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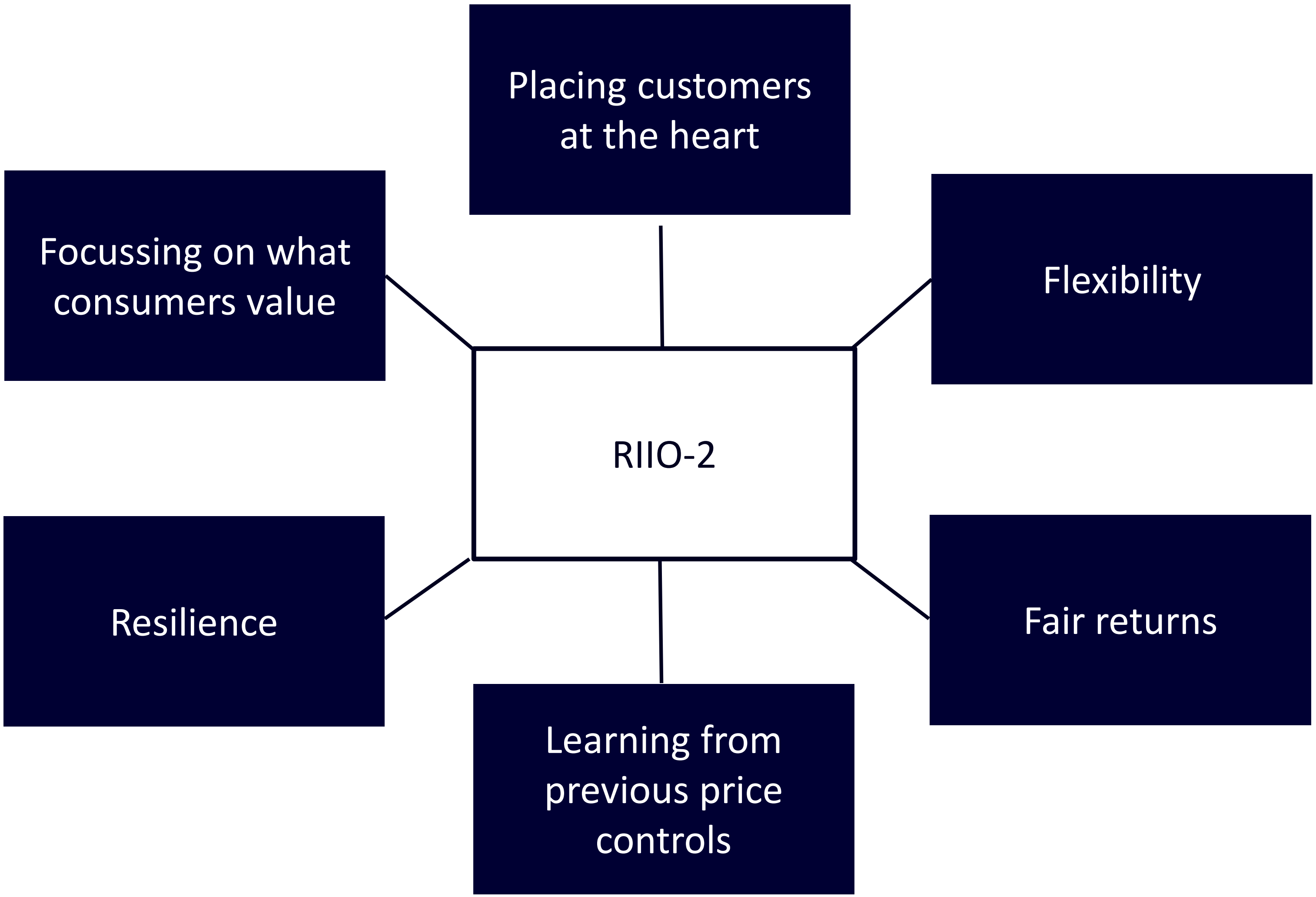
RIIO-2 Sector Specific Methodology Consultation

