Transcription

RIIO-2 Draft Determination investor call

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PRESENTATION

Operator

Hello and welcome to the RIIO-2 Draft Determination investor call. Throughout the call, all participants will be in a listen only mode and afterwards there will be a question and answer session. Today I'm pleased to present Jonathan Brearley, CEO. Please go ahead with your meeting.

Jonathan Brearley

Thank you. First of all, just to say thank you to everyone for joining this call today. You've had some time to go through our draft determination, so what we'd really like to do is to talk in much more detail about the decisions that we've made, or the draft decisions that we've made, but also about the process going forward.

I'm going to hand over to Akshay Kaul and Simon Wilde in a moment, but I just wanted to really say three things up front. The first is, just to be clear, we are passionate about getting the investment we need into the system to get to net zero and we are fully behind the green economic recovery in the UK.

Now, clearly, we do have to get the balance right here and we are looking at the evidence and making sure we strike the right balance between shareholders and customers. That all said, we have done that based on the evidence that we have in front of us today. We are still open for business, for consultation, for evidence admission and for further discussion. And I will be available and absolutely the team will be available to take that forward in the next six months. So, what I'd say is this is a draft, but we are very open to talk through the conclusions and to hear your perspectives.

And what I'll do now is just hand over to Akshay who will take you through I think the first part and then Simon the second part of the detail. Over to Akshay.

Akshay Kaul

Great. Thank you, Jonathan and good morning everyone or good afternoon or good evening depending on where you are in the world. Many thanks for joining us today and for engaging with the RIIO-2 process to date. We have sent you a slide presentation which is the material that we're going to talk through and let me kick off with slide five in your pack.

Today marks the start of a consultation process on our proposals for determinations. These are not the final word. Over the next eight weeks or so, we will engage widely with stakeholders to get as diverse a perspective as we possibly can on our proposal. The consultation will close on the 4th of September and I would really encourage as many of you as possible to engage with us over this period. We will then consider very carefully the evidence and the arguments that have been presented in consultation responses.

We will also organise some open meetings in the autumn where we can make transparent what the biggest points of contention in the process are. And then, in December, we will publish Final Determinations, followed by the statutory process to modify licences to give effect to our decisions. RIIO-2 will start on the 1st of April 2021.

Now coming back to our Draft Determination announcements today, let me give you a brief overview of the most significant points in our consultation proposals, and then I'll hand over to Simon to take a deeper dive into the finance proposals, which I know will be of particular interest to this audience.

I'm on slide six now, and I'd like to make five key points by way of overall summary. First, a key objective for RIIO-2 is to prepare the networks, as Jonathan said, to deliver net zero at lowest cost to consumers. We think that investment in networks is likely to rise as we go through the decade, and probably quite significantly, and to make space for this much needed investment on the energy bill, we are challenging companies today to be as efficient as they can be in how they run and finance themselves so that we can keep network services affordable for everyone in the years to come while meeting net zero targets.

Secondly, it is implausible to think that all the policy decisions related to net zero that effect network investment will be taken by December, conveniently timed for our Final Determinations. We fully expect major policy developments in power, in heat, and in transport that could require a substantial response from the networks to come through during the RIIO-2 period. And to adapt to this, we're liberating both the regulator and the industry today from the artificial constraints of the five-year, price-controlled timetable.

Our proposals set out the investment that we currently think is justified upfront in the baseline, but they also include significant potential to add additional funding throughout RIIO-2 as and when needed in whichever sector it's needed as new investment projects come through. To give you some feel for this, our upfront baseline funding level is roughly 25 billion pounds and we can see potential additional funding needs for up to 10 billion pounds from company spending plans that may materialise over the coming years and be funded through these uncertainty mechanisms.

The third point I want to make is that our baseline Totex allowances, which represent the costs we think companies can control, are sufficient for well-run efficient companies. We have applied an efficiency challenge to justified expenditure as we always do, and I make no apologies for that, but we have also applied strong scrutiny on value for money and asked network companies to improve the quality of their justifications for expenditure in certain key areas such as asset health, where the information that we received in company plans was partial or incomplete. We will listen very carefully to this new evidence before making Final Determinations.

Fourth, our cost of capital proposals are financeable for well-run efficient companies and they reflect our view of current market rates for low risk, regulated assets. And fifth, we still expect the average company to outperform the RIIO-2 settlement, albeit modestly compared to the high levels that we observed in RIIO-1. High performing individual companies could earn higher RoRE upsides under our proposals.

Let me expand on some of these themes a bit further and then Simon will talk in more detail about the finance aspects. Moving to slide seven, there are two key components to our approach to net zero in RIIO-2. As I mentioned, we are providing roughly 3.5 billion pounds of upfront funding to connect renewable generation and upgrade the transmission grid and over 500 million pounds for networks to reduce their own impact on the environment.

But alongside this we are introducing into RIIO-2 a set of uncertainty mechanisms to adjust allowances in period to meet net zero target as needed any time for any sector. For instance, we have introduced a system-wide net zero reopener that could be used to fund the large anticipatory investment schemes proposed by companies such as for motorway charging, which may need both distribution and transmission network upgrades, and on the East Coast transmission upgrade to anticipate 40 gigawatts of offshore wind in the North Sea which will need careful coordination of the onshore and offshore grid design.

In addition, we have sector specific uncertainty mechanisms that will enable allowances to flex quickly to meet new demands for connections on network upgrades, as net zero trajectories become clearer during RIIO-2.

We have also introduced a flexible Strategic Innovation Fund, initially sized at 450 million pounds that could be used to fund major innovation projects such as those that may be needed to prove hydrogen as a heating fuel. Again, we have introduced the ability to scale this up or down as needed during the RIIO-2 period.

And finally, our proposals for the Electricity System Operator give them the flexibility to refresh their business plan every two years with associated flex and funding levels as their role in the energy system evolves over time to meet the needs of operating a zero carbon electricity system.

On slide eight, I turn to the baseline Totex allowances. Our proposals are roughly 8.4 billion pounds below the company spending bids, which, particularly in the transmission sector, were claiming sharp increases in spending compared to the RIIO-1 levels of actual expenditure. What you can see on the chart on slide eight is the net effect of three things. First, as I mentioned, we have applied an efficiency challenge to encourage less efficient firms to catch up with more efficient ones and for the most efficient firms in RIIO-1 to improve further. For instance, we have set the frontier in gas distribution at the 85th percentile rather than the upper quartile in RIIO-1, and removed any glide paths and set higher ongoing efficiency targets at 1.2% per annum.

Second, we have removed expenditure from the baseline in some cases and moved it to an uncertainty mechanism where the needs case or scope of projects were not clear at the moment but may become clearer in time. And third, we have adjusted downwards the volumes of work needed, particularly in the case of asset health in transmission as a result of a lack of sufficient engineering justification in company plans. You will see from slide eight that in most cases our proposals look like sharp cuts when compared to the company spending bids, but much more moderate when compared to the RIIO-1 levels of actual expenditure.

The one stark exception is National Grid Electricity Transmission. Our proposals are much lower in relation to both NGET spending plan and their RIIO-1 actual run rate. This is because we received extremely partial and incomplete information from them on the underlying engineering justification for the work, which in many cases entirely failed to make the case for spending consumers' money.

As a result, we have had to do the best that we can with the information available to us. However, we recognise that asset health is very important from a safety and reliability perspective and so we are encouraging National Grid in particular to come forward with better evidence to support their requests for funding in this area. We will consider any such further evidence carefully before making Final Determinations at the end of the year.

On slide nine, I turn to our proposals on the balance of risk and return. We're indexing both the cost of debt and equity in RIIO-2, so investors are protected against movements in underlying interest rates. We are also lowering overall incentive rates, so one consequence of that is that companies face a lower impact from overspend in RIIO-2 compared to RIIO-1, and we are introducing additional protections for movements in input prices, such as for labour and materials.

We have considered very carefully the market evidence on rates of return for low-risk, regulated assets such as these and we think our proposals are financeable and reasonable in the light of this evidence. In particular, we are setting the baseline cost of equity at 4.2% real in CPIH terms for a notional company that is geared at 60%.

As I mentioned in my introduction, we expect the average company to outperform RIIO-2. For this reason, we have deducted 25 basis points from the cost of equity to set allowed returns at 3.95% to reflect this expectation, and we explain our reasoning in great detail in the finance annex. We are also willing to put our money where our mouth is on this expectation and Simon will talk a bit more about that in due course.

Investors often want to know how the best performing companies will fare in price controls. And on this, our expectation is that the GD companies, the gas distribution companies, that outperformed their quality of service targets to the level of the cap and underspend, say by 10%, against the baseline Totex allowances, could expect to outperform the baseline allowed return by about 150 basis points. Transmission companies that outperform the quality of service targets to the level of the cap and underspend by a similar percentage against the baseline Totex allowance could expect to outperform the baseline allowed return by about 100 basis points.

I hope that was a useful summary of the proposals and I'm now going to hand over to Simon who will talk through our key finance proposals in greater detail. Over to you, Simon.

Simon Wilde

Thank you, Akshay. And on slide ten you'll just see a list of some of the areas that we will look into in a little more detail. But before I do that, I just want to emphasise what you've already heard from Jonathan and from Akshay that this is a consultation. We have set out our evidence. We have set out our reasoning. The finance annex is, I'm afraid, a fairly complex and turgid 230 pages, to use two adjectives that I've heard this morning from one analyst, but I really would encourage you to engage with it because Ofgem as a whole and the finance team is incredibly open to engaging on the overall numbers and on the specifics in the way that we’ve come up with the numbers.

