Transcription

Title: Ofgem Investor Call

Date: 18.12.2018

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Conference Ref. No: EV00082404

Duration: 01:01:51

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. I will now hand you over to Martin Young, Head of Investor Relations. Please go ahead.

Martin Young
Thank you Jerry, and thank you to everyone for joining us today. Today marks another major step in the RIIO-2 process with the publication of our RIIO-2 Sector Methodology Consultation. It's my great pleasure to introduce Dermot Nolan, CEO; Jonathan Brearley, Executive Director, Systems and Networks; and Akshay Kaul, Director of Network Price Controls, 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 if you navigate to the Investor Relations page by clicking on 'About Us,' followed by 'How We Engage' and finally 'Investor Relations,' you will find the presentation. And with that, over to Dermot.

Dermot Nolan
Thanks Martin, and depending where you are in the world, good morning or good afternoon, or potentially even good evening. Today represents the latest stage in the RIIO-2 journey following on from the framework decision that we published in July. Since then, we've continued to enjoy a fairly active exchange of views with a wide range of stakeholders, and some of it certainly has been, if I may use the phrase, quite robust. Throughout the RIIO-2 process, we've made it clear that Ofgem recognises the benefits to all from the regulatory framework for UK energy networks being stable and predictable, a view that we continue to hold. We must also recognise that we face a rapidly changing energy landscape, and that regulation needs to be able to respond to this change. The pace of change means that this of the utmost importance.

In July 2017, we published an open letter on the RIIO-2 framework and we made it clear that investors needed to prepare for lower returns from 2021 onwards, commensurate with the risks of a stable and predictable regulatory framework. We also indicated that we would welcome outperformance when this results from genuine innovation and efficiency, and we will reward companies for doing so. Our views on both these issues remain unchanged.

Our updated cost of equity range, based on our proposed methodology and current evidence, is 4% to 5% CPIH real, and we have a working assumption of an allowed equity return of 4% CPIH real. This is explicitly conditional on a review and determination of the overall opportunities and risks companies are expected to face in RIIO-2, following a review of business plans.

A number of you have already commented on the proposals we've put out for consultation today, and we are, I would say, aware of these views. However, we are convinced the environment for investors remains attractive, and that our proposals are fair for those investors and ultimately for consumers. We have a short presentation that outlines this in more detail, but I will hand over to Jonathan Brearley now who will take you through that.

Jonathan Brearley
Sure, thank you Dermot, and good afternoon and good morning, depending on where you are. On slide 2, please turn to slide 2, we have set out the key aims to RIIO-2, and I want to take a few take a few minutes to expand on each of these with examples of proposals which we believe support these aims.

So first of all, we have customers at the heart of RIIO: we aim to put customers at the heart of the price control, and a variety of challenge, engagement and user groups are already in place, and there will be open hearing prior to initial determinations. It's also important that the networks provide additional support to vulnerable and poorly served groups where appropriate, and we are proposing arrangements to facilitate this.

Focusing on what customers' value: the RIIO framework is complex, and where possible we propose to simplify in RIIO-2. Steps that we propose to take include a reduction in the number of output categories, the removal of the IQI and its replacement with a business plan incentive, a new innovation funding pot to replace the NIC, and improved financial reporting.

Flexibility: the energy transition dictates the need for increased flexibility in the RIIO framework, and we are proposing changes that will make RIIO-2 more responsive. In July, we decided to revert to a five-year price control, but in addition we are proposing greater use of dynamic targets and uncertainty mechanisms as well as scope for anticipatory investment. We propose to still encourage efficiency and innovation in networks. For example, we are consulting on a reformed innovation stimulus to support this.

Learning from previous price controls: RIIO-1 has generally worked well with many positives, but there are also areas where the framework did not work as well as initially intended. We have learnt lessons from previous price controls and seek to build on these in RIIO-2. We are proposing to extend the use of competition where possible, and where it is likely to deliver a net benefit to consumers. We also propose to set blended sharing factors and reward ambition in cutting costs. Where possible we propose to index rather than forecast, and introduce deliverables for which allowances can be deferred if the need is no longer there.

Resilience: quality of service and asset health are essential in meeting customer needs, and we are consulting on safeguards in RIIO-2 to ensure that the former does not deteriorate and the latter is not compromised. Network resilience measures, workforce resilience plans, and cyber resilience are all proposed to form part of the RIIO-2 package.

Finally, fair returns: we have already outlined that we believe our proposed approach to cost of equity, which points to a range of 4% to 5% real in CPIH terms, and with a working assumption of 4% CPIH real, represents a fair return reflecting the risks of a stable and predictable regulatory regime. I will talk more about this later. Supporting this are proposals in respect of the possible introduction of a cash flow floor to address downside risks for debt investors, and return adjustment mechanisms, which would also provide protection against extreme downside scenarios.

To summarise, I want to make it clear that we aim through RIIO-2 to reward companies that are delivering a great customer service and outperforming tougher targets through efficiency and innovation.

I'd like to turn to slide 5 now, where I'd like to briefly expand on our proposals to focus on what is most important to customers and what they value. In RIIO-1, there are six output categories, and our proposal is to consolidate these into three: number one, meeting the needs of customers and network users; number two, delivering an environmentally sustainable network; and number three, maintaining a safe and resilient network.

Our proposed overarching outputs framework should improve clarity and accountability, and is structured around three output types: the first, licence obligations; the second, price control deliverables; and the third, output delivery incentives.

We are proposing a move to a more dynamic approach to setting targets and calibrating incentives, including the use of relative incentives where appropriate. Although we propose to set a number of common outputs in each sector, in some areas we are consulting on allowing network operators to propose bespoke outputs in collaboration with their stakeholder and user or engagement groups.

