OFGEM

OPEN MEETING SERIES

Network Price Control

Wales & West Utilities

Record of Virtual Meeting

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Transcribed by T A Reed (Wiltshire) Ltd
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ATTENDEES

Martin Cave	Chair, Ofgem
Jonathan Brearley	Chief Executive, Ofgem
Akshay Kaul	Regulatory Director – Networks, Ofgem
Michael Wagner	Deputy Director, Ofgem
Christine Farnish	Non-Executive Director – GEMA, Ofgem
Simon Wilde	Senior Financial Adviser, Ofgem
Graham Edwards	Chief Executive, WWU
Sarah Williams	Director of Regulation, WWU
Ian Weldon	Head of Treasury & Tax, WWU
Neil Henderson	Finance Director, WWU
Carly Evans	RIIO Finance Manager, WWU
Rob Long	Chief Operating Officer, WWU
Mike Brooker	Chair of WWU CEG
Sian Callaghan	Member of WWU CEG
Roger Witcomb	Chair of the Challenge Group
Robert Hull	Member of the Challenge Group

THE CHAIR: Thank you for joining us today at the Network Price Control open meeting for Wales & West Utilities, delayed from the spring by the impact of Covid-19. This and similar meetings are the first of their kind for Ofgem and, despite us not being able to be in the same room, we very much encourage you to get involved as it is important that we hear a variety of voices.

I'm confident that this meeting will allow us to have an open and constructive conversation about the consultation responses and key outstanding areas of difference ahead of our final determinations which will be published later this year.

WWU have told us that the topic areas they would like to discuss today are totex reduction, the financing package and increasing risk.

The company is first given an opportunity to deliver a 20-minute presentation. We also welcome today members of the company's Customer Engagement Group and Ofgem's Challenge Group. These groups are formed of independent experts convened to review business plans in detail. They will have an opportunity to feed in their views ahead of our opening the floor for discussions.

Please ask your questions on the chosen topics by using the Q&A function on the side bar. I'm afraid there may not be time to answer every question but we will consider them all when drafting our final determinations.

Members of the Ofgem senior team will also be asking some questions. We will be making a transcript and recording of this event which you will be able to watch again and will be available on our website once all meetings have taken place.

We start with the knowledge that energy networks in general have delivered a good service but at a high cost to consumers. This is well documented through our own and independent evidence. We also know that investment in the energy system is going to have to rise as we meet the net zero challenge at lowest cost to consumers while protecting the most vulnerable consumers. Our overall proposals unlock unprecedented funding for projects that cut carbon emissions to create a green, fair and secure energy system for consumers now and in the future. This will enable our sector to play a key role in a green recovery.

I would now like to hand over to Ofgem's Director of Networks, Akshay Kaul, who will give a brief update and set the scene in terms of where we have reached in the RIIO-2 process with Wales & West Utilities.

AKSHAY KAUL: Thank you, Martin. Good morning everybody. I would like to start by saying a big thank you to Graham, Sarah and their team from Wales & West Utilities, the WWU Customer Engagement Group, the RIIO-2 Challenge Group, and all the other stakeholders who have assembled today for your engagement with the RIIO-2 process to date and particularly your thoughtful and very extensive responses to our consultation on draft determinations which closed in early September and which is something that we have been reflecting on very deeply in the weeks since then.

We have had, over the last few weeks, very constructive engagement with companies and other stakeholders through a range of technical bilaterals, industry working groups, and of course asking supplementary questions directly off companies and other respondents.

What I wanted to do in this opening statement was just to provide an overall summary of the progress that has been made in our assessment and thinking since the draft determinations were published in light of the consultation responses and other discussions that we have had more recently.

I'm going to talk principally about the area of total expenditure, what we call totex, and cost assessment which I know is something that Graham and the team will go into more detail on, but I would also like to touch on some of the other important aspects of the settlement in preparing the company for net zero and the important topic of regulatory finance and the cost of capital.

