Transcription

Title: Ofgem RIIO-2 Sector Specific Methodology Webinar

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Speakers: Dermot Nolan (CEO), Jonathan Brearley (Executive Director, Systems & Networks), Simon Wilde (Senior Financial Advisor, Systems & Networks)

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Presentation

Operator

Welcome to the Ofgem RIIO-2 Sector Specific Methodology Decision Webinar. Throughout this webinar, all participants are in listen-only mode, so there's no need to mute your own individual lines, and afterwards there will be a question and answer session. Just to remind you, this conference is being recorded. I'll now hand the floor to our first speaker, John Bolitho. Please, begin.

John Bolitho

Welcome, everyone, to the Ofgem RIIO-2 SSMD Investor Call. I'm here today with Dermot Nolan, Chief Executive of Ofgem, Jonathan Brearley, Executive Director of Systems and Networks Division, Simon Wilde, the Senior Financial Advisor of the Systems and Networks Division, who will present to you. In addition, we have some other RIIO Deputy Directors and staff, as appropriate, to help in answering any of the Q&A. Dermot will introduce the slides, and then Jonathan will present Slides 1-10, and then Simon Wilde will present Slides 11-20, and then Jonathan will sum up. I will introduce the Q&A, and the Operator will take you through how to ask the questions. We are being recorded, and a transcript will be made available next week which, to remind you, is a short working week in the UK as Monday is a bank holiday. Thank you. Dermot?

Dermot Nolan

Thank you, John. Good afternoon, everybody. Good morning to those dialling in from America, potentially good evening to those dialling in from elsewhere, as well. I'm just going to make a very few introductory remarks before handing over to Jonathan. Just to recall that we published our Sector Specific Methodology Consultation in December last year. Today is the next step in the RIIO-2 process. Following the consultation document, we received an unsurprisingly large number and, indeed, a large range of responses. We've obviously spent a lot of time analysing these. We've gone through them in immense detail. Today, we're setting out our methodology decision. As we said in December, Ofgem does recognise - and I want to be very clear about this - the benefits to all from the regulatory framework for the UK energy network being stable and predictable, but we also recognise the rapidly-changing energy landscapes and the need for regulation to adapt, to respond to this kind of change. Throughout the RIIO-2 process, which started really with our open letter back in July 2017, I think we've been very clear with investors that they needed to be prepared for lower returns from 2021 onwards in line with market returns and the risk that should be rewarded in a stable and predictable regulatory framework. We set out in December our proposed methodology for setting the RIIO-2 price control. We've listened to the consultation feedback and we've made some modifications to our approach, and Jonathan and Simon will take you through some of those modifications in a moment. Just as a brief reminder, at this methodology stage, what we are trying to do is set out clearly the approach we intend to adopt at the determination, which will be in 2020. We've provided, today, certain values as working assumptions for companies to use in their business plans which will, of course, be the next stage of the process. These are important working assumptions, but I want to stress that inevitably they may change as market conditions vary over time. So with that is background. I am now going to hand over to Jonathan.

Jonathan Brearley

Thank you, Dermot. Picking up on your point on returns, let me address this up front. For cost of capital, we set out our proposed methodology in detail in December. Following consultation, we have amended our approach in a few areas, and updated for changes in market rates. Our updated cost of equity range, based on the revised methodology in current evidence, is 4-5.6% CPIH real, and we have a working assumption of an allowed equity return of 4.3% CPIH real. This compares with our 4% assumption in December. We will discuss the changes in detail later. I would emphasise now that it is explicitly conditional on a review of the overall opportunities and risks companies are expected to face in RIIO-2, following assessment of business plans. Our updated cost of debt working assumption is 1.9% CPIH real, up from 1.7% in December. This reflects updated market information on companies' actual expected debt cost for RIIO-2 as well as changes on market yields. We have also simplified aspects of our financial package with the suspension of work on our cash flow floor proposal and removing sector anchoring as an option for the return adjustment mechanism of gas distribution. Our proposed incentive regime also has a number of updates around business plan, totex and outputs which we will highlight in this presentation. Taken as a whole, we remain convinced that the environment for network investors remains attractive and that our proposals are fair to both investors and consumers.

Turning to Slide 2, we reiterate the key aims of RIIO-2 which remain unchanged. First, meeting a need for consumers and network users: customers will remain at the heart of the price control. To challenge engagement between user groups are already engaging with companies and other stakeholders to good effect. There will be open hearings in spring 2020, and we continue to emphasise the importance that networks provide additional support to vulnerable and poorly-served groups. Second, retaining a safe and resilient network, quality of service and asset health remain essential in meeting customers' needs, which continue to be recognised in our RIIO-2 approach. Network resilience measures, including cyber resilience, will form part of the RIIO-2 package. Thirdly, delivering an environmentally-sustainable network, the energy transition to a smarter, more flexible and sustainable system is a reality that we are looking to facilitate. Our proposals around competition, innovation, and uncertainty mechanisms will contribute, as does our move to a shorter five-year price control period. We have learnt lessons from RIIO-1, and we are building on these in RIIO-2. This includes our proposal on return as well as retaining strong incentives for improved performance. To summarise, I want to make it clear that companies delivering great customer service and outperforming tougher targets through efficiency and innovation will be rewarded.

Slide 3: I think by now that the RIIO timetable is familiar ground. A few points I would pick up on: First, the methodology decision is specifically for gas distribution and transmission, and the electricity system operator. The electricity distribution sector will be covered by a specific RIIO ED2 price control, which will kick off with an Open Letter this summer. Second, we are moving now into the Business Planning phase with draft business plans in July and October, and final submission in December. Third, and to reiterate, the methodology has been set at this point and not the final values, which will be assessed at Determination in light of the then current conditions.

Turning to Slide 4, we list some of the key decisions around outputs and incentives, and our approach to setting these. We will use indexation and competition, encourage innovation, and look to strike the right balance between a high-quality and low-cost background.

Slide 5: As I mentioned earlier, we have listened carefully to consultation responses, and are making a series of changes. For cost of equity, we have altered our approach to CAPM Beta estimation, firstly, broadening the range in line with consumer group recommendations, and, secondly, looking again at our treatment of company leverage, as requested by the network companies. These changes, coupled with updating the risk-free rate, give an updated cost of equity range of 4.5% to 5.6% in CPIH terms, with a mid-point estimate of 4.8%. Our working assumption for the allowed equity return is 4.3%. This remains lower than the mid-point of our cost of equity range due to a 0.5% assumption of expected incentive outperformance. This is referred to as Step 3 in our Cost of Equity Methodology. For cost of debt, we have confirmed our approach to sector-wide analysis based on full indexation with calibration at Determination, based on sector- efficient costs. The following evidence received in consultation, we have updated our estimate of sector debt costs as well as adjusting to changes since December in bond market yields. As a result, our updated cost of debt working assumption is now 1.9% in CPIH terms.