Incentives are an integral feature of RIIO, and one we are proposing to retain. However, we are seeking to simplify, and are proposing to remove the IQI and move to a blended sharing factor based on the proportion of a company's expenditure that can be considered as a high-confidence baseline, and that which won't can be considered as a low-confidence baseline. We are also proposing a new business plan incentive under which high-quality plans would have the ability to earn upfront rewards, with penalties for companies which fail to meet minimum requirements. We are consulting on using indicative incentive value ranges equivalent to plus or minus 2% of totex equivalent.

Moving to slide 7. Adaptability, flexibility, innovation and supporting those considered to be vulnerable will all be central to our development of RIIO-2. We have an energy system that is in transition, and an energy system where traditional boundaries have become blurred or no longer exist. Whole system solutions may well deliver benefits to consumers, and RIIO-2 can support this. We are consulting on whether additional mechanisms are required to enable whole system outcomes.

Innovation and efficiency have the potential to drive down costs and help enable transformation of the energy system, but we want to see companies undertake more innovation, and we are consulting on new measures, as well as proposing other reforms to the current innovation package. An energy system in transition, and one with the uncertainty around future demand for electricity and gas, gives rise to asset and stranding risk. Decisions on new assets, whether standard or large-scale investment ahead of need, so-called anticipatory investments, are clearly tougher. For the former, we are proposing enhanced cost-benefit analysis, while for the latter we envisage that a working group will be established to provide guidance on highly uncertain projects across all sectors. I spoke earlier about resilience and vulnerability, and wanted to reiterate that we see both as key components of the RIIO-2 framework.

Turning to slide 8. We have observed the benefits of competition and network provision through OFTOs, IDNOs and interconnectors, and have made it clear that our desire, we have a desire to extend the role of competition in RIIO-2 where appropriate, and where it provides better value for consumers. We are consulting on utilising competition to reduce the cost of meeting system needs, reveal information on cost, and provide an opportunity for the providers of flexibility solutions to demonstrate their value against more traditional network solutions.

We are considering using competition where appropriate to find ideas, we call this 'early competition', and for the delivery of projects, which we call 'late competition.' We have designed three models for new, separable and high-value projects, which are focused on late competition, namely CATOs, the SPV model and the Competition Proxy Model. As we have previously indicated, the CATO model is dependent on legislation, and we will continue to work with government to support the introduction of that legislation.

For early competition, we are consulting on whether there are benefits to consumers, the potential criteria for identifying projects suitable for early competition, and the high-level approach. We are consulting on who runs the competition; Ofgem, the ESO, and the network companies appear to be institutions that could discharge some or all of the roles and responsibilities associated with competition; amendments to primary legislation may be needed. We also believe that competition can drive innovation and cost-savings in projects which are not the subject of late or early competition, and we propose an enhancement of what we call 'native competition,' either through the business plan process, or by using competition as a price finder.

We are now on slide 9. In my opening remarks, I commented that our cost of equity range, based on one, the methodology that we're consulting on, and two, the current evidence, is 4% to 5% CPIH real, and that our working assumption is for an allowed equity return of 4% CPIH; excuse me, CPIH real. The finance annex, published this morning, sets out comprehensive detail of both the methodology and current evidence, and we can discuss further in the Q&A session. However, I want to make a number of points about our proposed methodology.

As a first step, we have used the CAPM methodology with an equity beta range of 0.65 to 0.76, a total market return of 6.25% to 6.75% CPIH real, and a risk-free rate of minus 0.69% CPIH real, which is proposed to be indexed to reflect changes in rates during RIIO-2. Step two in our proposed methodology is to cross-check the cost of equity against other regulatory settlements, market-to-asset ratios, OFTO tender round bids, and infrastructure fund discount rates.

CAPM cost of equity represents an expected return rather than an allowed return, and in proposing a working assumption of 4% CPIH real, we propose to apply an ex-ante outperformance expectation of approximately 0.5% per annum, which we will reassess at determination in light of the overall RIIO-2 package and updated evidence. Equity betas with re-levering and notional gearing will continue to be set on a sector-by-sector basis, although our working assumption is for a consistent 60% notional gearing and consistent equity beta across sectors and companies at this stage. This will be reviewed following the receipt of business plans.

Slide 10. We have a duty to have regard to the need to secure that efficient companies are able to finance their regulated activities, and a lower baseline allowed return in RIIO-2 may make it more challenging for companies to meet standard rating agency metrics. In July, we indicated that we would carry out further work on placing the onus on companies to address financeability through their business plan, as well as establishing the concept of a debt or cash flow floor.

The slide sets out steps a company might take, but I wanted to expand on our proposal to implement a cash flow floor, the key points of which are:

1. Companies will be required to report on a quarterly basis on their expected financial resources to meet anticipated requirements looking ahead for the next 12 months.

2. Subject to a cure period, a company with inadequate financial resources to meet its debt service requirements would be put into Cash Flow Supported Status, or CSS, where a company in CSS would be subject to restrictions on dividend and other related party cash payments outside of the ring-fence, as well as enhanced regulatory oversight. A company's Expected Cash Available before debt service would be compared to the forthcoming year's Debt Service Requirements, and if the latter is greater, then a Cash Top-Up, or CTU, would be paid by customers. The company would collect full charges in accordance with their normal allowances, but would pay 75% of operating surpluses to the System Operator to allow a reduction of charges to all customers and the repayment of the CTU. Once the CTU is fully repaid, the restrictions on related party payments and regulatory oversight would be removed.