To begin with totex, first of all, a big thank you to Graham, Sarah, and the team for submitting voluminous additional evidence in response to our draft determination proposals. As you probably know, our draft determinations on totex for Wales & West were based on the information provided by the gas distribution companies as a sector in their December spending plans but, since the publication of those draft determinations, we have engaged very actively and very constructively with all of the gas distribution companies, both collectively and bilaterally, on the various key areas which build up and lead to the overall totex allowance for each of the companies, including Wales & West. We have also had a number of engineering bilaterals to understand better the engineering justification for a range of the repex or replacement expenditure and capex, capital expenditure, proposed by Wales & West Utilities, particularly in the area of the non-mandatory expenditure which isn't mandated by the Health and Safety Executive. In many cases, Wales & West have provided significant additional information which we are considering as we develop our final determinations.

We have also had very constructive dialogue about the ways in which we model repex within our regression models and the way in which we seek to hold the gas distribution companies to account for the delivery of their capex and repex projects. We are considering how we develop these mechanisms so that they are capable of holding the industry to account for delivery but they are also proportionate and don't create an undue bureaucratic burden on the companies.

We have had IT bilaterals to understand in more detail the plans for investing in IT developments. Again, we have received significant additional information from Wales & West which will help us to understand the level of confidence associated with the delivery and the costs of the different projects which we are considering in assessing the balance of projects funded through the baseline expenditure, as compared to the reopeners.

We have listened very carefully to some of the concerns about the econometric modelling and, just to remind people, the econometric modelling, particularly the regression modelling, accounts for about 80 or 85 per cent of the overall totex allowances in the gas distribution sector, so it is a very significant part of our totex cost assessment. We have been working with industry groups to consider further the application of regional factors within the model. These are ways to make sure that the modelling outputs reflect the particular regional or local circumstances the different companies face that are different from the averages across the industry, and we are working with the industry to develop further the way in which we model, in particular, the circumstances for high-rise buildings or multi-occupancy buildings as some of the GDNs, for instance, have a much bigger estate of these high-rise buildings to deal with than others. Very good progress has been made in this area but more work is required before we can arrive at a firm conclusion for final determinations.

We set out our rationale for the 85th percentile efficiency benchmark and the 1.2 to 1.4 per cent ongoing efficiency challenge that we imposed on the industry in our draft determinations, reflecting both our view of historical performance of the industry, which significantly outperformed the RIIO-1 settlement, and our view of reasonable stretching forward performance expectations for the gas distribution companies under RIIO-GD2. We are reviewing both in the light of responses to our proposals from a range of stakeholders and also the recent CMA provisional findings on the appeal to Ofwat's PR19 final determinations. Very good progress has been made in this area but more work is required over the next few weeks before we can arrive at a firm conclusion for final determinations.

Finally, we have listened very carefully to the concerns raised by Wales & West and other GDNs about certain aspects of the econometric modelling, which we will continue to reflect on, which reflect other situational differences between, for example, Wales & West and the other GDNs, and we will have more to say on this when we get to final determinations.

Finally, but not the least, we have jointly identified with the industry some technical errors in the modelling for draft determinations and we have created an error log and worked with the gas distribution companies to correct for these errors. The magnitude of these technical errors in the modelling is relatively modest with an impact of around 2 per cent of totex allowances across all of the GDNs, which is broadly comparable with similar stages of previous price controls.

Moving on then to outputs and incentives, we welcome the work that Wales & West have led with stakeholders on their outputs and incentives package. We note the significant focus on proposals to improve the quality of service, as well as activities to support consumers in vulnerable situations. Following Wales & West, their Customer Engagement Group and other stakeholder responses to our draft determination proposals, we are now giving active consideration to making some adjustments to these incentives to ensure that, while driving the right behaviour, the balance of risk and reward is appropriate.

On net zero, we proposed in our draft determinations a number of uncertainty mechanisms to ensure that the price control can flex to a range of net zero scenarios. Wales & West were broadly supportive of this approach in their consultation response but highlighted correctly that these need to be agile to support developing net zero projects. We are continuing to work with the GDNs to ensure that the different uncertainty mechanisms are cohesive, that they cover the different types of net zero investment that might come through the sector, and we are giving active consideration to the setting of appropriate thresholds for these reopeners as well as their timing. We are also giving active consideration to new evidence provided by Wales & West on specific areas of uncertainty faced during RIIO-GD2, which may be well placed for the price control to help manage through these reopeners.