The first point on this topic we’ll look at is cost of equity on slide 11. As Akshay has mentioned, for companies with a notional gearing of 60%, we’re proposing an allowed equity return of 3.95% in CPIH real terms. In coming up with this proposal, we followed the three-step approach that we set out in last year's sector-specific methodology decision, but what we've done is we've updated market data and parameters and we have made a couple of finance policy changes which I will mention as we go through the analysis.

So, in step one we use CAPM to estimate the notional companies’ cost of equity. I'll run through the key CAPM parameters. So first is the risk-free rate. We continue to use the 20-year RPI real gilt as our benchmark, and we are continuing to propose an equity indexation mechanism where the cost of equity is calculated annually updating for changes in the risk-free rate. The current yield of that gilt is about -1.6% in CPI terms today, but it's expected to average at -1.48% in the five-year RIIO-2 period.

Our total market return assumption is unchanged from the SSMD and I note that the midpoint is in line with the CMA's provisional findings in the NATS appeal.

For asset betas, we have a similar range to SSMD of 0.34 to 0.39. But the reasons for changes are that we've broadened the support for this range by including listed European utilities, which was a request of companies that we did that, and we've looked more deeply at the betas of National Grid and SSE, including a decomposition analysis by our consultants.

We then use 60% notional gearing to calculate equity betas and that range is 0.66 to 0.79. One change though in the re-gearing process, we have removed our use of an enterprise value to RAV ratio which was a novelty at the methodology stage and removing it was again a company request. So, when we combine those three CAPM parameters, we come up with a cost of equity range of 3.6 to 5.0%.

As before, we use step two to crosscheck this range, using wherever possible market observable data. We have regard to a range of benchmarks, and I'd like to particularly focus on three things: One is implied equity returns from the prevailing EV/RAV ratios for listed stocks. Second is the continued low returns that have been bid for OFTOs with weighted average cost of capital materially below the range that we are suggesting today. And then thirdly, a final, and this is an additional crosscheck, is to take the Modigliani-Miller - approach used by the CMA in the NATS appeal where they calculate WACC based on the actual gearing levels of comparators; there's no de- or re-gearing.

All three of these measures imply cost of equity below the midpoint of our CAPM range, and we judge a network's cost of equity to be 4.2% CPI real based on the current evidence we have but again, are keen to get feedback during consultation.

Then moving to step three. As Akshay says, we continue to have an outperformance expectation based on our analysis of RIIO-2, which I'll describe. We deduct this from the cost of equity. In terms of updating that 0.25% number, first, we've been able to recalibrate the size of the expectation where we've looked at the details of the RIIO-2 incentive package - totex, and output incentives - and as a result we assess this now at the lower level of 0.25% due to some of the changes that Akshay has already referred to. This is down from our initial uncalibrated assumption at methodology of 0.5%.

The second change, and again alluded to by Akshay, is that we are proposing to introduce an ex-post correction mechanism. This is designed to mitigate against Ofgem having overestimated this outperformance number. So that if companies on average outperformed by less than the 0.25% equity allowances for all companies will be increased at the close-out of RIIO-2, so the average return is then corrected upwards to ensure cost of equity's is earned across the sector.

We see this as an important development. We hope it shall allow companies and investors to see Ofgem's continued interest in companies earning at least their cost of capital. And when you look at the details of this mechanism, I would note that it's a one-way potential adjustment that can only operate in companies' favour.

And then finally for the ESO, we do have a higher asset beta based on more asset-light infrastructure companies and that results in a higher cost of equity.

Moving onto slide 12. A few topics here, first one being cost of debt. Here we've also applied the SSMD approach of full indexation, which is the approach that we have at the moment in RIIO-1. We target full cost recovery of average debt costs, both embedded debt and new debt that is raised in RIIO-2 and we assess this average debt cost to be around 1.74% in CPIH terms for 2021 to 2026.

That number includes an allowance for issuance costs – over and above the coupon costs of debt – of 17 basis points, which is close to the 20 basis point assumption we made in RIIO-2 and is probably slightly above where some other regulators have found in recent decisions. The 17 basis points results from our evaluation of evidence that's been provided to us by companies.

The way that the 1.74% costs will be recovered is through a proposed 10 to 14-year trailing average of an iBoxx bond index. However, this time in RIIO-2 we're proposing to use the specific utilities' iBoxx index rather than our previous approach of an average of A and BBB general corporate bonds. We think this tracks sector issuance patterns better and removes the need for us to make a deduction due to the so called halo effect.

So, combining equity and debt allowances gives a weighted return on capital of 2.63% CPIH. By way of context, our investor relations team kindly surveyed a number of analysts in recent days. The mean for the equivalent weighted return of capital expectation appears to have been 2.76%. That is 13 basis points higher than today's proposal. And indeed, of our respondents, 80% thought it would be above our 2.63%, but fully 20% thought it would be below. And I leave it to your comments to tell us the degree to which the number today is close to or not close to investor expectations.

On depreciation, we're not proposing any changes for electricity transmission or gas distribution. But for gas transmission, we received a company request to shorten and frontload depreciation periods for RIIO-2. We also received information on shorter actual RIIO-1 asset lives due to the asset mix of investments that were made.

Given these data, as well as an Ofgem view that frontloading depreciation in a consistent manner across all gas sectors would more reflect current pathway options, we are proposing to align gas transmission and distribution depreciation policies using in both sectors a 45-year sum of year digits. As we did when we made this change for gas distribution in RIIO-1, we will adjust the Totex levels back to 2002.

Just quickly on a couple of other topics. We're not proposing major changes to capitalization and will continue to be guided by the natural split between capex and opex-like expenditure. For gearing, we're continuing to propose as we did at SSMD, a 60% notional gearing level for gas transmission and distribution. This is down slightly from the 62.5 to 65% for those sectors in RIIO-1. For electricity transmission, we propose 55%, which is where two of the three ET companies are already today. The reason for that is due to potentially higher levels of investment coming from the reopeners that Akshay has already described.

For companies with this 55% gearing, we will be allowing the same overall weighted return on capital, i.e. 2.63% and we adjust the allowed equity returns to achieve this, which explains the equity returns for those [55% geared] companies on the previous page. This is in line with a concept of a flat WACC across gearing which was recently recommended by the CMA.

On page 13, we look at the potential RoRE ranges from the overall RIIO-2 package. They are lower on both the upside and the downside than for RIIO-1. But, as Akshay says, they will still allow top performing companies to earn additional returns of 1 to 1.5% from Totex and output incentives.

Although ODIs in aggregate have slightly higher downsides than upsides, the calibration, both upside and downside, has been set in the expectation that companies have a fair chance of either outcome, and history tells us that companies do outperform on average. As a result, we do, as Akshay said, expect the average company to earn positive Totex and ODI returns reflected in our cost of capital assumption, albeit with the ex-post, fail-safe mechanism that I mentioned earlier.

And then finally, when we think about RoREs, to update you, we are proposing symmetrical Return Adjustment Mechanisms. That was one of the issues that we consulted on at an earlier stage. Symmetrical boundaries at plus or minus 3%. Outside of these bounds, sharing factors are halved, slowing down any further over or under performance, and this gives investors some measure of downside protection.

Turning to financeability on slide 14. As Akshay said earlier, we are of the view that the proposed rates of return and proposed Totex levels are financeable. You can see the details on this slide, and as I mentioned ET companies have 55% gearing and the two gas sectors 60%. We show here some credit ratios for each of the companies and you'll see that they are all above minimum strong BBB thresholds and this is on the Baseline Totex.

If you look at the finance annex, you'll also see that these ratios have been calculated using a higher Totex case. We show an Illustrative Totex case which has got approximately 6 billion pounds of additional spend, mostly in the ET sector. And you'll see that those ratios are also overall strong.

Finally, on slide 15, I just recap a few of the key finance changes in RIIO-2 compared to RIIO-1. We've already mentioned there'll be a more dynamic price control with lower baseline Totex and larger volumes for reopeners and this is why we've assessed financeability under more than one Totex scenario. And while returns are lower, they have been recalibrated to current market rates and expectations and we will be using both equity and debt cost indexation, which means they should be robust to changes in the macro environment.

Whilst there is an efficiency challenge in setting performance levels, we do expect companies to continue to outperform, and I've already mentioned this new ex-post adjustment to protect companies if outturn performance is not equivalent to the Ofgem expectation.

And then thinking about potential downsides, we do see RIIO-2 as de-risking companies across a whole range of measures. Not only the cost of capital indexation, but the use of operating cost indexation, the reduced exposure to cost overspends, the lower ODI downsides, a true-up mechanism we're putting in for RPEs, and the symmetrical RAM-protection, we feel as a package delivers a lower risk financial proposition.

Hopefully this quick run through of some of the finance topics was helpful. I am conscious the finance annex is 230 pages and the investor relations and finance teams stand ready to engage for any further clarifications.

I'll now hand over to Jonathan to open up the Q&A.

Jonathan Brearley

Okay, thank you, Simon. Just a couple of things from me to emphasise there. In total, particularly when we think about the net zero reopeners, we are expecting that the investment in networks will need to go up significantly, and as we've all emphasised, this is a stage in the process and we'd love to hear both your views but also receive any evidence that you'd like to submit. Let's open it up for questions.

Q&A

Operator

Thank you. If you do wish to ask a question, please press 01 on your telephone keypad. If you wish to withdraw your question, you may do so by pressing 02 to cancel.

Our first question comes from the line of Deepa Venkateswaran from Bernstein. Please go ahead.

Deepa Venkateswaran

Thank you, I have three questions. I think the first one is would you be able to quantify how much customer bills savings you get to from your proposals versus the company plans? Because I've seen the 20 pound, but I think that's versus RIIO-1.