3. The CTU cost would be spread across all consumers in a sector to minimise consumer bill impact.

Slide 11 sets out in schematic form how this would work in practice, and we have senior members of the regulatory finance team with us here with us the room, in case we need to delve more into the mechanics.

There are a host of other financial issues that we'll take into account as we move forward, and we summarise these on slide 12.

Number one, the cost of debt. In July, we retained two options for the cost of debt, recalibrating the RIIO-1 approach, or moving to partial indexation. We were also clear that a high bar of evidence would need to be met before we materially altered our existing methodology. We remain of this view and we propose ruling out partial indexation unless new information provides reasons to reassess this position. We also propose to rule out an annual within-period debt sharing mechanism.

Point two, inflation. In July, we took a decision to move to CPIH and indicated that we would carry out further work to determine whether phasing is necessary for the transition. Our proposal is that no phasing should apply.

Number three, 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. In July, we retained all three options pending further work, a position that we maintain in today's consultation. We also proposed that wherever possible, all companies should seek to obtain the Fair Tax Mark certification, but we are not at this stage proposing to consult on any changes as a result of the ring-fence review as part of the RIIO-2 process. We will continue to require enhanced disclosure as part of the RIIO-1 reporting requirements.

Number four, gearing. We will continue to review notional gearing in the light of the riskiness of the overall price control settlement, but we are currently assuming, as a working assumption in advance of receiving business plans, a notional gearing value of 60% for both GD2 and T2.

Number five, capitalisation rates. In July, we indicated that we would reassess our policy on capitalisation rates after we have received company business plans, and this position remains unchanged.

And finally, number six, depreciation. We are proposing to maintain our existing policy with a view to economic asset lives for depreciation, and have a working assumption of no change to existing depreciation policies. However, we are open to exploring further changes in depreciation methodology in line with the economic principles of intergenerational fairness, and we welcome views on sector-specific arguments relating to the useful economic lives of assets.

We're now on slide 13. The fairness of the RIIO framework is paramount, and in our July decision, we indicated that we intend to introduce return adjustment mechanisms, or RAMs, to mitigate the future risks of companies earning materially higher or lower than expected returns. This would also help ensure that companies' returns better align with the level of risk they are exposed to. We have further developed our thinking, and in today's consultation we make a number of proposals including:

- Making adjustment triggers mechanistic with an adjustment collar of plus or minus 300 basis points around the allowed return on equity, albeit that we expect that the collar would not easily be triggered under current RIIO-2 proposals.
- Consulting on the use of a sculpted sharing factor in the Gas Transmission and Electricity Transmission sectors.

- Consulting on the use of two different mechanisms (anchoring and sector average sculpting) in the Gas Distribution sector, where anchoring variants include absolute adjustment, proportional adjustment and targeted proportional adjustment.
- RAMS to be applied to RoRE outperformance and consulting on a wider definition of outperformance to include financial outperformance.
- A preference to implement adjustments as part of the closeout process, but also consulting on an annual adjustment through the annual iteration process.

On slide 15, we have an updated indicative timeline for the RIIO-2 process. The consultation will run until 14th March, and we expect to reach a decision in May. First draft business plans will be provided to the RIIO-2 Customer Challenge Group and Company User and the Customer Engagement Groups in July, with a second draft to follow in October. Business plans are to be submitted in December of next year. We expect to issue draft determinations in Q2 2020, with final determinations in November 2020.

Slide 16. Before we move to questions, I would 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 learnt lessons. RIIO-2 will build on previous price controls, but we will focus on what consumers want and value. Customers will be at the heart of a price control that will encourage innovation and efficiency, but will be sufficiently flexible to respond to different circumstances. There will also be safeguards to ensure quality of service and asset health.

We continue to welcome outperformance within our price controls, and RIIO-2 will have incentives to reward companies who do so. We have been consistent in our message that this will be a tougher price control for network companies, but one which will offer a fair return on capital, reflecting the risks of a stable and predictable regulatory regime. Our proposed cash flow floor, and backstop return adjustment mechanisms offer investors protection, and we believe that our proposed cost of equity range, based on current evidence and on our proposed methodology, of 4% to 5% CPIH real, and with a working assumption of 4% CPIH real, represents a fair allowed return and one which will continue to position the UK networks as an attractive environment for investors. However, we very much remain open to dialogue with analysts and investors alike, and please feel free to reach out to us through Martin. With that, I will now hand over to Martin.

Q&A

Martin Young
Thank you very much Jonathan, thank you very much Dermot. And Jerry, if we could now poll for questions. We do only have until 4.30pm I'm afraid, so please can I request that you limit yourself to a maximum of two question each, and with that Jerry, please can we take the first question.

Operator
Thank you very much. Again, just to remind everyone, if you would like to ask a question, please press zero one on your telephone keypad. And if you wish to withdraw your question, you may do so by pressing zero two to cancel. Our first question comes from the line of Chris Laybutt. Go ahead, your line is now open.

Chris Laybutt
Good afternoon and thank you very much. I'd just like to ask, I guess, an overview question. Dermot, you mentioned not long ago that you were discussing the process overall, and the one thing that you mentioned that investors may not agree with you always, but I guess you'd say that that was inevitable – excuse me. But it's problematic for investors if they're surprised. Are you surprised by the share price reaction in National Grid today, and do you feel that there has been an element of miscommunication through this process?