Finally, on the topic of regulatory finance and the cost of capital, we have had significant engagement with Wales & West to understand the financial parameters of the package and their response to the consultation. Although the CMA's determination for PR19 is provisional and we await their final findings, even at this stage we do consider this to be an important contribution to the debate on cost of capital. There are likely to be areas of cross-over between the water and energy sectors but there are also other areas, such as the computation of asset beaters, the approach to the cost of debt, which I know is something Graham and the team will touch upon, and the CMA's aiming up arguments which we think tend to be more specific to sectoral circumstances. We will be particularly interested in stakeholder views on this read-across and the extent of this read-across of the CMA's reasoning to the energy sector and the gas sector in particular today.

So, in summary, the ongoing engagement is key to ensuring that we have the ability to fully understand stakeholder responses and to continue to develop a robust price control which provides sufficient funding for Wales & West to continue operating a safe and reliable network, creates value for consumers, and helps the company to play their full part in facilitating net zero. We believe we are making excellent progress towards this goal as we develop our position to final determinations and we very much look forward to hearing your reflections this morning.

I am going to hand back now to Martin to continue the discussion. Thank you.

THE CHAIR: Thank you, Akshay. Can I now hand over to the company for its 20-minute presentation?

GRAHAM EDWARDS: Thank you, Martin, and thank you, Akshay. I thought that was a very fair reflection and summary of the discussions that have been taking place and I concur completely. I think there has been excellent engagement since the draft determination. You are right, we have provided voluminous additional information and we look forward to seeing that play through into the final determination.

Just before we get into the detail, I've got a few colleagues with me today. I've got Sarah Williams, Director of Regulation, Rob Long, our Chief Operating Officer,

Carly Evans, our RIIO manager, and we've got Ian Weldon, Head of Treasury. We are having some connectivity issues. I think probably lockdown in Ireland is affecting connection across the waves so if we don't manage to connect with Ian, then Neil Henderson, our FD, will pick up questions around financing.

Sarah and I are going to pick up certainly the front end, the presentation. We will share that between us, so that you don't get fed up with hearing the sound of my voice all the way through. Sarah will pick up the three themes in more detail. I'm just going to go through some introductory comments, I guess, about where I think we are and what are some of the key headline issues for us.

Before I get into the draft determination, just a few comments about track record, because I think it's very important from a credibility standpoint that networks are credible coming into the price control.

I listened with interest to the comments of Cadent and NGN on why each of them might be the most efficient network. We all know that regressions can give different results and I guess we do have a concern at the moment that Ofgem is relying on one single regression for its modelling, so we would hope that they reflect on that.

I'm not going to get into the debate about why we might be best. I will just focus for our part on what I think is not in doubt, and that's our track record on outputs, on customer service, on safety, and the feedback from stakeholders. We had fantastic feedback from stakeholders, as part of this price control process, in terms of they were very happy with the performance as it stands, and the key message was we want to continue with that level of performance, we don't want to pay for any more performance, but we don't want it to slip. I think that's the basis on which our business plan has been premised.

So I think we're coming into this control having delivered what we promised. We know that there have been issues across the sector about, in some instances, not delivering, whether it is repex or outputs. We're not in that place. We have delivered everything that we committed to at the start and I would like to think that that gives us real credibility in the eyes of the Regulator and, in particular, our stakeholders going into this price control.

So on to the first key slide, just picking up some headlines from the messages here, I guess the headline is on the strap line at the bottom. We are concerned that this package does not deliver on the requirements of current and future stakeholders, and Sarah will go into a bit more detail why we think that's the case, and it seriously impairs the viability and financeability of our network.

We don't just want to come out with a number of statements about why it doesn't work for us. We have actually sought to bring it to life with some scale around what we see as the shortfall, and it's significant, £440 million over the five years. Sarah will bring that to life shortly in terms of the detail.

What I just want to do for the next minute or two is just focus on what we see as the implications of that. That's in the three boxes at the bottom of the slide there. So just working from left to right, in terms of customers and stakeholders, Akshay has already made the comment that we have provided further information on repex. We think there was in the draft determination an inconsistency of approach. I think Ofgem have recognised that and we are pleased to see that and, clearly, we would hope that we end up being able to deliver the whole programme that we have planned in our business plan.