The second question is if I just look at the overall challenge on efficiency and cost of capital firstly, and I focus more on National Grid given the vast quantum of data that you've released, but if I look at National Grid, a big chunk of the non-load related expenditure has just been set that either there's not enough evidence or for whatever reason this is not needed. Then there's an individual cost challenge for individual projects. Then there's an overall efficiency challenge that is applied on top of it, and then in the cost of equity you make the 25 bps adjustment for outperformance. And then you also have a step two.

If I add all of these as a package it appears obviously unfinanceable. From an investor perspective, the returns are low, and it also doesn't make sense that actually on the electricity transmission, just sort of needed for net zero, you're actually reducing the spend there. So, please help square up how this actually reduces risks for investors.

And the third question that I had was on what kind of evidence would you need a company like National Grid to provide in the next – I don't know – four months? Presumably they've been running these networks for years and they probably know what they are doing in terms of the quality of assets and engineers. So, what would you want them to do? Apart from sending a lot of their engineering consultants to be parked at Ofgem to explain what’s needed. Thank you.

Jonathan Brearley

Okay, Akshay, do you want to kick off with those?

Simon Wilde

I don't know if Akshay is on mute, but with respect to that first —

Akshay Kaul

Apologies, I'm back in. Sorry. I apologise. This muting business takes some getting used to. Deepa, thank you, your first question on customer bills savings from our proposals compared to company plans. I'll get back to you on the company plans number. Just to summarise the bill savings from our proposals.

The upfront impact when you move from RIIO-1 to RIIO-2, on the 1st of April 2021 is going to be roughly 20 pounds for households on the bill. And I think as Jonathan has been explaining throughout the morning, we expect to see this initial reduction being offset later on in the period, both in the RIIO-2 and RIIO-3 periods as investment increases to meet net zero targets.

And I think our broad indication is that if we get the levels of investment that we indicate from the company spending plans, plausibly you could get 2 billion pounds a year of additional investment coming through. Then by the time we get to the end of the decade, network charges on bills will be back to where they were at the start of the decade. And I'll get back to you on the specific comparison you asked for versus the company plan impact.

On efficiency I think you asked a good question about National Grid in particular and why their numbers are so different. I think the two questions you asked was what kind of evidence do we want to see from them, particularly on the non-load side. And I think your second question was about the financeability of the overall settlement. So, if I can ask Simon to come in on the financeability, but I'll just quickly cover the evidence that we need to see on the asset health non-load side, and then I'll hand over to Simon on how we've gone about assessing financeability of the settlement in the round.

On the non-load side, and this is really about asset replacement, this is about replacing transformers, switchgears, cable lines and the like. These are not transformative new projects. These are pretty BAU as far as a network like National Grid is concerned, although of course asset replacement programmes do run in investment cycles. So, depending on when you originally invested in the assets they start to run out at a particular point in time and you start to see a kind of rhythm in the asset replacement cycles.

We've been through quite a major asset replacement cycle in RIIO-1 and we were hoping to see evidence from National Grid who had projected a big increase in the rate of asset replacement expenditure, both in terms of a strategic narrative to say what justifies such a big increase. Was it that there was a big investment 40 years ago that is now coming for replacement, etc, and we didn't see that, but also a micro justification in engineering terms. When you look at their population of assets, we normally expect companies like Grid to produce engineering justifications that say these assets are wearing down and here are the different options: We could do nothing. We could refurbish them. We could replace them, and this seems to be from an engineering point of view the best thing to do.

And again, it's just that the information that we had back in the original plans and through clarification had been pretty partial and pretty incomplete. Having said that, as I mentioned, this is a really, really key area for reliability and safety on the system. So, we take asset health very seriously and we are encouraging National Grid to improve the quality of the justifications and get back to us during the consultation period on this.

Let me hand over to Simon now to just talk about the financeability of the settlement in the round.

Simon Wilde

Yes, hi. Thanks, Akshay. In fact, I think I can answer the bill saving question, which is that, based on the numbers I have, if we'd followed the company proposals, bills would have gone up by five pounds instead of down by 20. There's roughly a 25-pound differential between the two sets of numbers but Deepa, we will double check that and get back to you as Akshay said.

On financeability I think there are two different ways to look at it. One is whether the companies are creditworthy. We have a duty to make sure the notional company is financeable and the credit ratios that I put up in the presentation and under the base case I think show that. In particular the ratios for NGET at roughly 1.7 times AICR are well above minimums. I did say that we run other cases and if anyone's interested and looks at page 110 of the finance annex, Tables 34 and 35 show all of those ratios are under both of our Totex cases, and at these higher levels, higher illustrative levels or totex, ratios come down a little bit. But again, in the case of NGET would be around 1.6 times still.

So, I think you're also seeing is this an investable proposition for equity. And this is where we really try to take seriously our market benchmarking in step two. Far from step two being a drag on returns, step two is supposed to let us look at what we observe investors looking for in for example water stocks at current levels. What are investors demonstrably looking for in the OFTO bids.

And we put all the evidence out there. Some of it new, some of it repeated and we will be engaging. And if we've got the wrong market benchmarks, we absolutely will be having that discussion with stakeholders.

Deepa Venkateswaran

Thanks Simon, I believe that on the business plan most companies said – I don't know about gas distribution, but I know for transmission and so on, no one was proposing any big bill rises. They were all saying because of the 4.3% cost of equity, the old one, bills were going to fall. So, I find it difficult —

Simon Wilde

The number I quoted is based on the company's business plans in terms of their Totex and their —

Deepa Venkateswaran

6.5%.

Simon Wilde

And their cost of capital, yeah.

Deepa Venkateswaran

Right. Their 6.5. Right, right. Okay, but I think versus the 4.3 and then with the Totex, I believe that the savings would not be 25 for sure.

Simon Wilde

You're totally right. That difference of 25 pounds between the five-pound increase in company ask and the 20-pound reduction has got two elements to it. One is the fact that companies were asking for considerably higher cost of equity in particular, and higher Totex levels. We can have a go at providing a decomposition for that if that would be helpful.

Deepa Venkateswaran

Yeah, that would be. Thank you.

Operator

The next question comes from the line of James Brand from Deutsche Bank. Please go ahead.

James Brand

Hi, good morning. I had the three questions, hopefully relatively short ones. The first is on the uncertainty mechanisms and some of the additional spending that you highlighted could go into those. I think you commented in the document that there might be over 10 billion of investment in transmission, or at least you could envisage that the companies might want to spend that amount.

I was wondering whether you could just maybe comment a little bit more about what we might expect to possibly be coming through under those mechanisms. Is something slightly over 10 billion overall for transmission reasonable? Could it be a lot more than that? Could there be other aspects of spending that comes into that number? I'm just wondering if I'm comparing what we could see compared to the baseline profiles for RAV growth that you included in your documentation? That's the first question.

The second one on National Grid. You kind of touched upon that maybe in the last answer, but for National Grid, just in terms of the difference that you're talking about between what National Grid has been spending and what you're thinking about allowing it, is that mostly capex, or is it mostly opex? Just trying to get an idea of whether there's a big underlying efficiency challenge that National Grid might need to just go out and slash its operating costs, or whether you're just mostly talking about lower capex here?

And then thirdly – sorry, I said they were short questions, I guess they're not. Thirdly, certainly on ODIs, I haven't had the chance to go through all of the detail on ODIs yet, but I was just wondering whether one of the issues in the water sector has been whether they're capped or not. And there were some instances in the last period of lots of outperformance from uncapped ODIs and Ofwat have also put in place a lot more caps and floors to be fair in the current period. I was wondering whether you'd been capping those ODIs or not? Thanks.

Jonathan Brearley

Thank you. Look, I'm just going to pick up broadly on your first question. I think it's an important thing to note here that this proposed settlement is not like previous settlements in the sense that we are deliberately building in much more scope for uncertainty mechanisms where it’s happened before, so we fully expect there to be investment cases made and we fully accept those to be substantial and that’s part of what we’re releasing today. But that is quite a shift from a traditional kind of decision at this point or a decision in December. And I think it's worth just taking that into account. Other than that, I will hand back over to Akshay.

Akshay Kaul

Very good. Thank you, Jonathan. James, I think your first question was what to expect in terms of transmission. I think the first thing to say is we don't have a central forecast of how much exactly is going to come through because there's no particular crystal ball with which we can gaze into the future, but we can certainly see a plausible scenario for significantly higher levels of capital expenditure in the transmission sector.

Just to give you a feel for some of the projects that we are going to consider as part of these net zero reopener mechanisms. You see from National Grid’s plan for instance that they put forward a one-billion-pound scheme to create a sort of transmission powered motorway charging network and clearly this is something we have to coordinate with government and with both the DNOs and with the transmission operators because the plan for the A roads and the motorways will likely need a combination of upgrades to the distribution grids and the transmission grid. But you can see from the scale of the numbers that those will be reasonably material sums of money.

Similarly, National Grid indicated I think a 4 or 4.5 billion-pound potential programme to upgrade the East Coast network to build loop circuits all along the East Coast to anticipate their 40 gigawatts of offshore wind in the North Sea. And again, we think this is definitely the right space to be ambitious and creative and imaginative and we can see clearly that you have to coordinate the design for the grid offshore and onshore. It makes no sense to do this in a silo so we're going to be working with the Electricity System Operator and the transmission owners to find a coordinated design that gets us the least cost solution to anticipate offshore wind.

But again, from the scale of numbers already in the plans, you can see that these two projects alone could use up 5 or 5.5 billion pounds, and then in addition to that, there is the normal run of the uncertainty mechanisms in transmission as new load comes on the system, new renewable generators want to connect every year. The ESO upgrades its programming to say this is where we need additional investment and those could add quite plausibly a few billion pounds as well.

So, it is not implausible that the spending in the transmission sector could go up, as I said, to another 2 billion pounds a year, and that's why it's important I think that we watch that and as Simon says it's for that reason that we have modelled not just the baseline Totex scenario for financeability, but also a kind of illustrative upside to see what happens in that situation.

