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RIIO-2 Draft Determination

Investor call

11:00 – 12:30

Thursday 9th July 2020

Presentation overview

- Welcome and introduction
- Timeline and next steps
- RIIO-2 design
- Finance deep-dive
- Key financial changes from RIIO-1 for investors
- Q&A

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Jonathan Brearley
CEO

Welcome and introduction

- Today we published '*Network Price Controls (RIIO-2) Draft Determinations for Gas and Electricity Transmission, Gas Distribution, and Electricity System Operator*'

- Five-year spending plan to 2026 to power forward a strong green energy infrastructure for GB, which delivers better service while cutting the cost of this investment for consumers.

- **T & GD:** 5-year RIIO-2 price control (1 Apr 2021 to 31 Mar 2026)

- **ESO:** 5-year RIIO-2 price control, Business Plan set for 2 years (1 Apr 2021 to 30 Mar 2023)

  The ESO will then submit a further Business Plan for the next period. This is designed to reflect the rapidly adaptable behaviour we expect from the ESO as it responds to the changing electricity system.

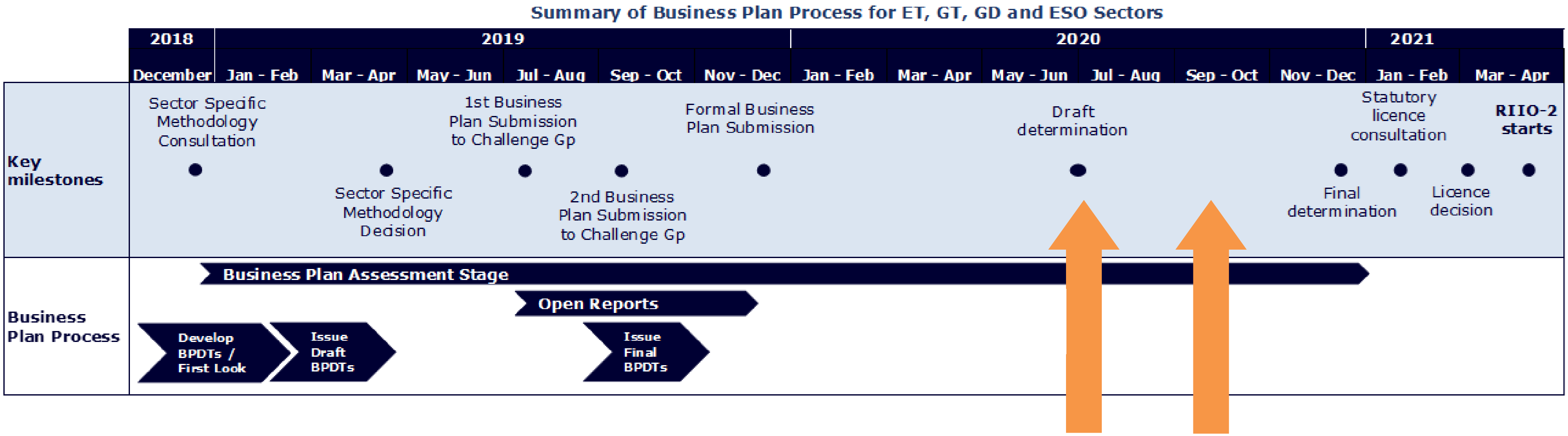
Akshay Kaul
Director, Network Price Controls

Timeline and next steps

RIIO-2 design

- **Two key components to our approach to Net Zero**
- **Baseline totex allowances**
- **RIIO-2 risk and return balance**

High-level timetable for RIIO-2 (excluding ED-2)



Draft Determination
9th July 2020

Consultation closes
4th September 2020

How to respond?

These are draft proposals, subject to consultation. We will publish our decisions on the RIIO-2 price controls in our Final Determinations later this year.

If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why.