We shouldn't forget that on repex we still see about 500 fractures a year in our old iron network. It used to be around 1,000, and I think that is a demonstration that the repex programme is working, but we still get 500 a year and every one of those could end up in a really serious situation. Believe me, we still bear the scars in this network of the nine-year old girl who died as a result of a fracture in 2007 so the repex programme is extremely important to us.

We've had great input from our stakeholders to the plan. I've already made that point and I'm sure Mike and Sian will comment a bit more from their standpoint about what that stakeholder input and indeed the CEG views are on all of that.

I guess our overall concern, having undertaken so much stakeholder engagement and got so much fantastic feedback, is that that is not reflected in our business plan. Quite apart from the fact that we're not seeing that reflected, I do think there's a danger here that if we're not careful it compromises regulatory credibility. We all saw the fallout from the water review from consumer groups and from challenge groups that stakeholder engagement wasn't taken sufficiently into consideration. I would like to think that won't be the case in this particular control.

The last point there, we want to play our part in net zero. We entirely understand why net zero spend should be taken out of the base allowances. We completely agree with that, it avoids any potential gaining by companies going forward, but we need to end up with the right mechanism and the right threshold so that we actually can make a contribution and we are encouraged by the discussions that are taking place at the moment around what that might look like.

Moving across the page, you would expect me to talk about investors and I guess the key message is that, despite your track record in GD1, cash returns for our investors are well below those allowed. We know some of the reasons for that in terms of the financing issues. Those are well rehearsed and we could actually spend all of this session debating this issue. Clearly, we want to talk about wider issues as well. The bottom line is, as it stands at the moment, there would be no cash distributions to shareholders in GD2 and we would be in trigger event territory, and that doesn't leave us with a sustainable business.

I think that picks up the issues in the third box that we know there are differences of view here. We are strongly of the view that, as a regulator, Ofgem should be reflecting on actual company, not just notional company, looking at actual circumstances. Our debt was incurred efficiently. The rules were changed going

into this price control. We think that it's only fair that that is reflected. We all recognise that there is difference of opinion. Ultimately, that will get resolved at CMA but, frankly, I believe our efforts are best served delivering for customers rather than slugging it out there.

The last point I want to make is around incentivisation in headline terms. We think there is a significant skewing of incentivisation and it does pose the question, I think, for us now about where is the I in RIIO in all of that in this particular deal?

I am going to stop there with my headline comments and I am going to hand over to Sarah to pick up some of these issues in more detail in the three key themes. Sarah?

SARAH WILLIAMS: Thanks, Graham. I'll take you guys through now each of the elements that Graham has covered. I guess one of the things I would like to respond to is to Akshay – thank you for your words at the start. All of the rest of the presentation, it goes without saying that we have been having some good conversations and we've really appreciated the time that has been taken since draft determinations to get to where we are today.

Where it stands at the moment, Graham has already explained, is that the draft determinations do compromise our ability to be able to deliver a safe and reliable network. You can see from the slide that we are £194 million short with an additional £150 million short in relation to our market evidence that we've recently found in relation to mains replacement.

We do welcome the engagement in all of these areas but I'm going to focus on three of them in particular just now. I'm going to start by focusing in on mains replacement. What's the issue? Well, we have two key issues. One is around a workload disallowance and the other is relating to the unit costs being too low.

I'll take the workload disallowance first. We were surprised to see that in the draft determinations there was a different approach taken dependent on which network you were working for and, in our case, our Tier 2B mains replacement was disallowed. This appears potentially to give a bit of a postcode lottery across the UK. The significant concern we have with that is that we are unable to comply with our HSE safety case. Clearly, they are a very important stakeholder and our safety regulator.

We spoke to customers extensively about our mains replacement programme and their view is that were actually wanting us to do even more mains replacement. They saw the safety benefits, the environmental benefits, and they also understood how it contributed to the reduction in carbon emissions going forward.