Investor Call

18/12/2018

RIIO-2 key aims



Companies delivering great customer service and outperforming tougher targets through efficiency and innovation will be rewarded

Summary of proposals

- **Proposals place consumers at the heart of the price control**
  - Consumer voice through challenge/customer engagement/user groups and open hearings
  - Proposing arrangements so that vulnerable/poorly served groups have additional support where this is appropriate
- **Proposals focus on what consumers want and value**
  - Aiming to reduce the number of output categories and incentive schemes => focus on what is most important to consumers
  - Proposal to remove the IQI and replace with a business plan incentive
  - Proposal to introduce a new innovation funding pot to replace the NIC
  - Changes to reporting of performance proposed to include more information on debt and tax
- **Proposals allow RIIO-2 to flex to a range of different future circumstances, while still encouraging efficiency and innovation in networks**
  - A shorter price control period of five years with proposed greater use of dynamic targets and uncertainty mechanisms
  - Scope for anticipatory investment
  - Reformed innovation stimulus focused on energy transition challenges, more coordination with Government and industry, as appropriate, and a greater role for third party innovators

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- **Proposals learn lessons from previous price controls, and build on them**
  - Use effective competition to drive cost efficiencies where it is possible and likely to deliver a net benefit to consumers
  - Proposal to set blended sharing factors, and reward ambition in cutting costs
  - Introduce price control deliverables (PCDs); possible deferral of allowances if PCD no longer needed
  - Index rather than forecast parameters, where possible
- **Proposals provide safeguards to ensure quality of service does not deteriorate, and that asset health is not compromised**
  - Proposed network resilience measures seek to constrain company ability to cut expenditure on asset maintenance
  - Consulting on companies preparing workforce resilience plans, and how they could be held to account for delivery
  - Companies need to be resilient to cyber-attacks
- **Proposals and process will offer a fair return on capital, reflecting the low risks of a stable and predictable regulatory regime**
  - Cost of equity – on current evidence, proposed methodology points to range of 4-5% CPIH real; 4% CPIH real working assumption point estimate; 50bp difference between allowed and expected returns assumed; to be updated at determination based on evidence and market conditions
  - Cost of debt - proposal to retain full indexation as the methodology for setting allowances, and proposed introduction of a cashflow floor to address downside risks for debt investors
  - Return adjustment mechanisms to protect consumers against excessive returns, and investors against extreme downside outcomes – adjustment collar of ±300bp around the allowed return on equity

Reflecting what consumers want and value from networks

- **Outputs and incentives**
  - Consulting on consolidating the six existing output categories into three new output categories:
    - Meet the needs of consumers and network users
    - Deliver an environmentally sustainable network
    - Maintain a safe and resilient network
  - Proposing overarching outputs framework structured around three output types:
    - Licence obligations
    - Price Control Deliverables (PCDs)
    - Service level improvements incentivised through output delivery incentives (ODIs)
  - Proposal to move towards a more dynamic approach to setting targets and calibrating incentives for ODIs, including the use of relative incentives, where appropriate
  - Proposal to set a number of common outputs in each sector; consulting on allowing network operators to propose bespoke outputs in collaboration with their stakeholders and user/engagement groups
- **Totex and business plan incentives**
  - Proposing to remove the IQI and determine blended sharing factors based on the proportion of a company's expenditure that is high-confidence baseline, and low-confidence baseline
  - Proposing a new business plan incentive in which high quality plans will have the ability to earn upfront rewards, with a proposal for penalties for companies which fail to meet minimum requirements
  - Consulting on using indicative incentive value ranges equivalent to ±2% of totex equivalent