Send to:

RIIO2@ofgem.gov.uk

Draft Determinations at a glance…

- A key objective of RIIO-2 is to **prepare the regulated network companies and ESO to deliver Net Zero at lowest cost to consumers**.
- We have added flexibility to the price control to **fund what is justified now and reopen what is needed later**.
- Challenging the companies to **be much more efficient in how they run and finance themselves**, and to justify baseline spending.
- A **reasonable allowed return** reflecting current market rates.
- **Expect the average company to outperform**, but modestly compared to the high levels of RIIO-1.

Two central components to our approach to Net Zero

Upfront 'baseline' funding where there is a clear needs case to invest now.

To this end, we propose:

- Approx. £3.5bn of baseline funding for areas such as low carbon connections and enhancing system operability
- At least £630m of innovation funding to do more research and development into green energy and over £500m funding to reduce the networks' own impact on the environment
- Funding the ESO to deliver the changes necessary to operate the system carbon-free by 2025

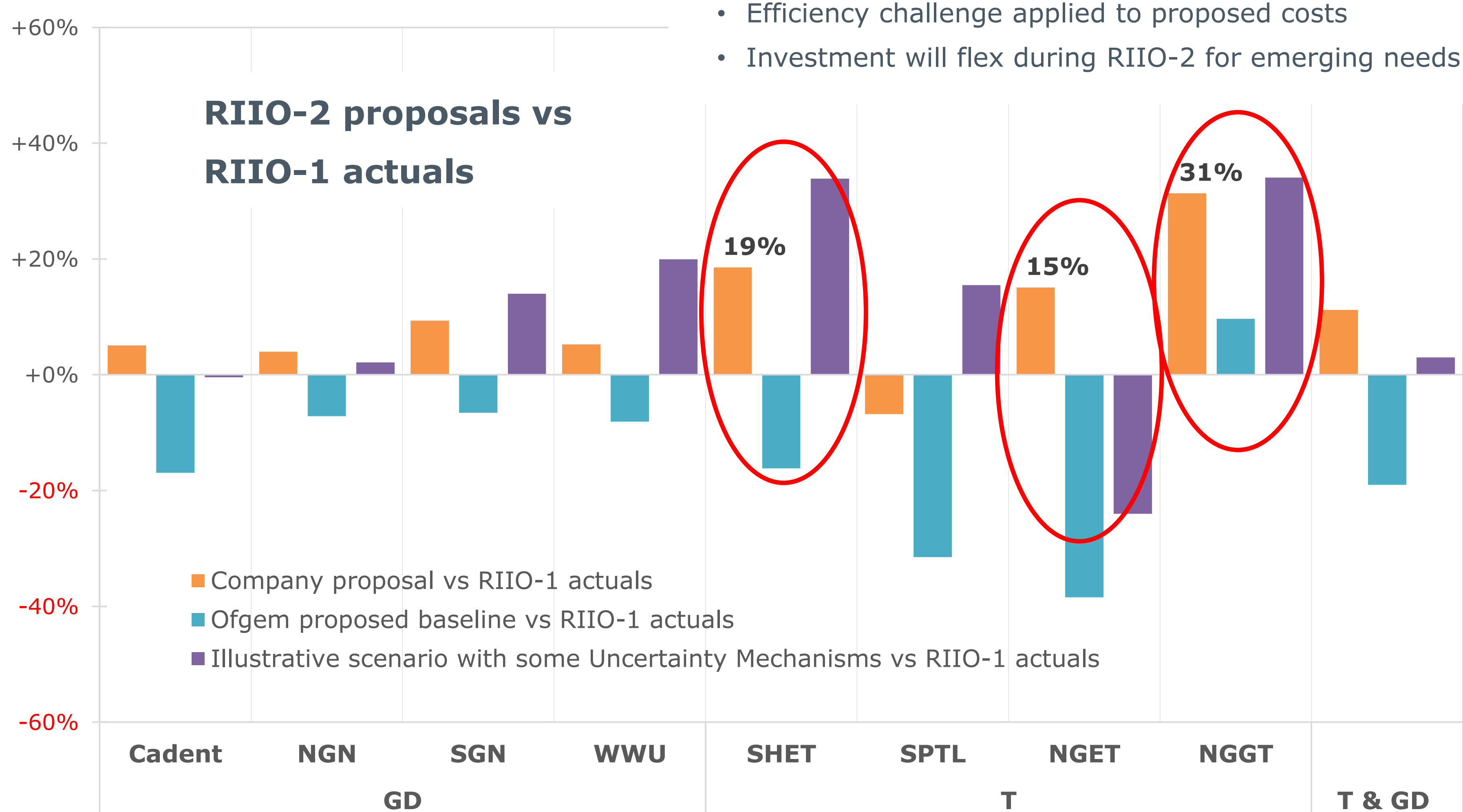
Uncertainty mechanisms available throughout the period to ensure the price control can flex as needs become clearer, that would allow companies to bring forward strategic network investments to facilitate Net Zero.