Your second question I think was about the differences between the spending and the allowances in the National Grid case, and I think you were asking whether that was mostly down to the efficiency factor, i.e. do they need to become more efficient in terms of their operating costs or is it mostly capital. It's a combination of the two. I think the majority of it certainly is the big impact is because of the big difference on asset health, and as I say we are in listening mode on that and we are encouraging National Grid to improve their justification in that area given its criticality for network safety and reliability, but I would be misleading you if I said that there is no operating efficiency challenge.

There is a reasonably significant operating efficiency challenge, but that aspect of it is relatively conventional to most price controls. The departure to some extent from RIIO-1 is that it is a stronger efficiency challenge. So, I think we had ongoing efficiency targets, if memory serves me right, of between 0.8 to 1% per annum in RIIO-1 and we are raising that up to 1.2 to 1.4% in RIIO-2 including because we have been providing a lot of innovation stimulus funding to the sector for a good ten years and we think it's about time that consumers started to see some dividends from that investment.

And then your final question was about capping ODIs and I think if I understood you correctly you were asking if we are capping the ODIs and I think the answer is that yes, there are caps and collars on the ODIs that are set out in the sector documents and obviously happy to discuss that in more detail if that will be helpful.

James Brand

That's very helpful. Thank you very much.

[47:20]

Operator

And the next question comes from the line of Jenny Ping from Citi. Please go ahead.

Jenny Ping

Hello, hi, good morning. Three questions from me as well. Just following from James's question with regards to the uncertainty mechanisms, if I look at slide 21 in your appendix, you helpfully give out the table of what your baseline proposals are on the Totex front, and then you have an additional column that talks about illustrative DD proposals, what it would look like, I guess with the uncertainty mechanisms.

So, on your footnote you talk about this is not a forecast or an indication, so what are these numbers based on? And are these effectively the maximum that we could see uncertainty mechanisms go to if the companies were to apply and get them? And then just also clarifying the return they would get for this additional mechanism and the uncertainty part would be the same as what we are discussing right now and there's no different raterunning alongside of that.

And then just very lastly on this, what is the process in terms of the companies? Do they have to apply the year ahead for what they think is coming up based on policy proposals that government comes out? So, just trying to try and understand how much visibility, forward looking, that we will have.

Secondly, just in terms of WACC, you say the cost of equity and the debt is based on what we see in the market now. Is there a certain cut-off date in which you applied the calculation based on? That would help to understand what the movements would be when it comes to final.

And then the very last question in terms of the 25 bps of outperformance wedge. Forgive me that I haven't gone through your big annex document, but can you just sort of talk about what exactly you've calibrated there because there seems to be a bit of a round number going from 50 bps down to 25? Just sort of some of the headline items that would be helpful. Thank you.

Akshay Kaul

Simon, do you want to start off on WACC and the outperformance wedge and then I'll end with the uncertainty mechanisms?

Simon Wilde

Yes. I'm very happy to do that. I'm just checking the exact date that we stopped at, so I'll come to that last. But on the wedge, and again, there is lots of material for you to go through, Jenny, so I apologise. What we've done, we've done a number of different things. We have looked at evidence for Totex underspends, not just in the energy sector, but more broadly. And we set out our observations that we do typically see 3 to 5% Totex underspend, and that's a fairly consistent picture. And we can actually see that Totex under or overspends are not a symmetrical normal distribution but are indeed a skewed distribution. That's set out in Figure 16 on page 72.

And so, one thing we can do is we can say well, if 3 to 5% Totex underspend is typical, what would that mean for RoRE given the particulars of RIIO-2? In other words, sharing factors which are now being proposed and the operating leverage, the relationship of Totex to regulatory equity.

And that alone is sufficient to put companies above 25 basis points of outperformance and without even looking at ODIs. That's one thing we do. The other thing that we specify in that part of the finance annex is we look at RIIO-1 outperformance, but we recalibrate it so as if the RIIO-2 incentives were in place.

We now have RIIO-2 incentives and all of those things lead us to believe that outperformance will be at least 25 basis points. We haven't calibrated to try and capture every bit of outperformance, particularly on aggressive outperformance cases. And that's why we do have a suspiciously round number again, which is that if we've got a belief on a P50 basis that companies will be outperformed by over 25 basis points, then the 25 basis points feels reasonable. And as I said, and this is the fourth time I mention it, but I really want this to be understood, we are putting in place this ex-post failsafe in the event that we've got that wrong.

So, I don't know whether that answers your question, Jenny. I am still looking to confirm, I want to give you the exact date, so I might give you that after Akshay has addressed question one.

Akshay Kaul

Thank you, Simon. Jenny, I think your question on the uncertainty mechanisms is partly about what's the nature of the number we've put out. Is it a forecast or not? And then also about the process of how companies can get access to that funding. So, just the first thing is that it's not a forecast, as I said. We don't know exactly how much investment precisely will be needed in what sector for net zero. Indeed, that is the very nature of the uncertainty that we're trying to respond to with the design of the controls. But we can see from a review of the company plans themselves, and they're just based on what companies know at the moment that these could be very material sums of money.

And to give you a feel for this, just kind of intuitive feel for it numerically, I estimate that if you looked at the RIIO-1 controls and you looked at outturn allowances at the end of the process, 80% of those were agreed upfront in the baseline settlement and 20% in net terms came through in-period mechanisms. Our expectation is that if we do get the scale of increase in spending, 2 billion pounds a year, as we see from the company plans, then that balance is going to shift towards something like 60/40 baseline to uncertainty mechanisms, or maybe even 50/50. So, the scale of this is highly significant, and I think we just wanted to make sure we get that across loud and clear.

The second question, which is a perfectly good and reasonable question, is about process, and I think I'll ask Jonathan to pitch in on this as well, but we are completely seized of the need to be agile and adaptive and quick in making the right decision at the time that it needs to be made, whether that is about these big anticipatory investment projects or it's about less anticipatory but more run-of-the-mill capex that is needed to meet net zero targets, we're going to set ourselves up essentially to make these decisions quickly as we go through the RIIO-2 period.

And in due course, we will publish the processes both for the net zero system-wide reopener, which will be intrinsically flexible so that we can make the decision any time for any sector rather than being very rigid in terms of windows and the sector-specific uncertainty mechanisms which are more likely to have set windows and a kind of calibrated process akin to what we've done in the past.

But let me just briefly turn to Jonathan. He wants to emphasise the point about Ofgem as an organisation and adapting to this change. Jonathan, do you want to comment on that?

Jonathan Brearley

Yes, I do. Sorry, Akshay, I was doing the same as you, I was talking into a muted phone. Once we've learnt how to use the mute buttons, then— In a sense, I just want to emphasise what Akshay has said. I think you've heard me say this before. If you look at the statements I made when I took this role, we recognise the scale and pace of change in the energy sector.

We recognise that we are going to have to respond more quickly and in a different way than we would have done five or ten years ago and we are setting ourselves up to make sure, as Akshay says, we can approve the right level of investment at the right time and it does come back to the point that I made earlier which is that this isn't like your kind of traditional price controls in the sense. We are saying flexing here is much more than you'd normally expect, and we will set ourselves up to do that in an efficient way.

Akshay Kaul

Thank you, Jonathan. Simon, did you want to close out on that?

Jenny Ping

Can I just follow up? So, just going back to that table, the illustrative column, so are these numbers per company the maximum if they had applied for all of the uncertainty mechanisms?

Akshay Kaul

No, there's no limit to the uncertainty mechanisms; they're not maximums in any way.

Jenny Ping

Okay, and can you confirm the returns as well is based on what we're talking about today rather than a separate process on the additional investments?

Akshay Kaul

Yes. Simon?

Simon Wilde

So, yes, we are proposing that Totex goes on to RAV and earns the proposed cost, which is calibrated as at the 11th of May, Jenny.

Jenny Ping

Okay, super. Thank you very much.

Akshay Kaul

Thank you, Jenny.

[57:34]

Operator

And the next question comes from the line of Mark Freshney from Credit Suisse. Please go ahead.

Mark Freshney

Hi, Mark Freshney here. Can I please ask on financeability from a fast money/slow money viewpoint? You talk in the presentation about basing it on natural capitalization rates, but how does that compare to what's happened in the past? Because if I look at something like gas transmission, it seems there's a big step up in depreciation, which would keep the company financeable and keep the credit ratios where they need to be. So, can you talk about that and what exactly you're doing on capitalization rates? Thank you.

Jonathan Brearley

Akshay, Simon, do you want to comment?

Akshay Kaul

Yeah. Simon, it's probably one for you.

Simon Wilde

Yeah, certainly. We have got a table on capitalization rates as you would hope, which I'm just pulling up. Just to comment on the more general point about that. The capitalization rate is set by us looking at the amount of the amount of capex and the amount of opex and it being capex divided by opex plus capex. In the past we've sometimes been asked to divert for financeability reasons and, just to be really clear, we are not doing that in these proposals.

And secondly, you did not ask the question, but there's a linked question of what about all of this money that will come through the dynamic Uncertainty Mechanisms and you'll see that we've modelled that as all being slow money, all being treated as new capex and we asked some consultation questions on that.

The relevant place to find it is Table 40 on page 151, so I'm not surprised you haven't got there yet, Mark, but in the case of NGET, for example, it was 85% capitalization in RIIO-1, the natural rate of capitalization for the baseline Totex is 75% and we look at using 94% for any additional measures. So, predominantly slow money for any additional uncertainty mechanisms because that's going to be more capex-like. And then you can see similar numbers for all of the other companies to NGET.