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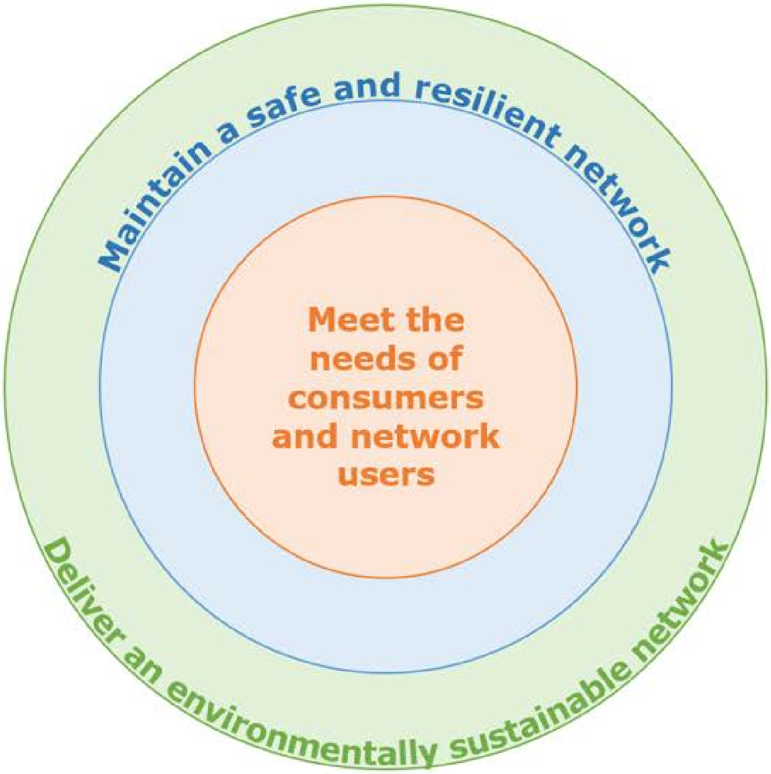
Reflecting what consumers want and value from networks

Proposing to consolidate six existing output categories into three overarching outcomes



Network companies must deliver a high quality and reliable service to all network users and consumers, including those in vulnerable situations

Network companies must deliver a safe and resilient network that is efficient and responsive to change

Network companies must enable the transition towards a smart, flexible, low cost and low carbon energy system for all consumers and network users.

Source: Ofgem

Adaptable and resilient

- **Whole system outcomes**
  - Consulting on whether additional mechanisms are required to enable whole system outcomes
- **Innovation**
  - Consulting on new measures that would ensure network companies undertake more innovation as BAU
  - Consulting on introducing a new innovation funding pot to replace the NIC and better focus on the big strategic innovation challenges within networks; increasing third party engagement, including legislative underpinning; removing the IRM reopener
  - Consulting on the case for retaining a NIA-type use-it-or-lose-it allowance
- **Uncertainty**
  - Proposing to establish a working group to provide recommendations on large-scale anticipatory investment
- **Resilience**
  - Proposal to require network companies to utilise monetised risk outputs more directly in formulating their business plans, and move to penalty-only regime in RIIO-2
  - Propose to require network companies to submit business plans that deliver workforce resilience, and to provide funding for costs for cyber resilience which are (1) incurred as a direct result of the introduction of the Network and Information Security Regulations 2018, and (2) above ‘business-as-usual’ activities
- **Vulnerability (distribution)**
  - Vulnerability package proposed, including minimum standards and requirements for supporting vulnerable consumers that the network companies must adhere to
  - Flexibility for network companies to propose their own initiatives to support consumers in vulnerable situations

Extending competition

- **Extending the role of competition in monopoly activities**
  - Consulting on proposals to extend the role of competition where it is possible and likely to deliver a net benefit to consumers
  - Considering competitions to find ideas (early competition), and for the delivery of projects (late competition)
  - The following models we have designed to date in onshore electricity transmission (for new, separable and high value projects) have been focused on late competition:
    - Competitively Appointed Transmission Owner (CATO) model
    - Special Purpose Vehicle (SPV) model
    - Competition Proxy Model (CPM)
  - For early competition, consulting on whether there are benefits to consumers, potential criteria for identifying projects suitable for early competition and the high-level approach
  - Consulting on who runs a competitive process – Ofgem, the ESO, and the network companies appear to be institutions that could discharge some or all of the roles and responsibilities associated with competitions (amendments to primary legislation may be needed)
  - Consulting on two possible approaches intended to strengthen the use of competition under the price control (‘native competition’):
    - Business plan process – reveal and evidence how the companies intend to use competitive processes
    - Competition as a price finder