- Our Net Zero re-opener sits at the heart of this approach and can be used at any time
- Strategic Innovation Fund to support achievement of net zero targets
- A second Business Plan for the ESO, to enable them to respond to change.
- Additional mechanisms to address sector specific uncertainties / challenges

RIIO-2 design (2) – Baseline totex allowances

Adequate allowances provided for investment that is needed in RIIO-2

- Unsupported proposals have been excluded
- Efficiency challenge applied to proposed costs
- Investment will flex during RIIO-2 for emerging needs



Cost of capital and rates of return

- Large reduction in the proposed allowed return on capital, **resetting to levels consistent with current evidence and market conditions**.
  - Cost of equity has been assessed at 4.2% (with notional gearing of 60%), and allowed equity returns at 3.95% (adjusted for expected outperformance).
- We expect network companies to share a **greater proportion of costs saved with consumers** whilst still maintaining a strong incentive for companies to operate efficiently.
  - **Stretching ongoing efficiency targets** (1.2% for capex and repex, 1.4% for opex).
  - **Lower sharing factors**, post-tax.
  - **Indexing RPEs** to manage input price risks (forecast upfront, then true-up on outturn).
  - Caps and collars on ODIs.
  - Return adjustment mechanisms offer extra protections.

Licensee	RIIO-2 company sharing factor
ET - NGET	39.2%
ET - SPT	39.1%
ET - SHET	30.9%
GT - NGGT	36.6%
GD – Cadent	49.7%
GD – NGN	50.0%
GD – SGN	49.4%
GD – WWU	49.6%

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Simon Wilde
Senior Financial Advisor

Finance deep-dive

- **Cost of equity**
- **Cost of debt, depreciation, capitalisation, notional gearing**
- **RoREs and RAMs**
- **Approach to financeability**

Cost of equity

- Baseline **allowed equity returns of 3.95% CPIH real** at 60% notional gearing
- ***Step one*** *– CAPM estimation*
    - Risk-free rate -1.48% CPIH real (average RIIO-2); equity indexation mitigates risk
    - TMR range of 6.25% to 6.75% CPIH real
    - Network company asset beta range of 0.34 to 0.39, notional equity betas of 0.66 to 0.79 (asset and equity beta for ESO of 0.45 and 0.85; cost of equity 5.28% CPIH real)
    - **Implies cost of equity range of 3.64-5.00%**
- ***Step two*** *– CoE cross-checks*
    - CMA NATS approach, MARs implied returns and OFTO bid returns
    - Forecasts, infrastructure fund discount rates
    - **Cost of equity proposal: 4.20% CPIH real** for 60% notional gearing
- ***Step three*** *– distinguish between Allowed and Expected Return*
    - **0.25% outperformance assumption**: based on long-run information asymmetry, calibrated to proposed RIIO-2 incentive package
    - **Ex post adjustment at close-out** to correct for potential over-estimation of outperformance
- At 55% notional gearing, **weighted average return on capital is kept constant**, implying 3.93% cost of equity and 3.70% allowed equity return

Finance deep-dive (2)