Other changes we're making include removing the competed element of the Business Plan incentive following stakeholder feedback and consultation. Confirming our use of company-specific Sculpting as a Return Adjustment Mechanism for gas distribution as well as transmissions, so we will not proceed with sector-wide anchoring for Gas Distribution. We are suspending work on the Cash Flow Floor. We still see merit in a focused measure to provide contingent credit support for companies under some circumstances. However, we now believe this support is not needed, based on our initial finance ability analysis, including a review of credit rating agency in reaction to our December proposals.

Slide 7: On Slide 7, we recap key aspects of the incentive regime. We will still target strong incentives for companies to strive for increased cost efficiencies. We will set incentive rates based on the confidence we have in our ability to set transparent and credible baseline cost levels. The higher our confidence, the greater the incentive rates. The levels of these rates will be confirmed at the determination stage. Likewise, for the Business Plan incentive, we are looking to encourage and reward ambitious, high-quality plans from the companies. We outline a four-stage process that assesses cost levels and assesses business plan quality, and we have confirmed an incentive cap of +/-2% of totex based on individual companies. We are no longer considering a sector-based competed element to the incentive.

On innovation, set out in Slide 8, we remain committed to a strong innovation fund in progress. We want this to cover both making a transformational project as well as smaller more specific innovations. We will reform the RIIO-1 innovation arrangements to help achieve these objectives. We are introducing a new strategic innovation fund in place of the network innovation competition, as well as updating network innovation allowance mechanism. We remain committed to innovation as a core aspect of RIIO, and want to see it focus even more on key priorities. These include addressing major transition challenges we face, as well as improving outcomes to vulnerable customers. We are committed to continuing to widen the scope for consumers to gain from increased use of competition in networks. As Slide 8 sets out, we will continue to introduce competitions when we see economic benefits, and will apply our current approach to on-shore late competition across all sectors covered by this price control. We are also making sure that RIIO-2 is capable of delivering some form of early competition, and have asked networks to identify projects which might be suitable. And, we are implementing competition in best practice principles to best capture value for consumers from the competitive processes undertaken by network companies within the price controls.

Slide 9: Throughout the RIIO-2 process so far, we have emphasised the need to ensure that returns are fair; fair for both companies and consumers. An important aspect of this is our introduction of a Return Adjustment Mechanism to safeguard against unforeseen excessive returns. Following consultation, we have decided to rule out both discretionary adjustments and sector-wide anchoring. We had only proposed anchoring as a possible RAM for gas distribution, having previously signalled a preference for a company-specific sculpting for the transmission sectors. Having reflected on the diversity of companies in the gas distribution sector, and various issues raised in consultation, we will apply company-specific sculpting for this sector, as well. In assessing our performance, we will only consider operational RORE i.e. returns excluding financial and tax performance. This means that all companies should have the same potential for RORE our performance from totex and output incentives. In addressing our performance, we will also exclude any reward received under the business plan incentive. We believe that this will maintain companies' motivation to submit vigorous ambitious business plans in the coming months.

Slide 10: The outline from our other operation decisions. First, output targets, we have been clear that ODIs need to target outcomes that consumers value. We have highlighted three areas, in particular, namely: meeting consumers' needs, including vulnerable consumers; two, maintaining the resilience and safety of the network; and, three, delivering an environmentally sustainable network. As we finalise our output measures, we will address each as, either: 1. A licensed condition; 2. Having an Output Delivery Incentive, or 3. Being a price control deliverable. Network safety and resilience is essential. Our measures will ensure long-term safety, security, and reliability. However, we acknowledge that investments to achieve this are occurring in a period of change for the energy system. To address this, we are adopting a carefully-targeted approach to managing uncertainty in the RIIO-2 period. In particular, for investments that might be considered in advance of immediate needs, we plan to establish a broader group to advise on proposed investments that are strategic in nature. And, through these arrangements, we will ensure that these are consistent with government policy. The next section of the presentation focuses on financial decisions, which Simon will address.

Simon Wilde

Great. Thanks, Jonathan. Slide 11 introduces a further nine slides that will cover the specific financial methodologies and inputs behind the headline equity returns already discussed by Jonathan. We don't plan to go through these slides in detail. Instead, they are to draw your attention to the relevant parts of the Finance Annex. I'm conscious at 160-pages long, it might otherwise be fairly hard to read, and we'll look to signpost you to the relevant places.

On Slide 12, with respect to our overall approach, we are confirming the overall approach to our cost of capital assessment set out in December's consultation document. For cost of equity, we have a three-step process to assess the cost of equity range and the allowed equity return. On cost of debt, we will continue to set the cost of debt based on the full indexation approach that's worked well in RIIO-1, and we calculate a weighted average cost of capital based on notional gearing. It's worth remembering, as has already been stated, that we're setting the methodology at this point. Whilst we do provide working assumptions, the final returns will be set at determination next year.

Turning to Slide 13, which is the first of three slides on Step 1 CAPM. Step 1 is to assess the CAPM cost of capital. On Slide 13, we address our approach to the first parameter, the risk-free rate. We have decided that we will continue to focus on the real 20- year gilt yield as our best guide to risk-free rates. We will then index annually the cost of equity to reflect changes to this real gilt yield. By doing so, we reduce the risk of companies experiencing windfall gains or windfall losses during RIIO-2 from interest rate movements. The details of our approach are set out in the table on Slide 13, which you can find on page 30 in the Finance Annex.

On Slide 14, the second CAPM parameter is Total Market Returns or TMR. We continue to believe that the appropriate range for TMR is 6.25% to 6.75% in CPIH terms. We've received and reviewed extensive submissions by stakeholders on this, and we remain confident in the stated range based upon the approaches set out on Slide 14. I draw your attention to the chart on Slide 14, which you can find on page 39 of the Annex. This sets out a current survey of investor expectations. Had we followed this evidence, we could, in theory, have applied an even lower TMR range. However, we were guided by our long-standing approach of focusing on inflation-adjusted long-run data. The final point I'd make about TMR is, had we set the price control in RPI terms, we would have used a lower range i.e. 5.2%-5.7%.

Slide 15 sets our approach to the third and final CAPM parameter, the equity beta, and the amended working assumptions that we've made. Again, we received significant consultation feedback on this point. Based on our review of the feedback, we have made a number of adjustments to our proposed approach. What we haven't changed is that we will continue to focus on long-run measured beta. However, we have widened our beta range to consider longer time periods. The low end of the range is now associated with an 18-year historical average. The second adjustment we've made is that we've adjusted our treatment of gearing. We've done that in two ways: First, insofar as possible, we now match average historical gearing with our beta estimation period. This is the request we've received from the network companies. The second gearing change is that we now take into account the market value of debt rather than book value, so we're consistent in our treatment of equity and debt. Taking all of these changes, this gives us a re-levered beta range of 0.66-0.85. This is wider than the 0.65-0.76 range that we had in December. Our current mid-point is 0.75.