Mark Freshney

Okay, thanks. If I could follow up on that. Well, in that case, if NGET has got 85% capitalization when you're going to 75 in RIIO-2 then that is a significant bump up to cash flows, regardless of whether you did it for financeability reasons. Is that fair? So, it provides financeability regardless of why you did. Is that fair?

Simon Wilde

That might be a consequence, but that's only if you regard Totex as a complete lump, a single amount, and don't dive into the mix of operating costs and capex. So, I agree that is the consequence, but I want to be crystal clear about how and why we've set these numbers, which is, as I said, in line with what I think is fair, which is treating capex as slow money and opex as fast money.

Mark Freshney

And sorry to keep following up, but my second follow up is if additional spend, I think once they said it was 100 but then 94%, but if – whether it’s 100 or 94, if it’s that order of magnitude and all of the money for the Uncertainty Mechanisms goes into the RAV, how could NGET be financeable if there's no fast money on that? I haven't looked at your sets of scenarios where you said they were financeable if you put in all of this like 25 billion, but how can it be financeable if there's no fast money on what could be half the Totex?

Simon Wilde

So, just to clarify my 100%. So, there is a small amount of fast money, then obviously slow money does start to come through in terms of return on RAV. That's why we've done these scenarios. We will let you test, you can find the models that we published, and you'll be able to see both of those scenarios, but I didn't say the financeability is unaffected, I said it remained financeable. So, in the case of Grid, when you look at our two scenarios in the models, you'll see that the AICR falls from 1.7 to 1.6, for example. And then obviously, if they were to do the same amount again and the same amount again, you would expect to see continued changes in the AICR. And what we're trying to signal is that we absolutely are going to be having due regard for financeability on the different Totex scenarios.

Mark Freshney

Okay, and a final question similar to two listed water companies that got more fast money by moving to CPIH more quickly, would you be open if companies came to you in the coming months and said, could we have a quicker transition to fast money? Could we have - for example, could we have a 65% capitalization rate? Would you be open to those kinds of measures?

Simon Wilde

So, first of all, our companies already benefit from the immediate switch to CPIH. There isn't quite the same dynamic for as for the water sector. Secondly, we say clearly in our financeability section that we are using notional gearing, particularly where the shifts are modest and no notional gearing proposed change is more than a 5% change from RIIO-1. So, we look primarily at notional gearing. We did include different capitalization rates as a tool that companies could recommend to us. One or two companies did, but in our judgement at the moment it is not necessary.

Mark Freshney

Okay, very clear. Thank you very much for your help, Simon. Thank you.

Operator

And the next question comes from the line of Dominic Nash from Barclays. Please go ahead.

Dominic Nash

Yeah, good afternoon everyone. I've got three questions as well, please. Firstly, going back to the reopeners. How did these reopeners sort of go with your pragmatic approach to regulation and how burdensome do you think they'll be on the companies and yourself as an organisation? And I think – I might have missed it – but I'm pretty sure you didn't answer Jenny's question earlier on will there be a different incentive scheme for them around, say, a higher WACC?

And that leads onto my second question here, which is if the WACC isn't high enough and you think that it is, but you're comparing them with OFTOs and waters, and waters have much more scope for outperformance and OFTOs don't have development risks. If the companies and their investors disagree with you, can they not actually open a reopener and refuse to do the capex that you need?

And then on the sort of third question, linking into this, is that we're obviously going through an unprecedented energy industrial revolution at the moment and we're also coming out of the back of COVID-19, Rishi Sunak's out there desperately trying to safeguard jobs. How did you balance the incentives between doing the right thing for consumers and getting an acceleration or getting the net zero spending to create job creation? And there's one final point which is, have you calculated beta correctly? Because I'm not convinced you have. I think it should be higher than the number you've got in your numbers when you re-leverage it back up. I don't think you're using fair values there in 50% notional debt. That's a question for another time.

[1:06:36]

Jonathan Brearley

I'm going to come in on your middle question, Dominic, and then I'll hand over to the team. We're very cognisant of the time we're in and throughout the COVID crisis we have worked closely with the industry to adapt what we do to the conditions that we're in now and we absolutely support and see it as part of our aims to make sure we have a green economic recovery. Particularly you've heard me recently speak before about the fact that decarbonization is as fundamental as our duty to customers today.

What we're doing here is trying to make sure that we do get the balance right, that we do get the investment in place, but at a price that is fair to customers. But as I've emphasised on this call, two things: one is on the Totex question that we are still asking companies to come forward with evidence. And on all that, actually, we're asking companies to come forward with evidence. And really the next period is critical to make sure we all do get this in the right place; in terms of our aims, our aims are to support investment to make sure that it gets developed at a price that is fair to customers.

Dominic Nash

Can I just cut in there? Have you had this conversation with government on your investment profile or is it done in isolation?

Jonathan Brearley

We work very closely with government. Clearly our decision ultimately is independent, but we work closely with government on how our plans align with them. Akshay, do you want to comment on that?

Akshay Kaul

Yeah, that's fine. So, I think, Dom, I think you asked the question – let's take the easier bit first, which I think we did answer when Jenny asked it, but I will repeat it anyway. I think you said is there going to be a different WACC for the reopener investment. And the answer is no. The WACC is just going to be set for the control period from the beginning. What the reopeners will do is just vary the amount of Totex that gets added on to the RAV.

I think then you asked a question about the burden of the Uncertainty Mechanisms. And again, that's a fair question. Having more adaptability, having more change process in any contract, in any price control does increase the resourcing burden to make those decisions, both for the regulator and for the companies, but I think we have to take the world as we find it.

The decisions have to be made at the time that they have to be made and it would be equally absurd I think, if you were to say that let's just stuff arbitrary sums of money into baseline Totex allowances and short change the current consumer as it would be to say if we can't make the decision by December of this year, then wait for another five years before you come back to it.

Neither of those extremes makes any sense. So, I think we think we have made the right balance between trying to protect the interests of current and future consumers while creating a relatively adaptable system. Now I accept that the challenge is both on our side and the companies' side. They have to come up with good proposals, attractive proposals, imaginative proposals that help to coordinate across the system, as I gave you two examples of big projects which require the coordination with government plans on motorway charging and the DNOs and the transmission entities to work together and on the offshore and onshore side.

We are very keen to drive the system thinking through and we need the industry to come along with us on it. But as Jonathan mentioned equally on our side, we accept that we have to be a different kind of regulator in the next five years because RIIO-2 is a fundamentally different kind of control.

You then asked a question about if the WACC is not high enough, Dom. I think you said what happens if investors disagree? Can they just refuse to invest? So, I guess the first thing to say is that a) this is a consultation; so, the first thing is that we're going to have this conversation with the market and listen to evidence on what people think about our proposal and Final Determinations will come at the end of the year. If investors disagree even at that stage, they always have the right to take this to the CMA and get a second opinion.

We think, obviously, spending decisions ultimately, once the control has been set out for our individual company management, but there will be a series of outputs and obligations in the licences and network companies are always really very good about complying with their obligations. So, I think as far as I can make out, even looking at the experience that we've recently seen in the water sector, companies do get on with it, but they will have, as I say, this right to appeal to the CMA if they don't agree with us, even at the Final Determination stage. There's still some distance to go before we get to that point.

Dominic Nash

It's not the final determination stage was my question; it was actually about the reopening of it. So, if you don't change the WACC of the reopeners, what incentive is there for a company to reopen or to put in a more ambitious spending programme in if it's a subnormal return?

Akshay Kaul

I'm with you. So, assuming it's the market return, companies will obviously make profits from the fact that they are growing their business, so more investment will go in the RAV and they will also get an allowance that they can in the normal way outperform with incentives, but if what you're saying is that during the reopeners, if the WACC is suboptimal, do they have a right to appeal to the CMA? I think was that the question you're asking, Dom?

Dominic Nash

It is basically, can they just refuse to invest? Like, why would Grid want to do an EV motorway charging station if it thinks it's going to destroy value? So, what mechanisms are in place on post the final determination for the reopeners?

Akshay Kaul

Yes, I think that what you're getting at with that question is the risk profile of the investment that is coming through the reopeners substantially different to the risk profile of the investment in the baseline? Is that a fair articulation of your question?

Dominic Nash

Yeah, but also, there’s choice involved here from the company, isn’t there?

Akshay Kaul

Yes, I mean they always have a choice as to what levels of investment they put into the network, but by and large we as a regulator try and set the cost of capital at an appropriate level that reflects market rates for investment and then the incentives are generally for companies to make sensible choices. If they can underspend while delivering the same quality of service, then they share the underspend with consumers and increase their profits and also whatever they do invest whether it's motorway charging or it’s East Coast upgrades or it’s connecting renewables goes onto the RAV and potentially increases the value of the business.

Jonathan Brearley

And so, Dominic, coming back to your question. I think the aim of this entire process is to get to the WACC that allows that investment to come forward. The debate I'm sure we're going to have over the next six months is what's the right level of that.

Dominic Nash

Okay, thank you.

Akshay Kaul

Did we answer all your questions or is there still something about beta calculation I think that you asked? Simon, do you want to comment on the beta?

Dominic Nash

On the beta thing, you’ve taken a geared empirical beta using fair value debt I believe. You then de-gear that and then you say you re-gear it to a notional 60%? Why would you go to a notional 60%? Should put the fair value of debt in the debt to RAV number as well to make sure it’s consistent?

Simon Wilde

So, what we actually do is if you look at Table 15 on the asset betas, we show all of the numbers with and without the market value of debt and as well as allowing anyone to pick their favourite estimation window or averaging period. And what we observe is the real stability actually of asset betas across all of those different measures. It's that chart which was full of yellows and greens which informs what's the European comparables, informs our 0.34 to 0.39 range. So, we actually think you get a very similar asset beta whether you do or don't include the market valued of debt.