Cost of equity

- **Proposed methodology estimates allowed cost of equity range of 4-5% CPIH real based on current financial data and market conditions**
  - Updated CAPM methodology used to indicate a range based on current evidence on total market returns (long-run outturn average), equity beta, and the risk-free rate
    - Equity beta: 0.65 to 0.76 (based on 60% notional gearing); Indepen beta study published
    - Total market returns: 6.25% to 6.75% CPHI real
    - Risk free rate: -0.69% CPIH real (to be indexed to changes in long-term real gilt yield)
  - Cost of equity cross-checked against other regulatory settlements, market-to-asset ratios, OFTO tender round bids, and infrastructure fund discount rates
  - Equity betas (with re-levering) and notional gearing will continue to be set on a sector-by-sector basis
    - Working assumption of a consistent 60% notional gearing and consistent equity beta across sectors and companies at this stage (consult on ED2 at later stage), but will be reviewed following the receipt of business plans
  - CAPM cost of equity represents an expected return rather than an allowed return – we propose an ex-ante outperformance expectation of approximately 0.5% per annum, to be reviewed in light of overall final RIIO-2 proposals
  - Working assumption of an allowed equity return of 4% CPIH real
    - Explicitly conditional on a review of the overall opportunities and risks companies are expected to face in RIIO-2, following a review of business plans and market conditions and evidence at determination stage
  - Proposal to index cost of equity to movements in the risk free rate, to mitigate risk of increasing gilt yields and to avoid need to 'aim up' in forecasting

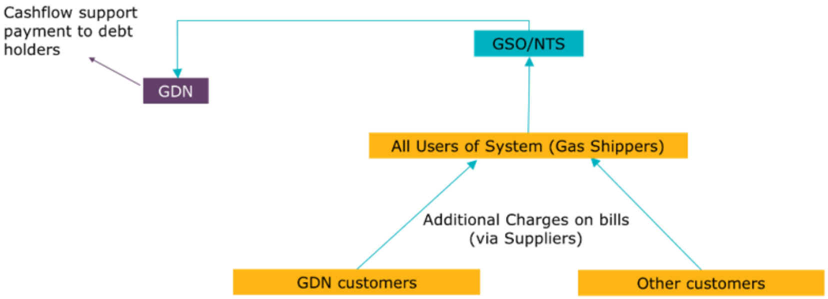
Financeability

- **Companies can address any potential financeability issues in a number of ways:**
  - Modifying the dividend policy to retain cash within the ring-fence during the RIIO-1 or RIIO-2 period
  - Injecting additional equity to reduce gearing
  - Refinancing expensive debt or other financial arrangements
  - Proposing alternative capitalisation rates and/or depreciation rates
- **Consulting on a proposed cashflow floor to enhance our approach to financeability**
  - Companies to report on a quarterly basis on their expected financial resources to meet anticipated requirements, looking ahead for the next 12 months
  - Subject to a cure period, a company with inadequate financial resources to meet its debt service requirements, would be put into Cashflow Supported Status (CSS)
    - A company in CSS would be subject to restrictions on dividend and other related party cash payments, as well as enhanced regulatory oversight
    - A company's Expected Cash Available before debt service (ECA) would be compared to the forthcoming year's Debt Service Requirements (DSR); if DSR > ECA, then a Cash Top-Up (CTU) would be paid by consumers
    - Company would collect full charges in accordance with its normal allowances, but would pay 75% of operating surpluses to the System Operator to allow a reduction of charges to all customers and the 'repayment' of the CTU
    - Once the CTU is fully repaid, the restrictions on related party payments and regulatory oversight would be removed
  - CTU cost would be spread across all consumers in a sector and back-stop measures to partition RAV in the event of non-repayment ensures value neutrality for consumers