On Slide 16 firstly, we can now combine our three CAPM parameters, and this gives an implied CAPM cost of capital of 3.9% to 5.6% in CPI terms. In the table, you can see this in the row labelled, 'Step 1'. Step 2 is our introduction of a range of market-based crosschecks that we compared with our CAPM values. In particular, we continue to look at the crosschecks that we introduced at the consultation stage. We observe equity returns in OFTO bids, we observe discount rates used by publicly-listed UK infrastructure funds, and we observe the survey evidence on listed investor returns that I've referred to previously. The crosschecks are broadly in line with our CAPM range, but as none of them is less than 4% CPIH, we adjust in Step 2 our cost of equity range to 4.0% to 5.6% CPI.

On Slide 13, we discussed Step 3. In Step 3 we applied the distinction between expected and allowed returns that was decided upon by Gemma in the July 2018 Framework Decision. We've received significant amounts of evidence in consultation on how we propose to apply this distinction, and, again, this has been considered in detail. We remain of the view that investors can hold expectations around potential incentive outperformance and that this needs to be taken into account. That said, we will calibrate the size of any expected allowed return distinction at the determination stage. This will be based on our assessment of the potential outperformance by companies against the final RIIO-2 package. In the meantime, historical evidence points to likely positive investor expectations of outperformance on balance of probabilities, and we continue to apply the 50 basis points outperformance assumption made in December. As a result, our updated working assumption for allowed return on equity is 50 basis points lower than our 4.8% mid-point of the cost of equity range. In other words, the working assumption for the allowed return on equity is 4.3% in CPI terms, as we've said.

On Slide 18, we turn to the cost of debt. For cost of debt, we confirm our proposed approach in December. This is to maintain full indexation without debt performance sharing in line with RIIO-1. At determination, we will calibrate the actual debt allowances to be broadly equal to the expected sector-wide efficient debt costs. In consultation, we received evidence that RIIO-2 debt costs are likely to be higher than those implied by our December working assumption of a 10-year trailing average. Having reviewed this evidence, we now adopt a working assumption which is based on current views of sector average debt costs. It's based on current market conditions, and it's based on implied forward rates. Combining these together gives us a cost of debt working assumption of 1.9% in CPIH terms. This is up slightly from the 1.7% assumption in December. But, to be clear, we will calibrate the final debt allowances at determination. Also, at that stage we will consider the size and applicability of possible adjustments such as the halo effect and other potential adjustments discussed in the Finance Annex. The 1.9% current working assumption does not contain any of these potential adjusting factors.

Bringing this all together on Slide 19, we combine these working assumptions and set out in the table, which you will find early on in page 8 of the Finance Annex. Bringing this together, you will see that we have an allowed return on capital of 2.9% CPIH real as our updated working assumption. In line with the cost of equity and the cost of debt, this is up slightly from the 2.6% WACC assumption in December.

We also compare on Slide 19 the assumptions that we made in December and that we are updating today with the Ofwat PR19 position. The latest updated position from Ofwat was as of December 2017. At that time, Ofwat had a cost of equity assumption of 5.0% CPIH. So, our current 4.8% assumption is marginally below that, although, because we are proposing indexation, we are offering investors protection from rate rises in the RIIO-2 period. Our 4.3% allowed return is lower than Ofwat as we continue to believe that companies are likely to outperform. But, as said earlier, any difference between allowed and expected returns will be calibrated later based on our RIIO-2 proposals.

Our final slide on finance is Slide 20, where we turn to financeability. Ofgem has a duty to have regard to the need to secure that licensees are able to finance activities subject to legislation. We continue to assess this duty with reference to the notional company. In December, we proposed a cash flow floor mechanism in the event that companies required additional downside protection. As Jonathan has mentioned, we have now suspended work on the cash flow floor as we no longer believe that companies need contingent credit support, and that they can address any financeability constraints to other measures. Our initial financeability analysis suggests that credit metrics for the notional company will generally be stronger in RIIO-2 than in RIIO-1. This is based on our current working assumptions of cost of equity and debt that I've already described. Our conclusion on financeability appears to be supported by the rating agencies that have also modelled notional companies for RIIO-2, such as Moody's.

Slide 20 sets out our initial financeability assessment for gas distribution. The Finance Annex sets out the same analysis for the other sectors, for those that want more detail. This analysis will be updated further, as and when we receive company-specific information through the business plan later in the year. Back to Jonathan.

Jonathan Brearley

Thank you, Simon. On Slide 21, we summarise some of the key points from today's publication. We acknowledge and we understand the importance of energy networks and why the energy sector change is underway. We believe that this RIIO-2 approach is recognising these points whilst appropriately balancing the interests of consumers and companies. The more companies continue to innovate and to find efficiencies and to be rewarded for doing so, at the same time, we continue to focus on what matters to consumers. I will now turn to John to open the call for questions.

John Bolitho

The Operator will be giving you instructions. At the risk of repeating them, the Operator will come back on the line and instruct participants to dial 01 if they would like to ask a question. Once participants begin coming forward, the Operator will announce each name and company, and unmute them one by one. We'll go forward to that now. Thank you.

Q&A

Operator

Thank you. As said, ladies and gentleman, if you wish to ask a question, please dial 01 on your telephone keypad now to join the queue. Once your name's announced, you can ask your question. If you find your question's answered before it's your turn to speak, you can dial 02 to cancel. Once again, that's 01 to ask, or 02 if you need to cancel. Our first question comes from the line of Mark Freshney of Credit Suisse. Please, go ahead. Your line is open.

Mark Freshney

Hello. Good afternoon. I have two questions. Firstly, on the proposal to go from a 10-year trailing average cost of debt index to, I think as you describe it, in the 11 to16 year trombone, there seems to be little in this report and also the one before Christmas on detailing exactly how you get there. Perhaps you could give a little bit more detail on the justification for that and why you don't go straight to a 20-year trombone like the electricity distribution industry, perhaps. Secondly, can you talk about dividend assumptions that you've made? I think in the report you reference a water company that has cut its dividend to. I think, 2% or 2.4% of notional equity. When you run your financeability assessment, what kind of dividend yield are you assuming? Thank you.