Dominic Nash

But you don't include it when you re-gear it? That's my question.

Simon Wilde

We don't. That's correct. And I'm happy to take this debate offline and report back, but we will – as I said, we find the asset betas relatively insensitive to those two choices, and if we take the one where we don't use market value debt, I think you'll probably be saying it is consistent and what we're saying is we get very similar asset betas either way. But again, we've put the numbers out there. We try to be very transparent and I'm really keen to get feedback through the process.

Dominic Nash

Thank you very much.

Operator

And the next question comes from the line of Martin Young from Investec. Please go ahead.

Martin Young

Good afternoon to everybody; I trust you're all well. And three questions from me and firstly on the uncertainty mechanisms. I hear what you're saying about it being given the same level of return, but surely some of these things that could be brought forward meet your criteria for assets which should be subjected to competition and therefore be remunerated potentially with a different level of returns. If I could just get some clarification on that. And in order to qualify for one of these uncertainty mechanisms/net zero reopeners, do you have to have spent anything by the time you bring the proposal forward to Ofgem?

Looking then at your chart on page eight which shows these illustrative examples, Akshay, you mentioned the possibility of ballpark 2 billion per year being potential under the uncertainty mechanisms for transmission. Bit of a back of the envelope calculation on what that chart on page 8 is showing you suggest that your illustration probably only includes about 1 billion in totality being allowed under the uncertainty mechanism. So, big differences between your illustration and what might outturn . So, a few words on that would be appreciated, please.

And then finally on the non-load related expenditure. You made it pretty clear that the ball is in Nat Grid's court to come back with a better quality of information. If they can't do this by Christmas, are they eligible to seek reopeners for asset health going forward? Thanks.

Jonathan Brearley

Hi, Martin, I just want to say hello and I'll hand you over to Akshay.

Akshay Kaul

Thank you, Martin, and good to hear from you. And yes, we're all well here. Let's just take those in order. I think the first question you asked was about whether some of the projects that may potentially come through the uncertainty mechanisms could they be subject to competition? And the short answer to that is yes. If they're new high value and separable projects and they meet the criteria for competition, then they absolutely could be subject to a competitive process in which case the rates of return obviously would be set by the competition.

You ask the question about do you have to spend, does the company have to spend money to get the proposals to Ofgem? So, I think in some cases they may well have to spend additional money, indeed throughout the process we have been encouraging companies to point out to us where they need preconstruction funding or initial seed funding to develop their proposals to the next stage.

We are always open to considering those and we know already we have logged the fact that even in this year Network Options Assessment there's some new projects that have potentially been added onto the radar after the company plans were submitted and we remain open to having a discussion with National Grid on pre-construction funding for those projects in the lead up to Final Determinations.

You asked a question about the scale of the uncertainty funding, 2 billion pounds per annum, which was my back of the envelope illustration relative to what we've put out in the illustrative scenario on page eight. I think you're right; the 2 billion pounds per annum is not as I said, any kind of central forecast. It is simply a sense of if we take what is in the company plans, it's there to give some sense of what could happen, what could plausibly happen, but it isn't in any sense a likely case or a central forecast of what we think is going to happen.

However, the illustrative scenario - what it's trying to do is essentially say okay, if we did get something of the scale of 1 billion pounds per annum extra, 1.2 billion pounds per annum extra, what effect does that have on the financeability of these companies? And it's really just testing the sensitivity of the financeability analysis which is its limited purpose.

And then your final question was about non-load expenditure. And as you rightly say, the ball is somewhat in National Grid's court on that. I think you asked if they don't come back with the evidence by December, could they have an uncertainty mechanism? And I guess the issue with that is just it depends on the situation. That if they really don't have any evidence to suggest that assets should be replaced or refurbished, then I think at some point we have to say, okay, you know that's what the evidence is saying.

But if there is some plausible situation where they say – I can't think of it – but for instance if there's some category of population of assets for which they will need to do some extra work and it will take a bit longer than December, then absolutely I think we will always be open to considering some flexibility around that. Particularly as I said at the beginning because we take asset health pretty seriously and we really do want to encourage Grid to make the clearest and best case that they can.

Simon, you want to add anything particularly on the illustrative scenario front?

Simon Wilde

I was about to say I'm relieved that Martin didn't ask me any finance questions. The illustrative case, and I mentioned this in one of the earlier answers, is designed so that everybody can see transparently what the incremental impact is on financeability of a particular outturn for UMs, and I think in the same way that Akshay's 10 billion— this one happens to have about an extra 6 billion, they are not specific general forecasts. They enable hopefully investors and regulator and the companies themselves to make sure that we all have a common understanding about what the impact is of these variable Totex levels on financeability and that we will be monitoring it on an ongoing basis.

Martin Young

Can I just have one small follow-up there on that page eight? You've obviously highlighted SHET, NGET, and NGGT. The outlier in all of that is even with some kind of uncertainty mechanisms playing through, you still see NGETs and Totex being below the RIIO-1 actuals, you still see it being below what they asked for in the business plan, which is not the case with the other two. Have you effectively applied the same sort of thought processes to what you have brought into the uncertainty mechanisms that you were prepared to put into your illustration example?

Akshay Kaul

Martin, can you just explain the question a bit better, because I can certainly explain to you why there is a difference between the numbers on National Grid versus SHE transmission and SSE from an asset health perspective, but I think you were linking it to the illustrative scenario, which I didn't quite get?

Martin Young

Yeah. So, page eight in your presentation, each of the three companies that you've highlighted have asked for more in RIIO-2 than they were spending in RIIO-1. In your baseline you've turned around and said no, actually, each and every one of you, well, I guess with the exception of the gas transmission, certainly the two electricity transmission companies, baseline you will get less than you had in RIIO-1 actuals.

But then you take a further step and you say, okay, if some of the uncertainty mechanisms come through, where does it take us? It swings SSE from being in a negative position to a positive position on the movement in Totex. It puts the gas transmission business significantly ahead of the baseline and above RIIO-1, but for electricity transmission it's still a drop versus RIIO-1, and it's a drop versus the ask, and quite significant.

So, I just wondered that the delta between baseline and what you've put in uncertainty mechanisms have you been fair to each and every one and done it on the same basis of probability.

Akshay Kaul

Understood. So, I think the first thing to say is the uncertainty mechanism as far as net zero investment in additional load-related investment is concerned we've taken a broadly consistent approach across the network companies. The reason that you're seeing that difference is because the starting point is very different between National Grid and the other two transmission entities.

Scottish Power and SSE gave us very well-argued cases on things like asset health and gave us relatively complete information, including very strong engineering justifications, whereas National Grid did not, even in relation to, as I say, the RIIO-1 actual levels of expenditure, which one would have expected would have been relatively straight forward to achieve.

They didn't do that, and that's why I was trying to emphasise the fact that we've had to perforce work with whatever information we were given, and it is partial and incomplete, and therefore we're really encouraging National Grid to improve that evidence base during the consultation process, and we will listen to that evidence when it comes. But that is the main reason why there is a difference when you apply the illustrative scenarios because the starting points are so different for the three transmission companies.

Simon, do you want to comment at all just on the consistency in terms of the illustrative scenario itself between transmission operators?

Simon Wilde

It reflects an example. It's some work that was done by a combination of our sector teams and reg finance of some of the uncertainty mechanisms which could well come forward. So, the models will make it really clear what's in there. It's not designed to signal these are the ones we think we will approve, and we won't approve the others. It was really a collection of ones that we thought were plausible.

Akshay Kaul

But we haven't made any special assumptions in relation to each deal that treats them differently. But going back to your question, there's nothing about the illustrative scenario that is distinctive; it's the starting position that is creating that effect that you observe.

Martin Young

Okay. Thanks.

Operator

And the next question comes from the line of Sharon Vieten from Columbia Threadneedle. Please go ahead.

Sharon Vieten

Hi thanks. I think I'll take my question offline; it's a very small simple one. So, let's do that. We're up against time as well. Thank you.

[1:27:41]

Operator

And the next question comes from the line of Maria Fassakhova from Fitch Ratings. Please go ahead.

Maria Fassakhova

Hi, hello everyone. I have three quick questions please. The first one is on the ODIs. Could you comment? So, I understand that you are not considering this bespoke ODIs and are considering common ODIs only. Could you talk whether these will be absolute or relative to the sector performance and how this is expecting to change the returns that the companies are able to earn from these ODIs?

The second one is on the cost of debt and in particular, if I understand correctly, you have ruled out a small company adjustment or some company specific adjustments on the cost of debt. Would you not consider these for ED too as well so that it sets a precedent even if a company has been underperforming on cost of debt due to size?

And the third one, if you could at all, and I understand maybe it's an early question to ask, could you maybe relay your thoughts with regards to capital intensity in GD2 versus the ED2 to in light of the transition to net zero? Thank you very much.

Jonathan Brearley

Okay, over to you, guys.

Akshay Kaul

Okay, let's take it one by one. So, Simon, do you want to deal with the question on small company adjustments and then we'll come back to the questions on costs and incentives?

Simon Wilde

Yes. Maria, I just wondering, was that a small company adjustment for cost of debt?

Maria Fassakhova

Yes, yes for the cost of debt.

Simon Wilde

So we did ask for proposals on that and one company came up with one, that the reason we asked ourselves the question, a smaller company may only be able to issue a benchmark bond every two or three years, whereas large companies could issue one every year and so it'll be easier for them to have a cost of debt that more closely tracks our indexed allowance. And we asked for evidence of what that cost might be.

The only proposal that we received was one based on insuring against rate movements using swaptions, and that did suggest really quite a large adjustment, but because swaptions give optionality rather than committing upfront, it felt that that was more than compensating for that risk. It would create the possibility of gains for the company and so we state in the finance annex that we don't take that forward. We didn't receive other proposals and we are still open, and I will invite in consultation anyone who's got other ways that are perhaps fairer than building in an expensive option premium.