If we were to undertake the programme as per the draft determinations, we would be looking at around about a 66 per cent increase in high volume gas escapes on those pipes, a position our customers simply won't accept.

It is also important to note that the move to a plastic network is all about getting it ready for the future and our commitment about having a net zero ready network by 2035. As Akshay pointed out, we've provided significant evidence, including further CBA justification, to Ofgem and it demonstrates that this investment pays back in under 16 years.

Also, we've looked at the bill implications. If we were to manage without any mains replacement expenditure, the cost of repairs to consumers would actually be around £5 in the bill over GD2, whereas funding the mains replacement programme will mean that that's only just over £1. I think you'll agree that's good value for customers.

We've mentioned already, and Akshay touched on it, in relation to the investment for high-rise buildings. We all know following Grenfell the level of concern around the safety of high-rise buildings and we look forward to working with Ofgem to move our allowances in that space to ensure we can deliver our safety outcomes.

The second issue I mentioned on mains replacement was relating to the unit costs. As it stands, the draft determinations, the allowances were set below our unit costs in our business plan. However, since then we've had some recent evidence from a competitive market tender which has demonstrated that those unit rates are in fact 40 per cent above our business plan. This is around £150 million additional to the £54 million shortfall already highlighted here in the mains replacement space. Clearly, this is real evidence from the market and Ofgem are currently reviewing that evidence alongside us just now.

I move to the second issue I would like to share with you and that's in relation to the efficiency challenge and the benchmark position. I was pleased to hear that Akshay mentioned that the Ofgem team are reviewing both the 1.2 to 1.4 per cent efficiency challenge and also the benchmark. As it stands, we have external evidence that goes far against the 1.2 to 1.4 per cent. We've provided this to Ofgem. The reports that we've seen suggest this should be closer to 0.5 per cent and, in fact, that was the amount that we included in our business plan upfront.

Equally, we had a report commissioned by the ENA, a company called First Economics, showing that that range should be in the region of 0.5 to 0.8 and even the recent PR19 CMA provisional finding was lower at just 1 per cent.

I pick up another point relating to our benchmarking and that's that we agree with Northern Gas Networks that differentiation is important. Those of us which are leading companies and we start with a lower cost base should have an efficiency challenge that reflects that which therefore would be tougher for those who have a higher starting cost base.

The benchmark position, as confirmed in the draft determinations, was built upon a model which we know has had some errors and that those will be corrected, and we look forward to seeing the additional information that comes out on the back of that.

In particular, we welcome the level of assurance that Ofgem is now pursuing particularly alongside the networks ahead of FDs.

The final point I would make on this part is that we are concerned, as Graham mentioned, around the reliance on a single model for cost assessment. The CMA has recently supported the Ofwat PR19 approach of multiple models at different levels of aggregation to improve the reliability. The compounding effect of both the efficiency levels and also the benchmark position potentially means that we would have to have a level of cost reduction that would lead to a deterioration of customer service and a serious risk to network integrity.

The final point I would like to raise in the totex shortfalls is in relation to IT and cyber. We were rather shocked when we received the draft determinations to see an 80 per cent reduction in our IT capex spend. We were requesting around £5 million a year and we were only allowed £1 million. There have been some significant conversations and, as was mentioned, voluminous evidence provided to demonstrate each of those projects, to demonstrate their benefits and their needs case, so we look forward to working with Ofgem to hopefully resolve that situation.

It's important because otherwise it could end up impacting the integrity of security of our network, there's a risk that our move to net zero won't happen without sufficient investment in system and telecoms, and also restrict our ability to deliver the important digitalisation priorities in GD2.

This covers three of the areas of our totex concerns. Clearly, you can see on the slide that there are others that are listed.

I'm going to move across now to our second theme, which is around our financing package. I would like to start here, if I can, by looking back at our track record in GD1. We have been one of the top performing networks with some of the lowest charges to customers. The cash returns to our shareholders in GD1 have been almost a third lower than Ofgem's allowed return, cash returns at around 4 per cent versus the 6.7. However, our debt ratings have been placed on negative outlook. That's largely due to a significant shortfall in the debt allowance in GD1 which would continue into GD2 if Ofgem's draft determination does eventually apply.