Simon Wilde

Thanks, Mark. Going to your Question 1 on cost of debt. I think we tried to be clear in December, and again in the May document, but we have reconfirmed full indexation with the approach that we take in calibrating the indexation is to attempt to compensate companies for sector-wide average costs of debt that are expected in RIIO-2 with a caveat that those costs of debt need to be, to have been efficiently raised. And, so, it becomes an empirical question of whether, with our forecasts of where the iBoxx may be, the spot iBoxx may be in RIIO-2, whether any particular trailing average, for example, the 10-year average, whether that would cover the companies' costs. In consultation, we received a couple of very detailed reports which will now be up on the website, so you can have a look at them yourself, that detail actual and verifiable company debt costs and the 10-year trailing average which is a working assumption in December, because we simply said, let's assume that we keep the same calibrations that we have with RIIO-1. We were able to convince ourselves that that would lead to under-recovery by the companies that we were looking at. To come to your question about why not move to a 20-year trombone, well it's the flipside of that, when we consider a 20-year trombone, and we estimate the amount of debt that they'd receive, that would potentially overcompensate. We're not wedded to any one structure. We're not committing to any one structure, but we're offering a new working assumption that achieves our stated aim, which is to neither overcompensate nor undercompensate on a sector-wide level. With respect to the dividend assumptions, we model a constant notional gearing throughout RIIO-2 - it's not as we keep gearing flat at 60% - and, so, dividends are, therefore, an output from the model, effectively. So, I'm not sure I can give you any particular dividend assumption that we've made in our financeability modelling.

Operator

Thank you. Our next question comes from the line of Martin Young at Investec. Please, go ahead. Your line is open.

Martin Young

Good afternoon to everybody. A couple of questions. The first relates to the potential bill impact as we move into the RIIO-2 timeline. You've been very clear all the way through the process that this has to stack up in the court of legitimacy. The Labour Party have obviously put forward some ideas. If you strip away the ones that perhaps could be described as based on ideology, there are some very valid points in there about the level of bills that consumers pay. You've indicated in the updated analysis, I think, that you could see about £25 per person from the reduction in the cost of capital as we move from RIIO-1 to RIIO-2, but given the multitude of levers that we have here, if we were to see a recalibration of the slow/fast money split in favour of fast money, as has been proposed by some of the companies, that would work against a bill reduction. To what extent have you done analysis to analyse that particular offset against the reduction in the bill that comes from the cost of capital, and would you be able to share the magnitude of that analysis? The second point: in terms of the business planning process, you've been very clear in your working assumption today. Some of the network companies have markedly different views on where the cost of equity should be put for RIIO-2. Have you given those companies any specific guidance as to what they should incorporate in their business plans as far as the cost of equity is concerned? Or, are they free to do whatever they feel best, and, then, put that up against the business planning incentive process that you've outlined in today's document? Thank you.

Jonathan Brearley

Hi Martin, I think I'll just take two of those, and hand over to Simon, particularly on the second. In a sense, you're right on your first point on bill impact. What we're really doing here is setting out the framework, and telling you where we think cost of capital is, based on our methodology and based on the evidence we have today. There are a huge number of other factors that will lead to the final verifications for the next price control period. I think we can only be clear on those once we get to final determination. We've been very clear in all of our communications that this is our understanding of the impact of the cost to capital change, but there will be other things that are taken into account when we come to assess the overall impact on the public. The only thing I will say on the working assumption on cost of capital is this is where we are today based on the evidence. One thing I would say is I am aware that companies have put different proposals as to what that number should be, but you need to know, this is what the regulator is saying based on its methodology and the evidence today. And, although I can't predict the future, I'm finding it hard to see massive shifts.

Simon Wilde

Specifically, in the detail of your second question, Martin, and hello, it's nice to hear you on the other side of the phone for a change, is that we have been very clear with companies that we want to see their business plans using our working assumptions for cost of capital. It's our understanding that companies will provide business plans on that basis. Some of the companies have gone very public with what their views are of cost of capital, and may well provide business plans also using their cost of capital assumptions, but we will be assessing business plans on a common and consistent basis using the Ofgem working assumptions.

Operator

Our next question comes from the line of John Musk at RBC. Please, go ahead. Your line is open.

John Musk

Afternoon, everyone. Just one question from me on the 50 basis points performance wedge, if you want to call it that. You left it slightly open saying that you may be persuaded on the basis of additional information to reduce that. I'm just trying to get an idea of what you would need to take that away. I'm thinking around the business plans that come in. If you were to get very robust business plans, perhaps something that might be akin to fast-track status in the water world which you thought had been robustly prepared, is that something that might lead you to think that the 50 basis points is no longer needed?

Dermot Nolan

This is Dermot coming in here. I think the answer to that is very clearly no. No, this is a separate, if you like, philosophical point which we believe in, and it's not necessarily to do with business planning. We've said what we wanted to say earlier about fast-tracking. We see no particular reason to revive that, so in that sense I think it would be a fairly clearly no on that. I would also say, just touching on something Jonathan said, touching one of the potential contexts of your question, is the sense we would always be potentially persuaded before making final decisions which are still some way off, but I want to make it very clear, that cuts both ways. I don't want there to be any sense of which these are working assumptions based on a large amount of evidence and analysis. I said they can change subject to further developments, further events, *etc*. But I want to be clear they could change both ways. So, do not automatically assume that they will change upwards rather than downwards. They can change both ways. There is no ratchet effect at play here, and I want to be very clear about that.

Operator

Our next question comes from the line of James Brand at Deutsche Bank. Please, go ahead. Your line is open.

James Brand

Hi, good afternoon. I'm hoping to ask three questions. I appreciate it's a bit more than-- there normally seems to be two, but they're relatively quick. The first is, just on the business plan incentives which I thought were pretty interesting, I was wondering whether you could just explain to us what a company would have to do to hit the maximum 2% rewards against totex. You seem to have a bit of a working example in the paper as to what would be required to receive the maximum 2% penalty. It looked like a 2% overestimate and a substantial amount of the costs being low quality baseline, but I was wondering whether you could maybe just flesh out what companies would have to do to hit the upside on that one. Second question is just, it seems like there's a couple of areas in your proposals where you'd initially thought about having a cross-sector competition based on anchoring, on gas distribution, and then the business plan incentive where you've moved a little bit away from comparing how companies were performing against each other to looking just at how specific companies are doing. I was just wondering whether you could flesh out a little bit more- maybe that's a misinterpretation of-- but whether that's right, you've pulled away from that, and what's driving that. Thirdly, on the competition, the 50 million threshold for early stage and 100 for late stage, are you at the point where you've got any idea how much of the overall totex or how much of the overall investment programme that might be captured by that - I guess we haven't got the business plans yet - but maybe you have a rough idea what proportion of the CAPEX would be encompassed in that competitive element. Thanks.