Cost of debt

- Full indexation as per SSMD
- Proposed change from combined A/BBB 10yr+ iBoxx indices to Utilities 10yr+ iBoxx index
- Allowed return based on efficient average costs across network sectors (GD, GT and ET)
- RAV weighted allowance proposed for SHET
- Halo effect estimation removed by switch to Utilities iBoxx index
- New issuance cost allowance of 0.17% applied to embedded and new debt
- Debt indexation proposals:
    - 10-14 year trailing average plus 0.17% for most Networks: implies 1.74% CPIH average debt allowance
    - Bespoke RAV-weighted mechanism continued for SHET: implies 1.47-1.58% CPIH debt allowance depending on totex levels
    - Bespoke short-term debt allowance for ESO to reflect bank funding
- Most Networks allowed return on capital allowance: 2.63% CPIH real

Depreciation

- Unchanged for ET (45 year straight line) and GD (45 year sum of year digits)
- GT aligned to GD, for period from 2002, in line with approach taken in RIIO-1 for change in GD depreciation
- Takes into account estimated economic asset life and balance between current and future consumers

Capitalisation / Fast- and Slow-money

- Rates set based on natural capitalisation of baseline opex and capex
- Consulting on treatment of totex under UMs – financeability modelling treats as slow-money currently

Notional gearing

- 60% for lower RAV growth gas networks and 55% for potentially higher RAV growth ET
- Current proposals no more than 5% variation from RIIO-1 notional gearing levels

Return on Regulatory Equity ranges

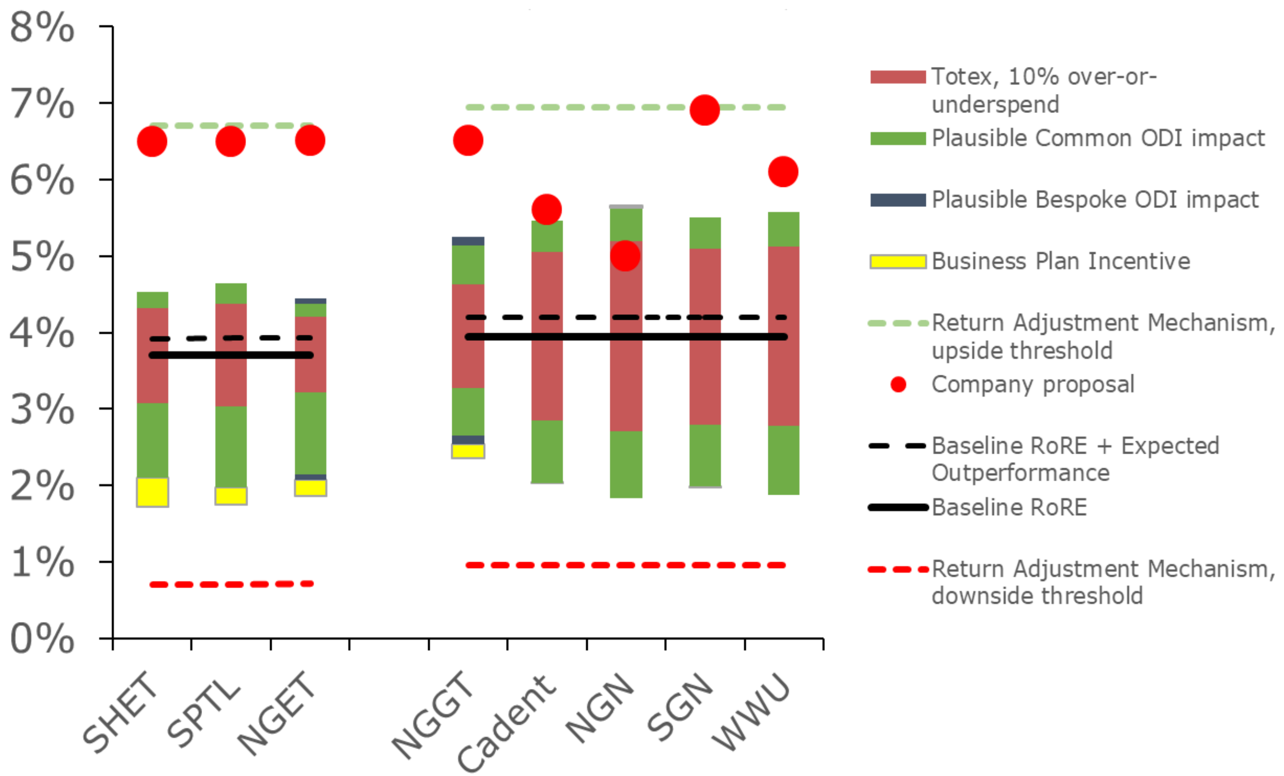

Figure 22: RIIO-2 average RoRE ranges and company proposals

Chapter 3, Finance Annex.

