentives, including the role of IQI, to be developed as part of the work on the individual sector methodologies
- **Annual reports/reporting**
 - Formal implementation of RIIO accounts deferred until RIIO-2 at the earliest
 - Strengthened annual reporting programme for the remainder of RIIO-1
 - This will include a transparent assessment of network company performance on financial parameters, including tax and financing, based on both notional and actual gearing

- **Cost of debt**

- Full debt pass-through option ruled out
- Further examination of a recalibration of current full indexation model, and a move to partial indexation
- We note the importance of considering this approach for individual companies in developing sector-specific methodologies
- High bar of evidence for a material change in approach

- **Cost of equity**

- CAPM used to estimate the cost of equity, and setting its key parameters
- Continuing to review the evidence submitted
- Not ruling out cost of equity indexation at this stage
- No update to the indicative range communicated in March, at this stage – we will update in December

- **Financeability**

- Move to nominal RAV ruled out
- Further work to develop remaining options:
 - Putting the onus on the companies to address through their business plans
 - Establishing the concept of a debt floor

- **Corporation tax**

- Review of taxation included in our review of company financial arrangements (“ring-fence review”)
- We will consult in December on any proposals arising from this work

- **Inflation**

- Intention to move away from RPI to CPIH in calculating RAV and allowed returns, with further work on whether a phased transition is needed
- We will make our final decision when we set the methodology for each sector

- **Depreciation**

- Policy of using economic asset lives maintained as the basis for depreciating the RAV
- Further work on what it means for each of the sectors, with any sector-specific proposals set out in December

- **Capitalisation rates**

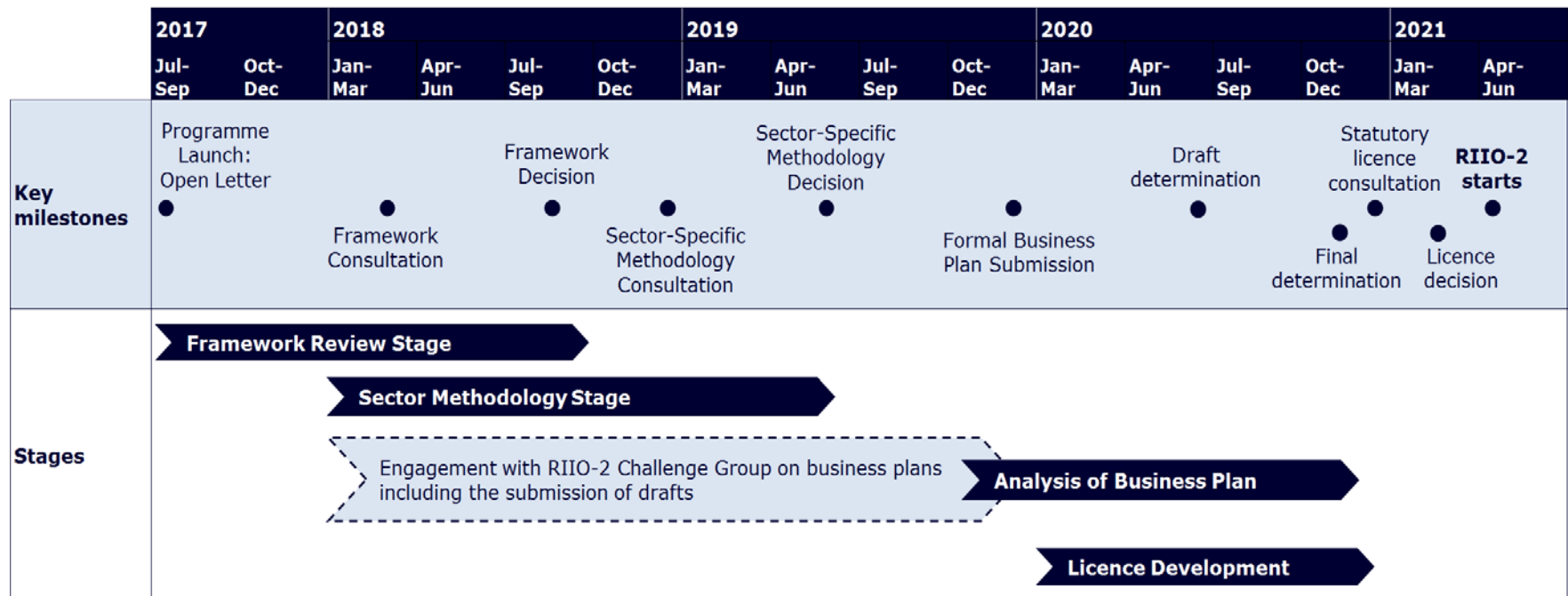
- Continuing to analyse our policy on capitalisation rates

- **Ensuring fair returns**

- Hard cap and floor ruled out as a return adjustment mechanism option
- Further assessment of remaining four options
- We will consult in December

- **Sector-specific methodology consultation in December 2018 for following sectors**
 - Gas distribution
 - Gas transmission
 - Electricity transmission
 - Electricity System Operator
- **Business plan submission to Ofgem in Q4 2019**
- **Determinations**
 - Draft determination in Q2 2020
 - Final determination in November 2020
- **RIO-2 price control commences April 2021**

Indicative High-Level RIIO-2 Plan for ET, GT, GD and ESO Sectors



Source: Ofgem

- We are facing a significant period of change in network usage
- RIIO-1 has worked well, but we have learnt lessons
- We will continue to use the incentive based RIIO framework to set price controls
- Higher returns are justified where these result from genuine innovation and efficiency...
- ...but we will continue to ensure that the regulatory framework remains fit for purpose
- This will be a tough price control for network companies...
- ...but those who deliver great customer service at lower cost will be rewarded
- An attractive environment for investors...
- ...but returns should reflect the low level of risk of a stable, predictable regulatory framework
- Updated cost of equity range in December

Contact:

Martin Young

Head of Investor Relations

020 7901 7114

martin.young2@ofgem.gov.uk

Ofgem is the Office of Gas and Electricity Markets.

Our priority is to protect and to make a positive difference for all energy consumers. We work to promote value for money, security of supply and sustainability for present and future generations. We do this through the supervision and development of markets, regulation and the delivery of government schemes.

We work effectively with, but independently of, government, the energy industry and other stakeholders. We do so within a legal framework determined by the UK government and the European Union.