Steve McMahon (Ofgem)

The first two are really for the Business Plan incentive. I think you're right that we said our revised approach today which is broadly consistent with what we said in December. I think just to reiterate, what we're looking for through the business plan incentive is ambitious cost forecasts, a deterrent against padding a cost, and ultimately for companies to review that information that we can use in terms of price control. In terms of the criteria that would apply against the four stages. We are planning to update our business plan and guidance document next week, and that will provide better details to the companies of what we want to see in the business plans for the purpose of the business plan incentive. I think if you read the document as well you'll also see that we we're going to work with the networks, there's a couple of workshops in June to make sure that we can understand some of the practical implementations of this. I think, look out next week for some more details on the criteria of what would constitute criteria against different caps for reward and penalty. I think the second point was around the idea of contestability. I think in relation to the business plan incentive, we got quite clear responses that actually having a competed pot might work against the objectives that we set. They would probably restrict collaboration and it would, potentially-- given the companies would be uncertain in terms of what the size would be, but then it might rub against the objectives that we set, so we think that there is an argument in that, and that's why we've moved to set that on an absolute basis, which better helps us to achieve what we want. I think when it comes to RAMs and the anchoring proposal, for us, we had looked at that on the basis of, is there enough comparability, contestability in the sector. I think our position in December was there potentially was. I think, once we reflected on the evidence the market distribution and the impact of some individual licensees, that may well not be the case. So, again, that's why we decided to rule that out for the purpose of the gap distribution, to provide greater clarity in terms of what we're trying to achieve, in terms of covering those particular mechanisms.

Jonathan Brearley

A couple of follow-up points from me: I don't think you should take this as a signal that we are moving away from contestability elsewhere in the price control. It is still absolutely in play in terms of how we do our incentives, and we are very supportive as an organisation for getting greater competition into networks. As to how much we can apply above those thresholds against totex, it's just too early to tell. We'll know more when we get the business plan.

Steve McMahon

I think that's right. The last question was around what the pressure was for competition, so late stage, we've said 100 million, early stage 50 million. At this stage, we don't know. We just need to wait and see what's in the business plans, and then we can take that forward.

Operator

Our next question comes from the line of Chris Laybutt at JP Morgan. Please, go ahead. Your line is open.

Chris Laybutt

Good afternoon, and thank you very much for the call this afternoon. Just one question from me, and perhaps-- it's on cost of equity or the equity allowance. If we could set aside the 50 basis points for the outperformance wedge, I guess I'm curious to know how you've arrived at a cost of equity assumption that's lower than water, given you're at 6.8% in nominal terms and Ofwat are currently using a working assumption which is higher than that, at 7%. Just given the risk profile of the two sectors. Thanks very much.

Simon Wilde

Thanks for that, Chris. I'd say a couple of things that explain the difference. One is that, obviously, Ofwat assume a zero outperformance wedge, although I think—so, therefore, the 4.3 is not directly comparable to the 5.0. Your question was more about 4.8 versus 5.0. I'd also observe that since December 2017 there have been some fairly significant shifts in risk-free rates, and so our number is based upon current risk-free rates. A third difference, of course, is that we have indexation. Our 4.8% includes the gilt forward curve's benefit of indexation, but it ignores the insurance benefit in terms of rising rates. And, just a more general point about water versus electricity, which is that my sense is that there are more similarities than differences between energy and water, given that neither of them have exposure to demand risk, and I'd note that I think the numbers are close.

Operator

Our next question comes from the line of Fraser McLaren of Bank of America Merrill Lynch. Please go ahead, your line is open.

Fraser McLaren

Good afternoon. A couple of questions from me, please. First of all, may I ask you about the level of investor engagement in the process so far? I recall you invited people to participate in an online survey earlier this year. Just wondering how many responses you got to that survey, please? Secondly, another question on ROE and just looking at the submissions by the network companies and what they and their consultants concluded about appropriate returns which are, of course, much higher than yours. Does your earlier remark suggest that you already think that they're wrong, and that on this whole ROE point there really is no scope for movement?

Jonathan Brearley

I'm going to come in and ask Simon to follow up. Just to emphasise, we do spend, as you know, Fraser, a great deal of time talking with the investment communities before shaping any proposals like this, and the consultation is designed to make sure we get feedback from whoever has an interest, whether it be the companies or the investment community themselves. The other thing I would say is, we are a regulator that bases ourselves on the evidence. Our job is to show you what we think, based on the evidence we have. The methodology we are setting here allows you to see how we think about this. It's your judgment as to what happens after that.

Simon Wilde

To answer your specific question, we approached several hundred investors, and eight chose to respond anonymously. However, I would also say that we have actually met, in terms of one-on-one meetings and calls with investors, multiples of that number. So, as Jonathan said, we have made ourselves, and will continue to make ourselves, available to any serious investor that wants to meet with us to discuss our position on RIIO-2 and on cost of capital. With respect to consultants' reports, we've made them all available to you. There are 21 of them, with many hundreds of pages. Please do read them. We've also looked to comment on them in detail, and I think you can take as given that any of their proposals that we have not taken is because we do disagree with them, and we explicitly explain in the Finance Annex why we disagree with them. I invite you to read them, and I think that sort of implies, unless somebody was to try and change our mind, if those arguments are played back to us again, why would we not come to the same answer that we've come to today?

Jonathan Brearley

Can I say one last thing as well? We want this process to be one where we do engage fully across investment communities. So, Fraser, if you or anybody else on this call feels that there is more we need to do to reach out to you, we're not always going to necessarily agree with you, but we do want to hear what you have to say, and we want to understand your perspective.

Operator

Our next question comes from the line of Elchin Mammadov of Bloomberg Intelligence. Please, go ahead. Your line is open.

Ellchin Mammadov

Hi, there. It's not directly on the RIIO-2, but I was wondering if you had any update on the competition proxy delivery model. That's all. Thank you.

Jonathan Brearley

We don't have a huge amount to add, to state publicly. Clearly, we are still going through the process and will be publishing further information soon.

Operator

Our next question comes from the line of Deepa Venkateswaran of Bernstein. Please, go ahead. Your line is open.

Deepa Venkateswaran

Thank you very much. Two questions from my side. The first one is a comment that you made on financeability: that you find that in RIIO-2, I think, in the context of the gas distribution companies, that their ratios look much better under RIIO-2. Is this largely only because of the CPIH shift? Or, is there anything else you're resuming on asset lives or pay-as-you-go ratio? Second question; sorry to come back to the outperformance wedge. On the slide where you highlight the difference between the cost of equity that you have versus what Ofwat have, it's the same investors. So, why would you assume that there is an outperformance wedge of 50 basis points when it comes to the energy networks, but there isn't one-- it doesn't seem very consistent across regulators given that they have a very similar incentive scheme of ODIs, totex, etc. I can understand about the indexation that you're providing, and, so, maybe there's some difference over there, but this whole performance wedge, it seems to be fairly inconsistent across regulators. So, maybe if you could comment on that? Thank you.