Cash flow floor schematic – gas distribution sector

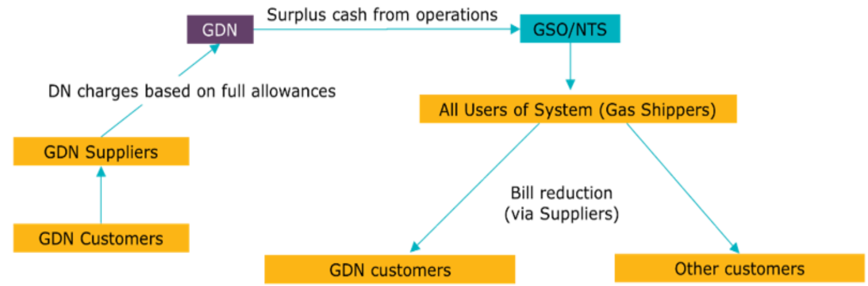
Step 1

- Cashflow shortfall identified via cashflow floor ('CFF') process
- Cash Top-Up ('CTU') payment made by all sector customers to GDN via GSO/NTS and Suppliers



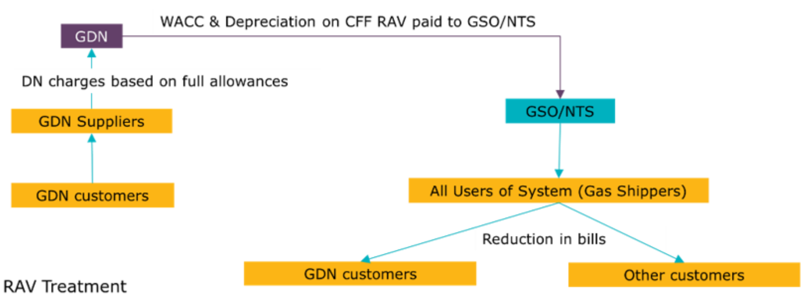
Step 2

- GDN starts repayment from surplus cash
- GDN collects full distribution network charges but pays operating surplus to GSO/NTS
- GSO/NTS reduces charges to all customers
- Continues until CTU fully repaid or *Step 3*

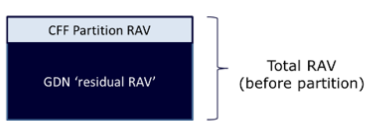


Step 3

- Company fails to repay 100% required after [10] years, leading to CFF Partition RAV for amount of CTU still owed by GDN
- GDN charges still based on full RAV but GDN pays GSO an amount equal to WACC + Depreciation on CFF Partition RAV
- Used to reduce ongoing bills of all customers



RAV Treatment



Source: Ofgem

Finance – other issues

- **Cost of debt**
  - Ruling out partial indexation unless new information provides reasons to re-assess this position
  - Proposal to retain a full indexation approach
  - Proposal to rule out an annual within-period debt sharing mechanism
- **Inflation**
  - Proposal that no phasing of the shift from RPI to CPIH is necessary
- **Taxation**
  - Double lock option for corporation tax remains pending further information from companies
  - Recommendation to companies to achieve Fair Tax Mark
- **Gearing**
  - Working assumption of a 60% notional gearing across sectors and companies
- **Capitalisation**
  - Capitalisation rates to be examined after receiving company business plans
- **Depreciation**
  - Working assumption of no change to existing depreciation policies, but continue work on sector specific considerations