We plan to continue delivering our excellent value for money as services for customers into GD2, just like we have in GD1. However, we must have a financially sustainable business to be able to do this. We need a business that is capable of funding investment in the context of strong investment grade status and one that delivers fair and reasonable returns to investors. The current draft determinations will not allow for this.

Let me take each one in turn. I'll start with the cost in debt where we're seeing a £122 million shortfall. The cost of debt and the associated derivatives efficiently undertaken by WWU should be allowed over the life at the notional leverage level. Ofgem's methodology does not ensure that. There is already a net shortfall of

£230 million from 2005 to today. The DDs then would lead to a further shortfall on top of that of £122 million.

Moving across to the cost of equity, here we see a £91 million shortfall. Ofgem's assumed revenues for cost of equity are significantly below our independent evidence that we've provided. Oxera produced a report which demonstrated the range and cost of equity should be between 6 and 7.08 per cent. We decided as a WWU business plan to pitch at the very low end of that at just 6.1 per cent. We also believe that the PR19 provisional findings on cost of equity at 5.08 per cent is too low. Ofgem's proposed allowed rate of just 3.95 would lead to an estimated shortfall for us of around £91 million during GD2.

If I combine those two things, you'll see that that makes a total shortfall there of £213 million. Shareholders, as Graham mentioned, are therefore facing a prospect of zero cash returns. Debt financeability would be impaired. Now, we have undertaken significant measures to date on capital structures, with support from our shareholders to underpin financeability for GD2 and beyond. This GD2 outcome really would be perverse for an efficiently operated and financed business. This is just not sustainable for the long term.

I've drawn your attention to some customer research we've undertaken. We commissioned Mindset Research to interview 200 customers individually to understand their views on the bill differences between ours and Ofgem's funding proposals on cost of equity and cost of debt. It was no mean feat getting customers to understand the financing of a gas network. However, through one-to-one conversations, the independent research came to the conclusion that 72 per cent of customers supported the WWU bill level and our financeability.

Alongside this we also tested our business plan commitments, and the acceptability of that was 94 per cent, so customers really are supportive of the things we're delivering for the price we're offering. This additional evidence has been provided to Ofgem and we urge them to take this into account.

The last point here I would like to draw your attention to is relating to the financing duty. We argue that there is a clear statutory duty placed on Ofgem to assess particular circumstances of each licensee, not just the notional company, as this does not reflect real circumstances. The finance duty imposes obligations on Ofgem and, as yet, we are yet to see how Ofgem have properly discharged this duty.

In summary, the current GD2 financing package falls short of expectations and is a significant concern to our business.

The prospect of equity financeability not being achieved, i.e. just no distributions to our shareholders, debt financeability being impaired with inadequate headroom levels and subsequent rating downgrades, this isn't a sustainable position for Wales & West going forward.

Turning to the final theme then, which is around our concerns on increasing risk, firstly, I would note that we are very supportive of the principles of RIIO and in RIIO-1 we've very much seen incentive regulation at the forefront of the RIIO principles. However, we do question where that has gone and I welcome Akshay's comment earlier where Ofgem are now looking at the level of incentivisation going forward. In the RIIO-1 incentive package, we on average earned around £6 million per high performance per annum. The RIIO-2 package as it stands today, at best, will mean that we could potentially achieve £1 million per annum. However, there is a real possibility that we would be in penalty which, for a high-performing network, illustrates to me a significant move away from incentive regulation and it's just not in the interests of customers or investors.

As you can see from the slide, the GD2 incentive package is dramatically skewed towards the downside. The upside on incentives in the draft determinations is halved from 0.74 to 0.35 per cent and the downside has more than doubled. This, in our view, just does not represent credible incentive regulation.

I turn to the last point, which is an area that we've been working hard with Ofgem on and have really welcomed the opportunity to develop uncertainty mechanisms together. We do support Ofgem's approach in introducing uncertainty mechanisms for elements of the price control, particularly those elements which are uncertain. In fact, we ourselves proposed an uncertainty mechanism in our business plan. Our net zero expenditure we estimated to be around £150 million throughout GD2 and we understood that that needed to be separated out from base expenditure due to its uncertain nature.