Simon Wilde

Yep, certainly. Thank you for that. So, on financeability, I didn't say that it was a very big improvement, but I did say that the ratios show improvements. I just want to get the scale of that right. It's due to a number of things, but the effect of the switch to CPIH is a material positive effect to the credit metrics. So, I think, that's something that we accept. If you look at the Moody's report on the gas distribution sector of 14 February of this year, they put a very clear analysis of why they agree with us. With respect to asset lives and pay-as-you-go, we've made no assumptions to changes in those. We will look at what companies put in their business plans, and that's why I did say that our initial financeability assessment will be updated after business plans. With respect to the wedge, if I may, the investors may be the same, but the regulators are different, and the regimes are different. I think if you look at the contrasting company experiences of PR14 in water, with RIIO-1 in energy, then I think it's very hard to conclude that those regimes are the same, and so we're forming a view on our proposal. We really have very little to say about Ofwat's proposal. We just put the numbers down there because we don't want you to think that we are not cognisant of them.

Deepa Venkateswaran

Could I just ask a follow-on question? You've obviously stated many times that you've learned the lessons from RIIO-1, and presumably the expectation is not a repeat of RIIO-1 in RIIO-2, given that you're going to be tightening the requirements for companies to earn rewards, the incentives are going to be tougher, you're going to rebase the expectations to what was delivered in RIIO-1. So, given that, I would have assumed that both you and Ofgem and Ofwat are trying to aim for something very similar: incentivising the companies fairly, but keeping customer interest in mind. So, given that, why would you still think that energy companies would have this outperformance wedge, and water would not?

Jonathan Brearley

One thing I would say, as Simon has emphasised, we are here to design a regime for energy, and it's not really for us to get into the detail of what Ofwat are doing. All I would say is, at a generic level, and then I'll hand back to Simon, what we're setting out here is a principled argument as much as anything else. --It asks the question of what we are calculating when we calculate the expected return, and therefore relate that back to the regime as a whole. I think it will become much clearer when we've laid out our incentives, what we think the scale of that outperformance might be, but it seems a very sensible question to me, particularly, given our own history within the price controls of energy that we're, at least, asked the question, 'Is there going to be a possibility of cross-sector outperformance overall?' And, if there is, then, you should be applying that against your expected value. That, to me, logically, seems perfectly sensible.

Simon Wilde

The only thing about that I'd add, I agree we have said that we have learnt lessons from RIIO-1. But that doesn't mean that we can overcome the inherent information asymmetry that will always exist in our relationships with the energy companies. Again, we address this in some detail in the Finance Annex, particularly the way we engage with some of the arguments that were made by other stakeholders.

Operator

Thank you. And the next question comes from the line of Dominic Nash from Barclays. Please, go ahead. Your line is open.

Dominic Nash

Hi guys, it's Dominic Nash here from Barclays. Two questions, if I may. Firstly, on the risk-free number, you're basically saying that your working assumptions are that companies should put your WACC into their business plans. Is it fair to say that that -2% risk-free on an RPI basis is now the thing that's set in stone? If there are risk-free changes now between business plans and beyond, then we can run through what your new ROEs and your cost effects are. Secondly, on the return sharing mechanism: could you just give me an update? Where are we on the cap on when you start to return 50% or 75% of the RORES? Will that be done on an annual basis via a November iteration? Or, is that going to be done on a cumulative basis, so that at the end of the review will you get the full true-up on that basis? Thank you.

Simon Wilde

OK. First point's valid. So, I'll reiterate. Dominic, it's great to have you on the call. I understand you weren't able to join last time around, but welcome. I think it's Dominic, rather than Olaf. On risk-free rates, we have set out why we think the 20-year RPI gilt is the right gilt to use, and I think it is a fair assumption that, unless we change our mind about that - and we've explained why we decided on it - but you should assume that we will be updating for changes in that rate because that is, after all, the whole point of indexation, which means that once we're into RIIO-2, there will be automatic adjustments based on that. So, I think that's a reasonable assumption.

Jonathan Brearley

Can I just clarify your second question? I think you're asking us if we sculpt our sharing factor-- so, if we give more back to customers as returns go up, roughly how are we setting that out? Is that right, or have I got that wrong?

Dominic Nash

Yeah, partly. I'm trying to get a gauge of what really is the maximum these companies can earn. I'm looking at your numbers, and it's probably high single digits, when you get to 75% sharing. Secondly, if you've got multiyear projects on totex outperformance, or if you blow the lights out in Year One, but you underperform in Years Two to Four, how are you actually going to work out the sharing?

Jonathan Brearley

I think a lot of that detail we still need to work through. What we're setting out here, basically, is the high-level decision to move away from alternatives, like discretional anchoring.

Steve McMahon

We've not determined how that will apply in practice at the moment, so that's still to be determined.

Operator

Thank you. Our next question comes from the line of Ali Agra of SunTrust. Please, go ahead. Your line is open.

Ali Agra

Thank you. I guess I'm still trying to understand the logic of the outperformance wedge. Given that there is a threshold under ROE for these companies, and anything above that they've got to share back with customers, what is the logic for having that wedge to begin with? Because once, presumably, they hit that ROE, they're going to have to share it anyway, so that is the maximum they can earn. So, why do we need this wedge?

Simon Wilde

Ali, thanks very much for asking that question because there is an issue here, which is that cost of equity is supposed to be the expected return of investors i.e. the return that you as an investor are looking for. We either estimate that rightly or wrongly, and you can agree or disagree with that, but that is our estimation of the return that investors need. Under an incentive-based regime, you can earn that return in two different ways. One is the base allowed return, and the second is any expected earnings from the incentive regime. For us to ignore it, means we are potentially allowing double-counting on the required return, and that is an issue that was identified in the report, and I think that it was explained relatively clearly in 2018, and that's what we're trying to address.

Ali Agra
I see. Then, just to also clarify - I thought I heard you earlier - has the threshold return been quantified yet or does that get quantified on a company-by-company basis as the plans are approved?

Jonathan Brearley
All to be determined later. Not fixed yet.

Ali Agra
Understood. Thank you.

Operator
Thank you. Our next question comes from the line of Ian Turner at Exane BNP Paribas. Please, go ahead. Your line is open.

Ian Turner
Good afternoon, everybody. Just returning to this Step 3 equity outperformance wedge again, I think you've probably got the impression that, certainly people this side of the table really hate it, and we regard it as arbitrary and just a way of pushing down the return on equity. So, could we come at it in a slightly different way. Do you think it complies with the principles in the UKRN work on the cost of capital? I'm thinking along the lines of consistency, good practice, backed up by academic thinking.