Ensuring fair returns

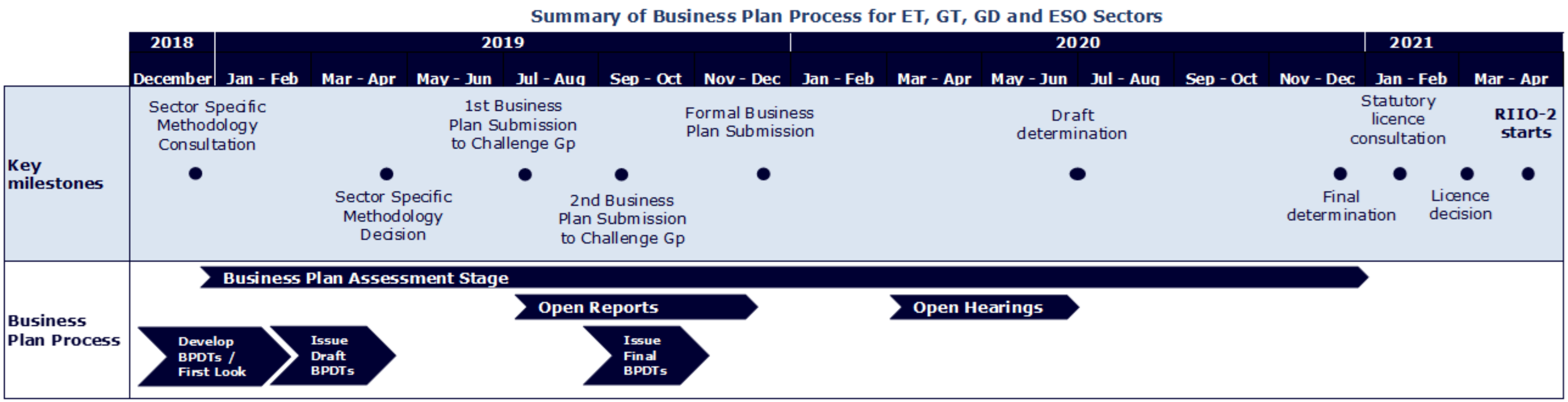
- **Return adjustment mechanisms (RAMs) are proposed backstop mechanisms to guard against excessive returns and protect investors on downside**
  - Proposal to make adjustment triggers mechanistic with an adjustment collar of ±300bp around the allowed return on equity
  - ±300bp collar would not easily be triggered under current RIIO-2 proposals
- **Further narrowing down of RAM options**
  - Consulting on the use of sculpted sharing factors in the Gas Transmission and Electricity Transmission sectors
  - Consulting on the use of two different mechanisms (anchoring, sector average sculpting) in the Gas Distribution sector
  - Anchoring variants included absolute adjustment, proportional adjustment, targeted proportional adjustment
- **What's included the scope of RAMs and how to implement**
  - Propose that RAMs would be applied to RoRE outperformance, and consulting on a wider definition of outperformance to include financial outperformance
  - Propose to implement adjustments as part of close-out process, but also consulting on an annual adjustment through the annual iteration process

Next steps

- **Sector-specific methodology consultation closes on 14 March 2019**
- **Sector-specific methodology decision in May 2019**
- **Business plans provided to RIIO-2 Consumer Challenge Group and Company User/Customer Engagement Groups**
  - First draft in July 2019
  - Second draft in October 2019
- **Business plan submission to Ofgem in December 2019**
- **Open hearings in Q1/Q2 2020**
- **Determinations**
  - Draft determination in Q2 2020
  - Final determination in November 2020
- **RIIO-2 price control commences April 2021**
- **RIIO-ED2**
  - Open letter Q3 2019
  - Sector methodology consultation Q1/Q2 2020

Next steps

High-level timetable for RIIO-2



Source: Ofgem

Key takeaways

- **We are facing a significant period of change in network usage**
- **RIIO-1 has worked well, but we have learnt lessons**
- **RIIO-2 proposals build on RIIO-1, but seeks to simplify the price control**
- **RIIO-2 proposals seek to put customers at the heart of the price control**
- **RIIO-2 proposals seek to flex to different circumstances, and encourage innovation and efficiency**
- **RIIO-2 proposals seek to have safeguards to ensure quality of service and asset health**
- **RIIO-2 proposals seek to offer a fair return on capital, reflecting the low risks of a stable and predictable regulatory regime**
  - Proposed cost of equity methodology – based on current evidence indicates a range of 4-5% CPIH real, working assumption allowed return point estimate of 4% CPIH real, indexed to real risk-free rate
  - Consulting on a proposed cashflow floor to address downside risks for debt investors
  - Return adjustment mechanisms to protect consumers against excessive returns, and investors against extreme downside outcomes

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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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