Our concerns, however, relate to things like the size of thresholds, which I know Akshay mentioned briefly earlier, which potentially, in our area, would mean that many of the perhaps low-cost high value projects wouldn't go ahead. These are things our customers and our stakeholders have asked for. Equally, the limited number of application windows potentially could slow down the investment or, I guess worse still, prevent that investment from occurring at all. The lack of upfront funding available is likely to mean that many companies may not invest without certainty that that money will be recovered or it may delay that investment due to the uncertainty of funding.

We are encouraged, however, by the conversations to date, in fact just yesterday, and in particular the Ofgem team's willingness to look at where we see the funding gaps and where we see the improvements that can be made.

I think it's fair to say that we are all trying to achieve the same goals. We want to make sure that networks have a key role to play in delivering legally binding net zero targets. We also want to make sure that any funding mechanisms are flexible and agile to make sure that we can respond quickly to investments that are needed in our areas.

Also, it's important however that customers are protected throughout all of this, they pay no more than they need to pay, and that they get the least cost pathway to decarbonisation.

I'm going to hand over to Graham now for the final part of our presentation.

GRAHAM EDWARDS: Thanks, Sarah. I realise there's a danger that we're overrunning slightly here so I'll be very brief in summing up and actually I think the statements on the slide pretty much speak for themselves.

Just to run through the headlines and pull all that together into some final messages, we've been a high-performing network, I think, in GD1 and before and one of the few delivering all of our primary outputs, so I think we come into this price control hopefully with high credibility.

We've made the point shareholder cash returns have been well below the regulatory allowance but they have taken a responsible approach to our financing issues and, we stress, at no cost to consumers.

We've done an enormous amount of stakeholder engagement and disappointed that a lot of that has been not covered in the DD, but actually encouraged by some of the discussions that have been taking place since then, so we look forward to seeing more of that reflected in the final plan.

We've stressed the point, and I make no apologies for labouring it again, this package as it stands threatens the integrity and financeability of our network.

We really do want to reach an acceptable outcome and I am encouraged by the discussions that have been taking place in recent weeks and I look forward to those really flowing through into the final determination.

We definitely want to play our part in the net zero challenge. Sarah mentioned I think we are all on the same page in this respect. It's just making sure that we as networks don't spend any more money than is absolutely necessary, recognising it is public money, but that actually we are able to make a contribution to the challenge of net zero.

So that's it from us. Thanks for listening. I will hand back to Martin.

THE CHAIR: Thank you, Graham and Sarah. We'll now hear from the WWU's Customer Engagement Group.

MIKE BROOKER: My name is Mike Brooker. I am Chair of the Customer Engagement Group, or the CEG, which I will probably call it for most of this presentation, and that's for Wales & West Utilities. My colleague, Sian Callaghan, joins me for any later questions.

Most of you probably are aware of the existence of the Customer Engagement Groups set up about two years ago with a strong brief to consider RIIO-2 business plans from a customer point of view and challenge the companies' proposals, in this case the gas distribution company, Wales & West.

All aspects of the business plan were on the table for challenge by CEG except financeability. Our presentation will not address directly the three themes chosen by Wales & West to present to this open meeting, namely financeability, totex and risk. Wales & West's response is underpinned by financeability, which is outside of our remit. Our focus as a CEG remains on the customer, what they ask for during the engagement process, and our perception of the draft determination on customer requirements. This does include our opinion on the implications of the determination for some aspects of totex and some of the areas covered by Wales & West in its presentation.

Therefore, today I'm going to consider only three things: firstly, what customers told Wales & West during the course of the engagement in the business plan process; secondly, our views as a CEG on the impact of Ofgem's draft determination on things customers said they wanted; and, thirdly, our request that aspects of the draft determination are reconsidered and that further evidence is provided which may have led Ofgem to a different conclusion.