Dermot Nolan
Absolutely not. I mean in terms of – one of the points about the share price reaction I think that is interesting is that to the best of my understanding, Grid has fallen by 7% and SSE, which is almost as exposed, has fallen by 2%, which I find slightly perplexing. Nonetheless, that is a point I would make. But I think as a more general point, I would say that these numbers that are being put out today are within the range we'd already put out. We have narrowed the range, we have not changed the, we have not gone

outside the range; we have simply narrowed the range that said we would. So whether or not people are surprised or not, I really don't think that they should be.

Jonathan Brearley
And just to build on that, this is a consultation: we are consulting on the methodology and we are just giving you indicative numbers; there is still a way to go, but we are a long way from final determination, and I think we are giving investors every chance to give us the evidence they want to, before we make our final determination.

Chris Laybutt
And I guess just one further point on that, I mean in terms of the mid-point of the previous range versus the point estimate today, we were surprised that that point estimate was 100 basis points lower, given this process has now been running for 12 months. Could you just explain, I guess, the process to get to that level, because that's the assumption that seems to have attracted the most attention today.

Jonathan Brearley
Right, I'm going to ask Simon to come in on specific numbers, but I just want to make the point we set out a range; we did not say we were going to land in the middle of that range – we set out a range. But Simon, I think you just want to come back on…

Simon Wilde
Simon Wilde, Senior Financial Advisor. It's a fair question you ask, but what I, it's important that we compared like with like. So the 3% to 5% was a cost of equity range, and we have narrowed that to a, in CPI, sorry in RPI terms, 3% to 4%, and in fact we have a mid-point to that range as our cost of equity estimate, so that's effectively 3.5%. So really, it's 50 basis points. The reason for the working assumption for the allowed return is because in the December document, we are putting into practice the decision we made in July to distinguish between the allowed and the expected return, and we set out in some detail why we think that 50 basis points is a reasonable starting point, although we also make very clear that we want to consult on that number.

Chris Laybutt
Okay, thank you very much.

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

Mark Freshney
Hello, good afternoon. Holistically, if I look at this package compared to, you know, what's on the table now for consultation in RIIO-2 compared to RIIO-1, it looks a bigger change from RIIO-1 to RPI minus X, in that it seems to almost take back a lot of risks onto the consumers. If I look at, you know, the cash flow floor, I mean I think it's a cash loan from consumers, and I think there's even a mechanism where consumers would take over some of the RAB if it was never repaid. The equity, as well as the debt, being indexed to bond yields, well, it basically almost takes the borrowing cost, you know, links it to government costs. And then, of course, you've got the RAMs, which basically cap and collar a lot of outperformance and underperformance. So it seems that there's very little that, there's less that management teams can do to influence the overall returns and get/drive those economic profits for shareholders and also savings, which is very different to the kind of magnitude it was in the past. So my question for you is – I mean this is a fundamental change – do you think that the economic profits that you offer are really enough to incentivise investment in public markets?

Jonathan Brearley
So look, I'm going to come in first, but I'm going to ask Akshay to talk through the structure of the price controls. We have been very clear and very consistent that we absolutely support and are developing incentive-based regulation, and there is plenty of room within this for management teams to do a lot better than they otherwise would, if they were to meet the outputs that we've set, and they were to deliver cost savings and innovation. But Akshay, do you want just describe the structure of the whole price control in broad terms, and then perhaps we'll come back to it.

Akshay Kaul

Yeah, thanks Mark. I think your question starts off with the right premise, that what we should seek to achieve in all price controls really is a sensible balance of risk and return. And in RIIO-2, I think our starting point is to look ahead and consider all the ways in which the future could be different to our expectations, and as a matter of the general design principle across the price controls, not just in finance, we are trying to avoid making forecasts that might turn out to be wide of the mark. But I think first of all, reducing the price control period to five years helps with that, but we are proposing, for instance, to index the cost of debt, as you said, to index the cost of equity, and to index the input prices for labour and for construction materials. You're right that in some senses this is a shifting of risk away from the companies, but we think that this is efficient, that it's good value for money, because it's taking away risk that the companies are not particularly well placed to manage. And it helps enormously in terms of delivering [inaudible] of consumers by avoiding substantive forecasting error, and we explain this in some depth in the finance annex, if you want to go through that.

The second point you made was about [inaudible] regulation and whether we're moving away from that, whether this was a radical change. I think the first thing I would say is that the – it comes right at the beginning of the document and we explain in the executive summary – that for the vast majority of times, this price control in RIIO-2 will operate like a normal, well-powered, high-powered, incentive-led, ex-ante price control. The reason we're introducing these return adjustment mechanisms is that even within a five-year period, given the extent of change that we're seeing in the system, it is entirely possible for the future to diverge very substantially from our expectations, both in the upside and on the downside. And again, we think it is sensible to have some regulation of those extreme boundary points to protect both consumers and investors alike from very extreme return outcomes on the upside and on the downside. And our task is really then to achieve that by having the least possible distortion on incentives, keeping them as sharp as we can on management teams to continue to outperform, and we're very confident if you go through the detail of how the return adjusted mechanisms work, that at the margin, there will always be reward for a management team that wants to continue to outperform the control and improve service quality and cut costs, so there'll always be that incentive.

And then outside, finally, the point you made about the cash flow floor. Again, the principles of the cash flow floor are to strengthen the ring-fence, to provide a bit of downside resilience for network companies, and we think that it's worth considering that as an option, as an alternative to simply raising the cost of equity for everybody just in order to meet some sort of headroom credit rating metric, which again we think is not necessarily good value for money for the consumer. But even in the design of the cash flow floor – you've seen the documentation – that we've been very careful to retain full incentives on company management, to do their level best to carry on outperforming the controls and not to rely upon the safety net.

Mark Freshney

Okay, thank you very much.