Maria Fassakhova

So, if I may summarise, you’re still open to sort of maybe ensuring that the companies don't bear the risk of underperforming on cost of debt just because of their smaller size?

Simon Wilde

Yes, I’ll put it slightly narrower, which is that if they can demonstrate to us that they do bear risk and/or cost, then we are absolutely open to that evidence and we are in effect asking for it again because we very much asked for it at the methodology consultation stage and again at the business plans.

Maria Fassakhova

All right, thanks.

Akshay Kaul

Great, and I think you had a question on ODIs, bespoke ODIs, and whether they're absolute or relative. I think from my recollection I don't think any of them are relative. I think they are all absolute and they reflect really our assessment of where companies have made a good case to have bespoke ODIs that reflect their testing with their local customers and stakeholders and it's an example of in a sense the adaptability of the RIIO regime to fit with local circumstances.

But as we explained in chapter five of the core document, in many cases companies that submitted bespoke proposals, they were in an area where it actually made sense to make them common across the sector, because all customers would benefit from them. And so, where we have accepted some of those bespoke proposals, in some cases we have made them common across the sector, and in other cases we have left them as bespoke to the individual companies.

It's a bit difficult to give you a precise answer on the financial effect of them because they do vary across each of the companies, some of them are bespoke ODIs specific to the company and others, as I say, are common across the sector, but let me make a note of that and I'll get back to you with a more detailed breakdown of their calibration within the overall ODI scheme that I described at the beginning.

Simon Wilde

Sorry, Akshay, may I just make a small addition which is, and aficionados may not have made it this far in, but Table 44 in the finance annex, which is actually in the appendices of the finance annex, you will find that we actually, company by company, specified common ODIs, bespoke ODIs along with all of the other numbers. So, you will be able to find that in there in the bowels of the Finance Annex in Table 44.

Maria Fassakhova

All right, thank you very much. Could I just follow up quickly on this one? As you've said that they will be absolutes, how would you then ensure that companies are not remunerated for sub-optimal performance or performance below industry average levels?

Akshay Kaul

I think that's been part of the process of analysis that we've undertaken, which is to say, is this proposal that they've made in the interests of consumers and what is the evidence base that allows us to set a target that is a sensible target for good performance? And we looked at what the quality of the stakeholder feedback has been on that.

Where we've made them common, we can actually compare when we're setting the target as we do for all the other ODIs what a sensible target should be. Where they are bespoke, then almost by design there is no comparability with other companies, and we have to look at the improvement for the individual company and I'll just give you one example to illustrate the point.

So, for instance in the gas distribution sector there is a bespoke incentive for Cadent on high rise buildings and the reason we haven't made this common across the sector is because there is a particular issue with Cadent's performance in high rise buildings in North London and we want them very much to improve their performance, and indeed the company wants very much to improve their performance.

So, we have set them a target based on their proposals for improvement and if they don't meet those targets, then obviously there will be penalties against that. So, that's not a comparative yardstick, that is an absolute standard of improvement that we expect from Cadent.

Jonathan Brearley

Okay, I'm going to just jump in here. I'm afraid I have to head off to another meeting, but Akshay and Simon are you happy to continue taking questions?

Akshay Kaul

We can carry on Jonathan, that's absolutely fine.

Jonathan Brearley

I just want to finish by emphasising this is a consultation. We do need evidence from the companies and from yourselves and we will absolutely openly look at that and transparently look at that before coming to our decision at the end of the year. I'm available if you would like to talk to me and I look forward to working with you all over the next six months. Thank you.

Akshay Kaul

Great, thank you, Jonathan. And finally, I think your third question was about capital intensity in GD2 versus ED2? Did I hear that correctly?

Maria Fassakhova

That's right. So, talking about electricity distribution which is two years later in terms of price control, etc.

Akshay Kaul

Okay, and when you say capital intensity, do you mean the level of capital expenditure relative to Totex in both of these sectors?

Maria Fassakhova

Meaning actually in terms of, so almost like slow money versus RAV or Totex versus RAV.

Akshay Kaul

Right, okay. So, I think it's a bit difficult to predict what the capitalization rates in ED2 will be because we try and set them so that they are natural rates that approximate the broad balance of capital and operating expenditure in the proposals when we set these price controls. I think we do have the figures, Simon, for GD2, which we can share, but I'm afraid I can't really predict what the comparison will be with ED2 because that is still two years ahead of us. Simon, do you want to just confirm what the capitalization rates are for GD2?

Simon Wilde

Yes, so they are in the finance annex. We have a separate section on capitalization which I'm trying to spin to, but we set them out very clearly, similarly to the conversation that we had with Mark with respect to ET. So, I would refer you to the same table. But just to give you – in a sense they range 26%, 17%, 25%, 22%, 33% for Northern, 38%, 28%, 26%. So, you can find those on Table 40, on page 151.

Maria Fassakhova

All right, thank you.

Operator

And the next question comes from the line of Fraser McLaren from Bank of America. Please go ahead. Fraser, if your line is on mute, can you please unmute yourself?

Fraser McLaren

Hello. Good afternoon, are you able to hear me now?

Akshay Kaul

Yep, we can hear you, Fraser.

Fraser McLaren

Hi there, good afternoon. So, I have a few questions please. First of all, just wondering if there are any parameters that we've discussed today which are not up for debate and therefore changed by the time of the final proposals. Secondly, in reaching your conclusions on Totex in particular, how much regard have you given to the views of the consumer groups so far as they were reflected in the business plans? And then on uncertainty mechanisms, is it not possible that so much reliance on these could delay much needed progress on enabling work for net zero. I mean if we just take Hinkley in the Scottish islands as examples then that doesn't bode well if that process had to happen on a much larger scale.

And then just finally on incentives. I mean, which have been a real hallmark of UK utility regulation over the years. There doesn't seem to be much to go for here when I compare it to water, for example. In the long term, that doesn't seem to be in the best interests of all shareholders in my view. Do you think that’s fair and is there the opportunity to strengthen those incentives by the final proposals? Thanks.

Akshay Kaul

Thank you, Fraser. Okay, let me have a go at them. Simon, jump in if you want to add anything. Just firstly, are any parameters non-negotiable? I don't think so. I think the whole consultation is open. We've asked questions in almost every aspect of the settlement and when we get to final determinations of course, we will consider it all in the round, but we welcome feedback, evidence, arguments on every single parameter that we are consulting on.

The second question you asked was about consumer groups, which I presume you meant the challenge groups, and again, as we explained in the core document in chapter three, we have carefully considered the feedback both from the company level, customer engagement groups and user groups, and from the central RIIO-2 challenge group in reaching our decisions, both on the cost and quality of service side as well as in terms of the financial parameters, particularly with respect to the dialogue that we've had with the RIIO-2 challenge group.

And I should just say that we found that an incredibly useful aspect of the process, because for the first time we've had a well-articulated, well-informed set of voices on the consumer side, really engaging with the process with as much traction as the companies themselves. So, I think that's been very, very welcome, and it is, as I say, reflected in our proposals for outputs and costs as well as finance.

On the uncertainty mechanisms, Fraser, you ask a reasonable question. Is this going to delay things? I think that if – and this is the thing we have to work with the industry collaboratively on – if we set things up so that decisions can be taken quickly at the right time, then almost by definition it shouldn't delay anything and it certainly is a lot better than having no adaptability at all and saying to people you either decide by December or you have to wait for five years before you make any further decisions.

As I said, neither of those makes any sense in regulating the kind of system we see before us. So, I think the challenge is a common one for us and the industry to make these uncertainty mechanisms work in the most fluid, effective and timely way. But I'm hugely optimistic that they will give us the flex that we need to be able to make the right decisions at the right time.

And then you asked a question about the calibration of the incentives and the fact – I think you compared to water and said that there isn't much to go for in energy. I'll leave it to your judgement as to the comparison with water and whether there is or isn't much to go for in energy, but as I indicated, I think the range of ODI outperformance on a kind of illustrative 10% Totex underspend plus maxing out on the quality of service incentives, that range I think is narrower than the range in RIIO-1.

So, I think we should be pretty direct about that and that is simply reflective of the evidence that we had in the determination process. What kind of quality service improvements are in the interests of consumers, where are they likely to get better value? And then the question is about the incentive rates. We have lowered the overall incentive rates from I think a range of 45 to 65% in RIIO-1 to something between 35 to 50% in RIIO-2 and that is just again reflecting the fact that we think that very high incentive rates are not necessarily in the best interests of consumers either.

And in the context of investability, I think an overall lowering of the incentive rates is actually quite helpful from a downside risk protection point of view. We still think that 35 to 50% is a really powerful and strong incentive and will drive the right kind of behaviour from network companies where that makes sense.

And then, we're not really trying to compete with other regulators to say we should have a higher range of incentives or a higher overall incentive rate. We're just trying to get this right against the evidence that we have received.

Simon, do you want to add anything on any of those four?

Simon Wilde

No, I think you covered that well. Thank you.

Fraser McLaren

Many thanks. Would you mind if I just follow up with one very brief question? And that's just about the extent to which the lockdown has or has not held back your analysis in any respect? Are there any areas where there's still a lot of work to do notwithstanding what you were expecting from National Grid, of course, but from your side, do you feel that there's any ground to catch up in any particular area?

Akshay Kaul

It hasn't held up anything, Fraser. It has been more of a challenge than it would otherwise be, particularly because a lot of this is computational and getting people to run these sort of complicated models is always easier when you can just get around a table physically in an office than if you were dispersed and working from home. So, we certainly have had to cope with that challenge, but I don't think it has meaningfully impeded the analysis. I think what has just impeded it, as you mentioned just now, is just the quality of the information, and sometimes the information is partially missing then there has been a limited amount that we could do about it.