Jonathan Brearley
I'm going to hand over to Simon in a bit, but I just wanted to address your first point, really. Our job is to find the best way to get a fair balance between shareholders and consumers in the rewards for the investments we need from the system. We really do want to consult with people here, but there are going to be times when we disagree. You'd expect that, and we absolutely take those views into account, but we're doing our best to do the job we've been asked to do. Simon, do you want to comment on the UKRN--?

Simon Wilde
The UKRN is a foundation, and it's up to you to assess whether you think that is a good academic foundation or not, but the approach that we are taking is in line with their recommendation. The method that we're doing it, we are having to develop ourselves. But just to address your point of consistency and good practice, I think they potentially conflict with one another, but every time a regulator makes a change, albeit a change for good reason, he or she could be accused of not being consistent. But if that change is well-founded, you could argue that it's good practice, and we're weighing up those two things against each other.

Operator
Thank you. And we have a follow-up question from Mark Freshney at Credit Suisse. Please, go ahead. Your line is open.

Mark Freshney
Yes, thank you. Two questions, firstly on the financeability metrics. Do they include everything i.e. potentially, the SPV that competition proxy assets may sit in, as well as the main RIIO RAB, or is it the case that the competition proxy at SPV is completely separate and that the companies will have to find some other way of making that financeable? My second question is - forgive me, I haven't looked at the documents you just referred to - but on the cost of debt, one of the thorny issues is that there've been a lot of bond buybacks which result in higher net debt, but lower interest charges. For example, Cadent: you look at what was in there, I think it's fair to assume that there was about £1 billion extra net debt in that business reflecting the very low interest costs. Has your work on looking at empirical cost of debt and what the companies are financed at, has it taken into account those bond buybacks and the fact that net debt is higher than it would otherwise be?

Simon Wilde
Two questions: one is the financeability assessment that has been done on the RIIO regulated businesses. So, it does not include external businesses which would include, for example, non-RIIO regulated businesses on the competition proxy model. With respect to your question about cost of debt, you raise a good question, and we've been engaged heavily with the companies about this. We actually do signal in the document that we will take into account efficiently-incurred costs, and those costs can potentially include the cost of bond buybacks that then feed through to lower cost of debt. We actually say in the document there are two ways of looking at this. You either keep in the old expensive debt as if it was never bought back, or you can look at it with the lower new cost of debt, but with the acceptance that you ought to think about what were the one-off costs that were required to get to that lower debt. So, you'll see in the document that we discussed the merits of both approaches.

Jonathan Brearley
Can I just make one point just for clarity: the competition proxy and the SPV are implemented under the RIIO broad framework, but they will be treated separately in financing terms.

Simon Wilde
I misspoke. What I should have said was RIIO-2 RAV.

Operator
Thank you. Our next question comes from the line of Bartek Kominsky of SocGen. Please, go ahead. Your line is open.

Bartek Kubicki
Hi, good afternoon. This is Bartek Kubicki from SocGen. I would like to get a little bit more detail on the parameters used for ROE calculations, or the return on equity calculations. First of all, you could maybe summarise and perhaps repeat why actually equity EBITDA and total market return are declining on the RIIO-1 to RIIO-2 basis, given the fact

that this should take into account the long-term view and should not change that much. So, that would be the first thing, and the second thing: you're fixing the total market return rather than the equity risk premium. If we assume, according to the books, that total market return is equity risk premium plus risk-free rate, if we assume in an unlikely, but maybe-could-happen event, that risk-free rates go up to 6.25%, then the implied equity risk premium goes down to zero, which is actually quite unoriginal. Could you comment on why are you fixing total market return rather than the equity risk premium, so in the environment of rising real risk- free-rates, you are actually not benefiting network companies because the total market return should also rise together with the rise in the risk free rate, and it will not, under the assumption that you are actually fixing the total market return. Thank you.

Jonathan Brearley

I'm very glad you're all making Simon work so hard. So, Simon?

Simon Wilde

Yes, fine. So, your second question is a very interesting question that I will come to, but with respect to the beta and total market returns, they are different from RIIO-1. The beta, we are proposing to estimate beta in a different way. This time round, we are looking at longer term measures in beta: 5, 10, or 18 year historical averages, in line with the advice that we've received. However, even if we had gone back and used the approach in RIIO-1, which is much shorter term betas, shorter-term betas move around, and so they would inevitably have changed. And I would only point you to the betas that Ofwat is using, which are based on two-year and five-year betas. So, you almost can't have it both ways. If we're going to use a long-term beta, which we are now using, one would expect that to be a stickier number, but RIIO-1 was using short-term betas, and that was eight years ago. So, of course, beta will have changed. With respect to total market return, you are right to ask us about this because we've said in the past, and we've restated now, that we do look at a mix of backward-looking measures and forward-looking measures for market returns, but our primary starting point is backward-looking long-term historical terms. And we are still looking at, predominantly, the returns from the same period as we were looking at in RIIO-1 - obviously updated for a few years. However, we are now analysing those returns with an updated view on inflation, and we go into this in quite a lot of detail, and explain why on a CPI basis this is the correct return. It is lower than RIIO-1, but I'd say two things about that. One is that we support our historical analysis with forward-looking evidence, and we feel the forward-looking evidence strongly supports our current range. The second thing is, we say that TMR is broadly stable over time, and that clearly doesn't exclude the possibility of relatively modest shifts in any eight-year period. But we do cover this in great detail in the Finance Annex, and we'd be delighted to take detailed questions. With respect to your proximal conceptual second question: again, we've looked at this in some detail, and actually the companies have as well, and perhaps here I'll quote one of the company's reports which you might like to look at, which is the Oxera Report. Oxera, themselves, accept that as risk-free rates change, TMR is much stickier and much more likely to stay the same, and, in fact, the equity risk premium does move up and down, and I think they did some analysis that said they felt that whilst premiums might move a bit, the correlation was many, many times greater in terms of the TMR staying the same and the risk premium not changing. In other words, their analysis said that when risk-free rates go up, TMRs are pretty stable, and we see variable equity risk premia, and so, this is the evidence presented to us by the companies themselves. We agree with that, and that's the approach that we used.

Jonathan Brearley

Can I just mention on that, if you want to follow up on that in a more detailed discussion with us over the coming weeks, we'd be happy to do that.

Operator

Thank you. Our next question is a follow-up from Chris Laybutt at JP Morgan. Please, go ahead. Your line is open.

Chris Laybutt

Good afternoon, again. I guess just returning to my earlier question on the returns allowance, my question is: you seem to be challenging what I would consider to be a long-held view that the risk profile of operating energy and distribution assets is quite different to the operation of water assets. I guess especially that's in the context of the significant challenges that lie ahead for the electricity sector. Are we right in thinking that you now consider the risk profile of transmission and distribution and water to be homogenous?