Source data available from Table 44 (Appendix 6) and Table 45 (appendix 7) of the Finance Annex.

Source: Ofgem analysis.

RAMs

- Sculpted symmetrical sharing RAM **for all sectors** at +/- 300 bps on RoRE
- The cap and floor are sufficiently wide to not be easily triggered
- Downside RAMs offers credit support, mitigating decline in RoRE below approx. 3% nominal

Finance deep-dive (4)

Approach to financeability

- Duty to have regard to the need to secure that network companies are able to finance activities subject to legislation, assessed with reference to the notional company
- We consider all networks to be financeable on basis of notional capital structure taking account of the allowed costs, cost recovery and allowed returns in these Draft Determinations

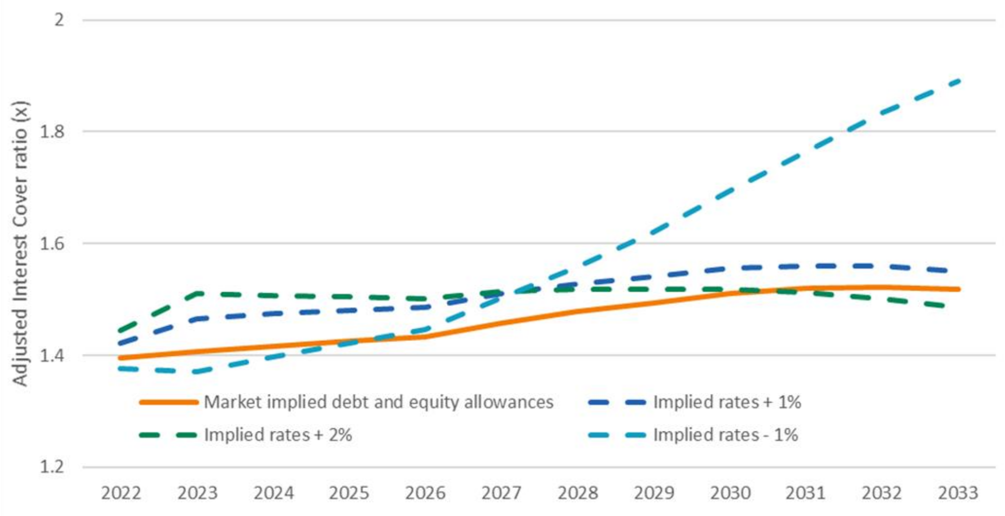

Figure 27: AICR evolution under different rate scenarios (Chapter 5, Finance Annex)

Source: Ofgem analysis

Table 34: Summary financial ratios for notional company structures (FYE 2022-2026 average), **baseline totex allowance** (Chapter 5, Finance Annex)

Licensee	RIIO-2 Starting Notional Gearing	AICR	FFO/net debt	RIIO-1 & 2 RAV growth (nominal)
SHET	55%	1.52	10.7%	11.2%
SPTL	55%	1.58	13.2%	6.0%
NGET	55%	1.68	14.4%	3.1%
NGGT	60%	1.51	11.4%	1.7%
Cadent	60%	1.45	10.2%	2.2%
NGN	60%	1.43	9.8%	3.0%
SGN Scotland	60%	1.42	9.9%	2.7%
SGN South	60%	1.43	10.0%	2.6%
WWU	60%	1.45	10.2%	2.5%

Source: Ofgem analysis – ***Note that actual company credit ratios may be quite different to notional ratios, depending on actual capital structure***