Operator

Thank you. Our next question comes from the line of James Brand. Please go ahead, your line is now open.

James Brand

Good afternoon, two questions please. The first is on the cost of equity, which is obviously being reduced very sharply, and you're not the only regulator that's in the position at the moment where, you know, they're suggesting much lower cost of equity than we've had in the past. But I'd just be interested in your thinking that this is coming, and I would imagine this is apparent to you from your investor engagement, but it's coming at a time where particularly most international investors, if not UK domestic investors, are perceiving investments in the UK as much higher risk than they have been in the past. And particularly investments in UK networks as higher risk than they have been for some time, partly because of political risks around the Labour, potential Labour government in the future, and their policy of nationalisation. So just wondering what your thoughts are when you set the cost of equity around dealing with those risks. Obviously one could have a long debate about, you know, which risks are diversified, diversifiable and non-diversifiable, and how that fits into a CAPM framework and maybe some of those risks are diversifiable, but just interested in your thoughts on whether you pay any attention at all to some of those risks that seem apparent at the moment from Brexit and politics.

And the second question is on the cost of debt index. You've proposed to retain a full indexation approach. There seemed to be a hint in, or a comment in the document that you might be looking at potential changes to the index, potentially around duration and investment grade bonds that you select. I was just wondering whether you could flesh out your thinking a little bit more about that on the debt index. Thanks.

Jonathan Brearley

So a couple of things from me then I'm going to hand over to Simon just to take us through how we've thought about cost of equity and in a sense how it's been structured. We do have a stable regulatory regime in the UK that has a very long track record now, and we at Ofgem have established that track record over a number of years, including recently when we've made some decisions that are in the face of what has been quite a large debate within the political arena. So our view is that what we need to do now is to make sure the benefits of that regime are shared between customers and shareholders. What I'm going to ask Simon to do is just to talk us through the background as to how we calculated it, and essentially how we come back from there, and then we'll talk about indexation.

Simon Wilde

Thanks for that. So James, we've tried to be explicit in the approach we're taking towards cost of equity because it is a complicated mix of theory and practice, and we do want to take into account the uncertain times that we find ourselves in. So to be explicit, to set the cost of equity, so ignoring the allowed versus expected return, to set the cost of equity we're going with a two-step process. Step one is to apply the CAPM as usual. We are proposing consultation on some changes to it, and in fact we're proposing changes to all three of the main building blocks: the beta, the total market return and the risk-free, and again I'd encourage people to engage with the detailed material. But at its heart we are using, we are using the CAPM, and that gives us, that gives us a range. But step two, and I think we've probably been more explicit here than we have been in the past. We are saying let's find some real-world examples of what investors are, returns investors are looking for. And I would point you to some of the evidence, for example, on pages 29-30 of the finance annex, where we list a dozen or so major investors or advisors and what are they telling their clients about the expected returns in the UK market over the next 5, 10, 20 years, depending on the, depending on the house. And that averages at 6.6% nominal and that's for taking average market risk. So that's a benchmark that we've taken into account.

Likewise, we've looked at the discount rates and the premia or discount in net asset value of the listed infra fund sector. We've looked at the bids that we are receiving from multiple parties on the OFTOs. And again, in the annex we lay out in detail what those numbers look like. And today we feel that the nominal rates of the 6-7%, knowing that of course there's upside on top of that, are supported by that evidence base. But I want you to assert this in two ways. One is we're consulting on that evidence base today, so we want to hear from you if there are things that we should have taken into account. And secondly, we will review this in 2020. So I note what you say about, you know, investors demanding a premium but we use the most up-to-date information we have. So as of today these are the numbers. If that feeds through in 2020, that's going to create an evidence base that we will have a discussion about at determination. So sorry for going on in such depth, at length, but we want people to understand we're consulting on methodology, on a process, and giving you our best estimate of what the evidence says today. They are three quite different elements of what we're trying to communicate.

Jonathan Brearley

Can you talk about indexation?

Simon Wilde

Yes, so the other point which I think people are saying is, how does the Ofgem number compare with the Ofwat number, for example? And, you know, we've consulted closely with our fellow regulators and we have very, very similar views of the world. What I would note is that our 4% CPIH is, will be indexed to changes in the risk-free. At consultation the ENA, one ENA report told us they thought that risk-free rates would increase by 150 basis points during RIIO-2. Under our proposed mechanism that would increase baseline returns by around 60 basis points. So immediately you would go from the 4% to 4.6% and not just that, it's providing an insurance policy or a hedge to investors at a time when the direction of rates is unclear.

Jonathan Brearley

Okay, thank you. Is there anything else in that question that we have not covered?

Simon Wilde

I'm sorry, I haven't answered a question of cost of debt indexation. Just very briefly, we've, on cost of debt, we've indicated direction of travel which is to maintain the RIIO-1 full indexation. We've said as a working assumption, assume it's still the same two indices, the single-A rated and triple-B rated non-financial corporates. But we've also said we will calibrate that at the determination stage, and the principle we will use to calibrate that is we will look at the actual expected debt costs on a sector-by-sector basis, and we will look to see which particular calibration, which mix of trailing average period, which mix of index selection will most closely match the sector averages, and again that follows quite closely what was in RIIO-1.

Jonathan Brearley

Thank you.

James Brand

Brilliant, thanks for those answers.

Operator

Thank you. Our next question comes from the line of Jenny Ping. Please go ahead, your line is now open.