Jonathan Brearley

I don't think we are taking a view as to the risk profile of water assets. Our job is to understand what we think are the risk profile of the electricity and gas updates. That's probably all we want to say at this stage.

Chris Laybutt

I guess just in terms of the difference between transmission and distribution, historically in RIIO-1 there were different allowances for the different subsectors. If you could just touch on your thinking behind moving to a single rate of return for those sectors, as well. Thank you.

Simon Wilde

What we've actually said was we are setting a cost of equity and cost of capital for a notional energy network. We've left open to hear views on the relative risk differential between gas and electricity and distribution and transmission. And, we will be addressing that at determination, so we have not closed that off. I want to be very clear about that. I would also note though that every time you speak to somebody, the riskier sector is the one of the person that you are speaking to, whether that's gas distribution or electricity transmission, but nevertheless, despite making that comment, we will be at determination, thinking about that issue.

Chris Laybutt

Very good. Thank you very much.

Operator

Thank you. The next question is from Martin Young at Investec. Please, go ahead. Your line is open.

Martin Young

Hi again, it's Martin Young at Investec. Just one quick question in respect of the timeline on page 13 of today's call document. Looking at that, I just wondered when we are next likely to hear from yourselves. Obviously, June 2020 from the draft determinations, but will there be any formal major communications from Ofgem along that timeline before June 2020? Thank you.

Steve McMahon

Hi Martin. There's various parts of the price control that run to different timescales. --There will be various consultation processes which is where you pick up on some of the decisions that have been made today, and focus more around implementation. There's obviously parts that are focused on the cost assessment process. The other big thing in this is the start of the process of electricity distribution. We will kick that off in the summer with an open letter. I think our draft timetable is maybe around next summer. Around about the time of draft determinations, we would have our sector strategy methodology consultation for electricity distribution. Those are the main publications from our side.

Operator

Our next question is from the line of Verity Mitchell at HSBC. Please, go ahead. Your line is open.

Verity Mitchell

Hello, everybody. It's been a very long afternoon. I just have a very simple question I'm not sure has been answered yet. Does your financeability analysis depend on the outperformance wedge? I wasn't quite clear on that.

Simon Wilde

That's a fair question. We used the cost of equity in our numbers, i.e. 4.8%, on the basis that we've said that we would expect companies to earn the baseline return, but also to outperform. And if you look at the way that the credit rating agencies rate companies during the periods, they do take into account forecast outperformance during the period.

Jonathan Brearley

Sorry, a simple way of saying it is the expected return would be the same in all cases.

Correct. I think the question was: do we use the allowed return of 4.3 or 4.8, and we use 4.8 because that's what we expect to happen.

Operator

Thank you. And the final question in the queue comes from the line of Ahmed Farman at Jefferies. Please, go ahead. Your line is open.

Ahmed Farman

Hi. Thank you. Just one quick question from me. I was interested in your business plan incentive. Could you share with us your thinking on how you think this will work in practice; if there is a company that is able to achieve the +2% allowed totex? Will this be part of the-- rightly spread over the price control part of the allowances? Or, would it be an up-front type of benefit or reward that would be given to the companies?

Steve McMahon

Hi. It would be an up-front reward. I think we've said the four-stage process - I think, as I mentioned earlier on - There'll be guidance to come down next week, a full business plan and process on what we're expecting across each of the policies in terms of the company business plans submissions but the business plan incentives itself, the change reflected two things: one was, obviously, as we've discussed, whether it was a competed pot, or absolute. The other around the design was the potential for cliff-edges, I think, in what we said in December: companies] 4% threshold against our cost assessment would have been potentially treated very differently, so that's the rationale for change. This would be up-front, so it wouldn't be subject to RAMs here, and we've made that very clear, and there'll be further guidance to come down on that next week.

Operator

We have had one further question come through, and that's from the line of Ian Turner at Exane BNP Paribas. Please, go ahead. Your line is open.

Ian Turner

Hello, again, and apologies. I know it's Friday before a bank holiday, and we're all talking about CAPM parameters, which is probably not the thing we ought to be doing. Just coming back to this idea about which is the more stable, the equity risk premium or the total market return, obviously you're indexing the return on equity for changes to the risk-free rate. If you go down the route of assuming it's the TMR that's stable, then that would mean that the indexation of the risk-free rate isn't really worth anything or isn't worth very much. For example, a theoretical company that had a beta of one, that would actually mean there was no indexation and that their returns were invariable under changes to the risk-free rate. Is that what you mean by that? Is that the correct way of thinking about it? Is that what you intend?

Simon Wilde

Thanks for asking that, Ian. In our consultation document in December and, again, in May, but probably more in the December document, we do go into detail and we show all of the different options and all the different implications, but you are correct that just rearranging the CAPM formula means that under our formulation, if there is a change in risk-free rate of 100 basis points, then the change in the cost of equity will be that 100 basis points multiplied by one minus beta. That's just rearranging CAPM, and, therefore, obviously you're correct, if beta is one, one minus one is zero, and it would have no effect at all. However, I don't think we're proposing a beta of one, we're proposing a beta significantly below one, and therefore it does have an effect.

Operator

Thank you. And as there are no further questions in the queue at this time, I'll hand back to our speakers for the closing comments.

Dermot Nolan

This is Dermot again. Can I thank everybody for participating in the Friday afternoon call, which as you said, Jonathan, a peculiar love for CAPM methodology aside, I'm glad you've all shown the patience to talk with us through this, and we value your questions. I will say, we will obviously remain very open to meeting all of you in various fora over the coming weeks, months and, indeed, years. We obviously value hugely what you have to say.

On some of the points that were raised, I won't go back over them, but there are clearly some points of disagreement. We will listen to what you say, but as Jonathan mentioned earlier, ultimately we may disagree, we may not, but we may disagree. I would also remind you that, though you are an incredibly important set of stakeholders, we have other stakeholders, other respondents to the consultation, other people who are interested in the process, and we will, of course, be listening to them, as well.

But, again, I go back to what I said at the start: by and large, we want to be as clear and predictable as we possibly can. As Simon mentioned, there are paradoxes in the sense that if we were being entirely predictable, we would probably do exactly as we had done for the last 25 years. That is, frankly, clearly, not good practice, so we have to respond to evidence. There's the famous Keynes remark which I'm sure you all know which I will not quote at this point in time because, as I said, I'm sure you all know it. Having said which, we want to be clear. We want to be predictable. We want to listen to all stakeholders. We will continue to do so and continue, I think, to try and respect the integrity of the process. In that sense, I wish you a good weekend, safe in the knowledge that we will talk to you all again, I suspect, in the next period of time. So, thank you very much for participating, and thank you to all the team for preparing such a long detailed set of documents. Thank you very much. Have a good weekend.

Operator

This now concludes the conference. Thank you all very much for attending. You may now disconnect your lines.