- Ofgem does not target any particular rating or credit ratio. We complete an in-the-round assessment
- Recent market evidence suggests we do not need to adjust our notional company financing assumptions for the impact of Covid-19. Will continue to review

Summary of key financial changes from RIIO-1 for investors

- Ensuring only clearly evidenced totex is agreed to up-front, with greater expectation for reopeners.
- Reducing the return to equity investors through alignment with current market conditions and the risks that networks face.
- Indexing rather than forecasting key variables, such as interest rates (both equity and debt allowances now proposed to be annually indexed for changes in market rates).
- Stronger cost efficiency and output performance challenge.
- Reined in underspend upside, but also better protected on overspend downside.
- Bespoke suite of arrangements for the ESO.
- Moving from RPI to CPIH.
- Front-loaded depreciation for GT (aligned with GD).

Closing remarks

Questions

Please submit your consultation response to:

RIIO2@ofgem.gov.uk

IR contact: Investor.Relations@ofgem.gov.uk

Jamie Tunnicliffe
Head of Investor Relations

Aidan Stringfellow
Senior Manager, Investor Relations

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Our core purpose is to ensure that all consumers can get good value and service from the energy market. In support of this we favour market solutions where pratical, incentive regulation for monopolies and an approach that seeks to enable innovation and beneficial change whilst protecting consumers.

We will ensure that Ofgem will operate as an efficient organisation, driven by skilled and empowered staff, that will act quickly, predictably and effectively in the consumer interest, based on independent and transparent insight into consumers' experiences and the operation of energy systems and markets.

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Appendix

Totex comparison[1]:

RIIO-1 actuals, RIIO-2 company proposals, DD baseline, DD illustrative scenario

£m 18/19 prices	RIIO-1 actuals (6-year average*5)	Business plans	DD proposals – Baseline	DD proposals – Illustrative[3]
Cadent	5,081	5,317	4,078	5,059
NGN	1,207	1,249	1,083	1,233
SGN	2,800	3,058	2,527	3,192
WWU	1,123	1,182	997	1,347
GD sector	**10,212**	**10,806**	**8,685**	**10,831**
NGGT	**1,981**	**2,602**	**1,559**	**2,656**
NGET	6,163	7,090	3,332	4,682
SHET	2,021	2,388	1,609	2,706
SPTL	1,475	1,389	970	1,704
ET sector	**9,659**	**10,867**	**5,910**	**9,092**
ESO[2]	**859**	**1,247**	**1,165**	**1,870**
Industry total	**22,711**	**25,523**	**17,319**	**24,449**

[1] The RIIO-2 totex comparators used here exclude some variables (eg RPEs) that are included in the RIIO-1 actual totex figures. They are used here to allow for a better comparison between RIIO-2 Business plans and the DD proposals. This is not the methodology used to derive the RIIO-2 comparators on slide 8 of this pack – the figures used for the chart on slide 8 were chosen because they lend themselves to comparing RIIO-1 actuals and RIIO-2 proposals.

[2] The figures for the ESO are 5-year extrapolations of totex drawn from their 2-year allowance. The 5-year figures shown are not a forecast or an expectation.

[3] The illustrative uncertainty mechanism case provided here is one that could be considered with additional totex above that proposed in the baseline proposal. This illustrative case shown here does not represent a forecast or an indication of re-opener allowances.

Impact of COVID-19 on the price controls

- COVID-19 has **presented some new challenges** - we have addressed these as part of the Draft Determinations, and will continue to address as part of our ongoing work.

- We will **continue to deliver RIIO-2 to existing timetable**, but recognise need for robust contingency planning should the impacts of COVID-19 worsen.

- Between now and Final Determinations we will **engage with the companies to gain a fuller understanding of the impacts on RIIO-1 and consequential impacts on RIIO-2 through a series of workshop and bilateral meetings**.

- Although **unable to proceed with Open Hearings**, we have sought to reflect in our DDs the stakeholder input that fed into their preparations. We will run **webinars** to help stakeholders engage with DDs, and are considering **Open Meetings** after our consultation closes.