Jenny Ping

Hi, good afternoon. Jenny Ping from Citi here. I just wanted to follow up the previous question on the cost of equity. You're saying that you have cross-checked with some of the other regulators. From what I can see from the CAA, for example, in the most recent consultation process, they're still talking about a cost of equity of 5-7%. Water we touched on, but clearly is still marginally higher, so why do you think the energy sector should be different to some of the other regulator sectors i.e. lower in this case? And then secondly just linked to that, are you, do you fundamentally believe that essentially what we're looking at in the lower cost of equity shows, you know, some of the OFTO bidders and some of the infra funds ultimately have a very different cost of equity requirement. Which, by going down that route, aren't you essentially pushing some of the listed companies to consider going down that route in order to maximise their returns? Thanks.

Jonathan Brearley

Right, I'm going to let Simon come in on the comparison question but I'd make the point that Simon made in his last answer, which is, look, there is difference in the structure that we're proposing, and we have done the cross-check with Ofwat and we think broadly we're in a similar position once you take that into account. On the point of our view of ownership and whether we want, you know, whether we expect or even want public to private ownership to happen, it's not really a matter for Ofgem. Our view is to regulate the companies and to make sure that we get long-term value for consumers. What you do as shareholders, and what different shareholders do is really a matter for them. Our job I'm afraid is much more objective, to look at what we think is in the market. Simon, do you want to just come in on the first point?

Simon Wilde

So briefly on the first point, we've discussed each of our CAPM parameters with our fellow regulators and we're happy to have discussions with people about how to reconcile those views, but particularly with water there are two big distinctions. One is that Ofwat is assuming zero outperformance, and we are assuming a 50 basis point outperformance, but starting a conversation on that number. And then secondly, Ofwat has picked a fixed risk-free rate. They've aimed up slightly, but they've picked a fixed risk-free rate, whereas we are offering investors full protection for changes in the risk-free rate. And when you adjust for those two factors you get to a very, very similar cost of capital. In terms of whether one is riskier than the other, it's hard to say. I would note that Ofwat is saying that the water companies' RAVs or RCVs will grow by 14% in PR19, whereas we haven't seen the business plans yet, we are not expecting that degree of RAV growth, and therefore there may be some differences in capex delivery risk. But I leave that to others to look at.

But my final point, on the cross-checks. It's fair that some of our cross-checks are private markets, OFTOs, M&A market to asset ratios and the discount rates, but the returns that are being looked for by the like of Vanguard, Schroders, J.P. Morgan, BlackRock and are being advised upon by the likes of Aon, Hewitt and Willis Towers Watson for the whole UK market, that is explicitly a listed company benchmark. So I would say we try to address both sets of investors, although totally respect the point that Dermot made that, Jonathan, that we are neutral to that.

Jenny Ping

So you don't take into account of what Ofcom or CAA does in their regulatory process.

Simon Wilde

No, we do. We do.

Dermot Nolan

I'm just going to come in for a second. We absolutely do. Without overstating this, of course we do. The data for Heathrow is – should – there's no reason whatsoever that the beta for Heathrow should be the same as the beta for a network energy company. And we'd rather [inaudible]. Sorry, for being slightly impolite on that, but I think that's a rather silly question.

Jenny Ping

Thanks.

Jonathan Brearley

Okay, next question.

Operator

Thank you. Our next question comes from the line of Deepa Venkateswaran. Please go ahead, your line is now open.

Deepa Venkateswaran

Thank you. I have one question and one observation. So on the 50 basis points of expectation outperformance that you've kind of built in into the allowed return, could you kind of explain where you expect this to come from and because I also see that it's being addressed specifically in the floor and so on, sorry, in the cap and so on. Could you explain where is the 50 bps that you expect to come from? And secondly in terms of observation, clearly this is following on from Jenny's question. In terms of the returns that you're seeing in the private market transactions, some of them are in the past and they do use very heavily-geared structures. Ofwat has clearly suggested some mechanisms which means that now highly-geared structures will not have the same benefit and politically if you see what the Labour Party is saying, one of the reasons they want to renationalise companies is they have taken offence to these kind of highly-geared structures. And therefore it feels like again the direction of travel here is very different to what we're seeing other regulators or what indeed some of the politicians are saying.

Akshay Kaul

Thank you, Deepa. The first question I think you asked was about the…

Deepa Venkateswaran

The 50 bps, yes.

Akshay Kaul

The 50 basis point outperformance, where it comes from.

Deepa Venkateswaran

Yes.

Akshay Kaul

It comes from [inaudible] incentive mechanisms, and they're of two types. We have a Totex Incentive Mechanism where if companies underspend against the allowances that we set them they get to keep a share of the underspend. And secondly, we have a variety of output delivery incentives where we set service level targets for improvement and if companies deliver or outperform those service delivery targets then they get outperformance incentive rewards. We also have this time round a fairly substantive business plan assessment, business plan incentive, where companies give us ambitious targets for service quality or cost reductions. Then those companies will be at the frontier and their starting positions will be, will be considerably better than the average baseline allowed returns that Simon's been talking about.

The one thing I think I would say about the 50 basis points is that we're not simply assuming that the outperformance, the average outperformance that we have seen in RIIO-1 is going to continue into the future. So we have made explicit allowance for the fact that we have tightening the price controls. We're going to the five-year regulatory period. We are moving to dynamic targets. We are moving to slightly lower overall incentive rates, we're possibly rationalising the output delivery incentives as well, and we're introducing things like price control deliverables and so on. All of which should mean that, you know, the ex-ante price control should work a lot more accurately and the average company should not expect to see the same kind of 270-330 basis point outperformance that they have enjoyed in RIIO-1.