So, I definitely think there is work to do in that asset health area with National Grid. And also, I suppose I'm very happy to share that we have asked the ENA, the Energy Networks Association, to work on a kind of two-phase project on the green recovery with us and what that is doing is essentially saying a) between now and September can we first of all figure out what investment could be accelerated within RIIO-1 and then more interestingly, now that you have seen the Draft Determinations in line with the consultation responses coming back in September, we've put the challenge to them to say what could be accelerated within this Draft Determination programme whether it's in the baseline or it's an uncertainty mechanism, what work can be jointly accelerate to drive the green recovery. And again, I'm very optimistic that we will together with the industry be able to get a powerful result in that.

And then the third and final area where I guess we haven't been able to do work, not because the lockdown *per se* has affected us but just because the evidence is unclear, is just on COVID-19 effects on network companies and the cost and quality of services.

You can clearly see that the lockdown has had an effect on the prioritisation of work and in some cases like the Iron Mains Replacement Programme, the gas companies have been unable to carry out a lot of the activity because it involves going into people's homes and that's why we're being relatively open about that in the determinations and asking for evidence from stakeholders, including companies to tell us what effect they foresee on the quality and cost of network services and then we will try and take those into account, either in the closeout of RIIO-1, if the effects are only 2020, or indeed into RIIO-2 if they are going to be material in during effects.

Fraser McLaren

Many thanks.

Akshay Kaul

Thank you.

[01:47:29]

Operator

And the next question comes from the line of John Musk from Royal Bank of Canada. Please go ahead.

John Musk

Good afternoon, everyone. I'll keep it brief. Just one question. I'm interested in the outperformance wedge and the 25 basis points and then your new failsafe ex-post mechanism. Is that not slightly perverse in that if companies don't outperform, they'll be handed back a 25 basis points on their RoE. So, will the worst performing companies actually get paid something back versus the best performing companies? Maybe I'm not understanding that correctly.

Simon Wilde

That's a good question, John, and I haven't gone into it in detail. What we assess, we've put the companies into two pools. We have an electricity transmission pool and we have a gas pool – so that's the gas companies and gas transmission companies – and we will look at the sector average outperformance of those two pools and if one or both of those pools just hasn't outperformed, we are open to the interpretation that that says that we should not have estimated that level of outperformance on an ex ante basis, and so we will correct for it.

And so, it's got an important incentive effect. So, within that pool, if you are a poorly performing company and the average is marginal outperformance, all of those companies will be added back the same amount of capital. So, there is always a marginal incentive to outperform for all of the companies, but it does mean that we, and I hope investors, will have a greater confidence, as I said, in companies earning at least their cost of capital.

John Musk

Okay, thank you.

Simon Wilde

The details are in the finance annex and I will look it up. And before we finish, I will tell people exactly where they can find it.

John Musk

That'd be great, thank you.

Operator

And the next question comes from the line of Sam Arie from UBS. Please go ahead.

Sam Arie

Hi. Good afternoon everybody. Thank you for the presentation. A tonne of work published today and the questions too, so thanks for hanging on for those of us at the end of the line.

I think just one sort of big picture type question from me and I've been thinking how to formulate it, but I think it goes just like this: when you think about everything you know now and you weigh it all up, what do you think the chances are that you end up seeing higher Totex through RIIO-2 than the previous period i.e. if you look at your page 21, what's the probability that when we get to the end of the period, the actual total spend will end up being more than the 22.7 billion in RIIO-1? And if I could just say briefly why I'm asking it might help you with your answer.

But if I just think about what we've learned today and what markets are reacting to quite sharply on some of the stocks affected, especially Grid’s, then there's your headline rate, and then there's the Totex cuts, or so they seem to be. And on the headline rate I think yes, you're slightly below what was expected, but your risk-free rate is – what? – 75 bps lower than we had last year, so I suppose you could argue the spread for the company has actually gone up a bit today, not down because of your reduction in the outperformance wedge.

So, then the worry that must be driving things is that these Totex cuts look pretty heavy. That would explain why the reaction is a bit larger on Grid than SSE for example. But then you've also said that these numbers could go up quite a lot during the period because of the way the uncertainty mechanisms work, and you also talked about Grid not having given you all the info that you wanted.

So, I suppose if we want to judge if the reactions today are fair, then what we've got to figure out is whether you're really guiding lower Totex in RIIO-2 or really just a change in approach or a change in level of info available at this point, which means – you see what I mean? – we’ve got to try and figure out whether we're going to end up with more spend in total or not. I'm just wondering, coming back to the question, what's the chance we actually end up with more Totex in the next period than the last in your view?

Akshay Kaul

That, I think, is a really, really good question, and if I may just answer it slightly obliquely. As I say, we don't have a central forecast of what will come through the uncertainty mechanism, but my starting point is where I began. I think we expect that there will be significant increases in network investment to meet net zero targets as we go through the decade, and certainly if we look at numbers that are put out by the likes of the Committee on Climate Change and other advisers like Aurora, etc.Those do indicate an overall increase in network expenditure, the total expenditure, from networks as we head through the decade and I don't have any particular reason to believe that analysis is not credible or sensible. So, that in a sense is our starting point. I think you're asking me to put a probability number to it, which I'm going to shy away from because I don't have any reasonable basis on which to attach probabilities to these things at the moment and the reason for that —

Sam Arie

I was going to say high, medium or low would be fine. It sounds like you are sort of saying high. Is that my putting words in your mouth? There’s a high chance we could end up with higher Totex in the next period in the last.

Akshay Kaul

I think certainly based on what the climate advisers and infrastructure advisers are saying, my sense is it’s more likely than not that overall levels of expenditure will increase rather than decrease. But the first rule I learnt in these sort of spending controls is that one has to be cautious about making these sorts of predictions because a lot depends upon –

It depends on two things: Firstly, it depends on what happens in the rest of this period. As you know, we've been talking a bit about National Grid's asset health proposals that have nothing really to do with the net zero uncertainties, it's just to do with the quality of their engineering justification. And the second thing is to do with the net zero uncertainty. I mean, if there were big decisions on heat, for instance, let's imagine the government decided to electrify heat, then that would have, I think, quite dramatic effects on the expenditure, say on electricity distribution and possibly on electricity transmission, but quite a negative impact on gas distribution.

Contrariwise, if there was a big push towards hydrogen, you could see an increase in expenditure in the gas distribution sector and possibly less of an impact on the distribution and transmission sectors. So, the makeup of where this new investment goes, I think, is highly uncertain because these policy decisions are still to be taken. But the only thing we can I think say with some degree of confidence is when you step back and you look at what experts like the Committee on Climate Change are predicting, then it does seem to be the case that overall levels of expenditure ought to rise across the system, if you follow my meaning. Not necessarily in a particular sector, because the makeup may be different, but across the system they ought to be going up.

Sam Arie

Well, I thank you for that answer which I think is hugely important because with massive respect to everything you published today and I think it's a phenomenal output that you've brought this morning across massive scope of very difficult questions, there is a slight risk that the kind of headline message people take away is that the spending isn't allowed. There's been a massive cut in spending, and actually what I understand from your previous presentation in your answer just now is as much as anything else what we're seeing is really just a change in your approach to when the spending will be signed off and people could take a view whether that's positive or negative, but it doesn't sound to me like we should expect lower Totex in RIIO-2 than RIIO-1. And you seemed to be confirming that with your answer just now.

Akshay Kaul

Yeah, I mean, I certainly think it is more likely than not that across the decade, overall expenditure levels will go up. But as to when exactly that happens and in which sectors that happens, it is impossible to attach any probabilities to that.

Sam Arie

And that's for us to go away and think about I guess.

Simon Wilde

And, Sam, I would just say, and hence the need for this flexible approach that Jonathan and Akshay have outlined, the worst thing would be a rigid, high-baseline set of assumptions where we baked in some views on hydrogen versus electrification of heat. I think everybody is going to have to get a little bit used to RIIO-2 feeling a bit different, but it does feel just simply impossible to make the right calls now. What we need is a flexible system.

Sam Arie

Yeah, that's super clear. And if I may, I remember Jonathan making exactly the same point at an event we hosted for him a couple of years ago, and I think the way that he proposed to handle it looks like a very intelligent adaptation of the framework and a good approach so long as it's clear to everyone on the call that they shouldn't simply read a massive cut in Totex from slide 21, which I suspect it has not been 100% clear to everyone so I appreciate your extra confirmation here at the end of the discussion.

Akshay Kaul

And that's a really helpful question, so thank you. Thank you for asking it.

Sam Arie

All right, well, thank you. Thanks for the call.

Akshay Kaul

Great. I think we're pretty much out of time, so can I hand it back to the moderator and just give a huge thank you to everybody for taking part today. The conversation doesn't need to end here. Please keep in touch with us throughout the consultation period. We are very open to having bilateral sessions if you want to come and meet with us. And obviously if we can do anything in terms of further clarifications or answering questions, just get in touch and we will be very happy to do that. Back to you, moderator. Simon, sorry.

Simon Wilde

I did say I would tell people where they could find the description of this ex-post mechanism. It is on pages 83 to 85 and it's paragraphs 3.153 to 3.160 and we would be really happy to take questions on this. I tried to highlight in the upfront presentation, this is a new element that we have introduced at least partly in response to some of the concerns we've heard from people on this call.

Akshay Kaul

Thank you, Simon. And may I just wish everybody a happy Thursday and enjoy the rest of the weekend. Back to you, moderator.

Operator

This now concludes our conference call. Thank you all for attending; you may now disconnect your line.

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