But having said that I think in the past we set ourselves, was to ask ourselves really, whether having done all of this is it in the balance of probabilities more or less likely that companies will outperform? And I think Simon will come in on this in a bit more detail, but we will explicitly return to this question in the summer of 2020. And if we feel at that time that the balance has shifted one way or the other we will very transparently reflect it in the outperformance wedge. All we've indicated for now is based on the information we have available today and the evidence that we have available today, our best judgement is that in the balance of probability companies would enjoy a degree of information advantage which would mean that the average company will have a modest [inaudible] of outperformance, and 50 basis points to us feels about right for this stage of the process. Simon?

Simon Wilde

I'd echo everything you've said there and I think it's really important again where we're trying to compare between different regulatory settlements, the expected return for this settlement is 4.5%. The allowed return is 4%, but we think we are creating a package that will let companies earn on average around 0.5%, and I fear that might've somehow not been picked up, and I would really emphasise that point. And to the extent that we are convinced it should be less than that, the mechanic we are proposing means that if we have a lower outperformance wedge we would have a higher allowed return. And so that is the debate and the discussion that we're going to be having in 2020.

And just on the private sector, as I said in my earlier answer, I think we're generally picking up evidence from public and private. What I would note is the OFTO returns which we give you evidence for are 7%. That is a 7% return even after 90% gearing. So, one would assume that at a gearing level of around 60%, as we're proposing, that number would come down further. So again I think when you look at the directionality, I think it reinforces our point. Thank you.

Deepa Venkateswaran

Can I have a small follow-up on the timeline?

Simon Wilde
Sure.

Deepa Venkateswaran
September 2020 is when you're going to review that 50 bps wedge, or is there an opportunity in the consultation now if companies are of the view, for instance, or investors are of the view that this 50% - sorry 50 bps assumption of an ex ante is not – so I just want to know, is this set in stone until September 2020, or is this still something you will review based on evidence or responses?

Akshay Kaul
No, we're very open to consultations responses. I mean, the whole point of consultation is to get as wide and open debate as we can. The reason I mentioned the summer of 2020 is that the best basis on which to make the judgement about the average companies outperforming is when you see the calibration of all the incentives in front of you. So by May of 2019 when we make the final decision on the sector methodology, I think we will conclude on the totex proposals that we are consulting on, but we still will not expect to have calibration of the output delivery incentives. And that's the reason I said it probably makes sense to wait until the summer of 2020 when we have all of that in front of us to make a fully-formed, in-the-round assessment.

Jonathan Brearley
I think that's right but I would emphasise the more information we get, the earlier we get it, the easier it is for us to respond.

Deepa Venkateswaran
Thank you.

Jonathan Brearley
Okay, thank you.

Operator
Thank you. Our next question comes from the line of Fraser McLaren. Please go ahead, your line is now open.

Fraser McLaren
Hello and good afternoon, it's Fraser McLaren from the Bank of America Merrill Lynch. I'd just like to ask about the process for introduction of more network competition. Just wondering if in the RIIO-2 period you're intending to press on with this forced back door route or if you're assuming that you'll actually get the necessary primary legislation through to enable a proper process. And just secondly the combination of that outstanding proxy, of the outstanding proxy competition issue, and these ROE proposals could be interpreted as pushing the companies towards an appeal of your decisions. Now, surely that's not a hallmark of successful or stable regulation, and I'd welcome your views on whether you agree.

Jonathan Brearley
So I'm just going to come in on the end of your question, but I'm going to ask Akshay to deal with the, how we intend to implement competition. We have the regime we have precisely to ensure that we have a stable regulatory regime, but again I don't think it's Ofgem's job to say every single thing that we do should not be appealed. The appeal route is there because at times regulators disagree with shareholders, companies and investors, and therefore all I'd say is I don't accept that if we were to go to the CMA that is a sign that somehow that we're not being successful. Our job as ever is to make sure that we protect the long-term interests of consumers and sometimes that does mean we're going to disagree with different parties in the market. In terms of our competition and I'll leave you Akshay to respond to the characterisation of some of our proposals.

Akshay Kaul

Thank you, Fraser. You talked about that legislation. We remain hopeful that at a point in the not too distant future we will get a legislative window to enact the legislation necessary to implement the CATO regime for late competition, and that very much remains our direction of travel. But in the meantime while we are waiting for a suitable legislative window, as you mentioned, in RIIO-1 itself we have introduced some alternatives to CATO to be implemented within the existing legal framework of the price controls, and that is the SPV model and the Competition Proxy that has been applied to Hinkley Seabank and has recently been proposed to be applied to the Orkney project. And what we've indicated in the RIIO-2 documentation is that these three models very much remain tools available to us to implement late competition when it comes to RIIO-2. Obviously our ability to implement CATOs will depend on whether by the time RIIO-2 begins the enabling legislation is in place or not. If it isn't then the transitional models that we've developed remain very much open for use.

Operator

Thank you. Our next question comes from the line of Lakis Athanasiou. Please go ahead, your line is now open.

Lakis Athanasiou

Hello?

Operator

Please go ahead, you can now ask your question.

Lakis Athanasiou

Yeah, yeah, you, you mispronounced my name, it's Lakis Athanasiou. Hi guys.

Speakers

Hello, Lakis.

Lakis Athanasiou

Yes, I've got two things. One is an observation and the other one's a question. My observation is on cost of equity. I think all you've done to get your 4.0% is back it out of a 9% FFO to debt metric, 100% CPI indexation. I think all this stuff on CAPM and betas and expected versus allowed is actual window dressing, just as Ofwat had to back out to 4.5% to get to 9% FFO to debt metric at 50/50 indexation, and interesting that you had a ready list of the difference between you and Ofwat, because Ofwat can't move off their number, how can you justify them having a higher cost of equity? You forgot pension deficits, by the way. That's an observation. I think all you've done is just back out the credit metrics, nothing else, to get your cost of equity.

My question is –

Jonathan Brearley

Inaudible.

Lakis Athanasiou

Sorry?

Speaker

That's an observation Lakis.

Lakis Athanasiou

That's an observation which you can comment on if you want to, but again what a coincidence that the FFO to debt metric is 9% on your cost of equity and on Ofwat's cost of equity with their indexation. On cost of debt my question is the, and that's what surprised me a bit, which was the 1.7 ten-year rolling average. Your later review was the 20-year rolling average with the electric distribution companies which would have got you to 2.4% average, which would have been in line with Ofwat's number. So I'm just wondering why you've, you know, just to get clarity on why you've decided to stick with ten-year rolling rather than jump to the 20-year rolling which was done on your later price review period.

Jonathan Brearley

Go on, Simon.

Simon Wilde

So actually I will take the bait to comment on your observation. And it, I'm not a great believer in conspiracy theories but it was a genuine, a genuine coincidence. Now, you know, once I've convinced you of that, Lakis, you can, you can come on and tell everybody, but just to set the record straight there was no backsolving of cost of equity.

Lakis Athanasiou

What, I think, I think it actually was a genuine process, but at the end of the day you have various flexibilities and then you go to the backstop. And I think that's how Ofwat does it as well. So you kind of fool yourself you're going through a process but you're not. Anyway, thanks.

Jonathan Brearley

We'll take that offline, Lakis and we'll keep going through [inaudible].

Simon Wilde

So, specifically on the cost of debt and I refer to the previous cost of debt from James where he asked about the particular structure. I want to be very clear. We are keeping the concept of indexation, we're keeping the concept of the iBoxx. We will absolutely look at a ten-year, versus a 12-year, versus trombone, and once we see the company business plans we can understand the amount of new debt that they will be issuing and we will then have a better handle on what the expected sector-by-sector base cost of debt is, and then we'll be able to judge whether the current ten-year broadly matches the expected debt costs or not. So we thought rather than changing now for the sake of it, we want to send a very clear message, this is the mechanism and then we will calibrate the mechanism at determination once we know what the companies' expected debt costs will be in RIIO-2. So I hope that answers the question. We're not…

Lakis Athanasiou

I think it does, yes.

Jonathan Brearley

Okay, thank you.

Lakis Athanasiou

Sorry. Well, no – no, but just to understand what you've said, is you've put this as a benchmark. If it turns out that you look at a specific sector or group pf companies or even just one company, it's different and you think, 'Ah well, you know, we can understand why' you may shift on that. Is that what you're telling me?

Simon Wilde

So you actually said two different things in your question, Lakis, so I want to be very precise.

Lakis Athanasiou
Yes.

Simon Wilde
Because you mentioned sectors and companies. So we've been clear that we will look at this on a sector-by-sector basis, and…

Lakis Athanasiou
I was thinking gas transmission [inaudible].

Simon Wilde
That's a fair point. But we will look at the embedded debt costs. We will then look at the amount of new debt that needs to be issued in RIIO-2, we will estimate what we think that will be issued at, we will then come up with what we think the cost of the sector's debt is. If it's around 1.7 then we won't need to change the mechanism. If it's a different number we will look at potentially changing the mechanism.

Lakis Athanasiou
Okay, understood. That's [inaudible]. Yes, that's very clear, thank you.

Jonathan Brearley
Thank you. Next question.

Operator
Thank you. Just to remind everyone, if you would like to ask a question, please press zero one on your telephone keypads. You can withdraw your question at any time by pressing zero two to cancel, and there'll now be a further pause whilst questions are being registered. Once again, if you do have a question please press zero one on your telephone keypads now. And we have a question from the line of Chris Laybutt. Please go ahead, your line is now open.

Chris Laybutt
Good afternoon. Again, just one quick question on the appeals process. There is a comment in the paper that suggests that if companies appeal one portion of their final determination that there could be a reopening event that may change other areas. Just wondered if you could clarify how that might work if you were to do such a change.

Akshay Kaul
Thank you, you're right. We've talked about essentially a principle of doing an in-the-round settlement for RIIO-2 where we seek to provide sufficient funding to network companies to carry out their activities, neither too much nor too little. And the main problematic feature of a single-issue appeal system is that it can undermine the in-the-round nature of the regulatory direct control settlements. And so we are again starting the conversation with stakeholders about a situation in which an appeal disturbed the fair balance in the round between consumers and investors, how should we respond to that to redress the balance? And of course one of the possibilities is that if there is a material imbalance then we take a look at all the inter-related issues and then we modify, we reopen and modify the price controls to redress the balance. But, as I say, I think this is something that we are basically starting a conversation about because we, alongside lots of other stakeholders, are somewhat concerned, not overly so but, somewhat concerned at the degree of disturbance that a whole variety of very, very narrow single issue appeals, the distortions they can cause in the system, and we'd be very interested to hear what people have to say on that subject.

Chris Laybutt
Okay, thank you very much.

Operator

Thank you. And we have no further questions on the line at this time.

Martin Young

I think in that case, Jerry, we may as well draw it to a close. So a big thank you to everybody that joined us this afternoon and thank you especially to all of those who asked questions. If there are any further questions, please feel free to reach out to me and once again I speak for us all here that we very much look forward to continued constructive dialogue during the RIIO-2 process. So thank you once again, good afternoon and all the very best for the festive season.

Operator

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