Let us turn first to customer engagement. After a slow and somewhat flawed start on customer engagement in-house, Wales & West brought in independent market researchers and developed a strategic approach to engagement. This led to a detailed programme of work which gave insight into the priorities that customers will looking for and these were the priorities that were identified: firstly, to maintain customer services at the current high levels and the safe operation of the assets; secondly, to move to net zero carbon ready by 2035 and to ensure that generally environmental impacts were reduced; thirdly, to protect vulnerable customers and provide them with bespoke services which meet their needs; and finally to maintain the bill at no higher than current charges. I have to say this last point regarding bills was a big surprise for many of us. We had assumed that bill reduction would be a key driver in all of this.

Today we are concerned with shedding some light on Ofgem's draft determination of the Wales & West business plan proposals. Clearly, both the plan and the draft determination cover a huge amount of detail so my comments are very top level. Indeed, we have already produced a 50-page report on the final plan proposals and we have ten minutes today to talk about it.

Firstly, I want to highlight the CEG's concern that Ofgem appears to have created a draft settlement which is based on a fundamental belief that a reduction of bills is the primary customer priority. As I have highlighted, engagement data showed no strong evidence from customers that reduction in bills was desirable at the expense of other priorities. While we understand that Ofgem has a goal to increase the value by lowering bills, we are concerned that by concentrating the focus on this, there may be a loss in the services that customers value.

However, we are at one with Ofgem in seeking improvements in efficiency. Throughout the Wales & West business plan development, we challenged the company on its efficiency targets and were unable to agree with them on the final target they submitted. We firmly believe there is scope for improvement in this area.

Whilst we continue to hold the company to account regarding efficiency and in terms of promising to deliver what has been prioritised by customers, we are now concerned that the draft determination does not recognise customer requirements. Ofgem mandated and supported the engagement of the process as a new and integral part of the business plan development and CEG are concerned at the apparent lack of customer voice as evidenced in the determination.

Secondly, I want to consider some of the detail included in the draft determination. We have identified those areas which appear to be at risk under the draft determination as it stands and I will go through some of these: the removal of the £4 million vulnerable consumer allowance which we believe will lead to reduced services to those who most need them. Customer research called for more provision in this area and the scale of the Use It or Lose It provision is inadequate for companies to make a significant extra contribution in this area.

Secondly, it appears that in their draft determination, Ofgem disallowed all Tier 2B mains replacement, and we've heard something about that today from Sarah, in stark contrast to other gas distribution companies. We understand that the consequences are that Wales & West will not be able to meet the safety requirements of health and safety or deliver a net zero network for 2035 or meet customers' priority for safe reliable service. The only alternative would appear to be that Wales & West focus delivery of their health and safety obligations on an enhanced repairs programme via an OPEC solution for which there is not a provision in the draft determination.

Also, there is an 80 per cent in IT allowance from £5 million per annum to £1 million per annum which we believe could detrimentally impact upon the security and integrity of the network. Additionally, CEG are disappointed that support for the pathfinder model, which appears to provide a cost effective and useful mechanism for de-risking partnership projects to deliver the move to net zero ready by 2035 has not been made available.

Finally, we think there are issues surrounding the reopening mechanism Ofgem use, quite sensibly, to better support possible activities where detail is short at this stage. We believe the project thresholds are too high to encourage companies to carry the financial burden into a next price settlement. For example, this uncertainty mechanism potentially jeopardises the ambition to deliver a net zero network by 2035.

The CEG would ask that the draft determination be reconsidered, particularly in all of these areas we've highlighted. We know that discussions between the company and

Ofgem are proceeding on some of these issues and are encouraged by the positivity with which both sides are addressing the process.

In addition, we would welcome more information from Ofgem as to how they've used customer engagement data in their consideration of the business plans they have received. It is of concern to this CEG that Ofgem may have overlooked data which reflected customer requirements. The CEG supports the process of engagement with customers and stakeholders which forms a good basis for ethical business practice, working for the long term, working openly with customers and stakeholders, listening and finding solutions together and building trust. We believe Wales & West has endeavoured to meet those goals though we recognise this is an ongoing process.

To sum up, we make three points. Customer engagement outcomes seem to have been overlooked. CEG does feel that Ofgem, who initially mandated the whole engagement process, has created a solution that does not recognise customer requirements and misunderstands what customers value by focusing on the blunt tool of bill reduction. The draft determination as it stands has a risk of substantial detrimental impact on the key areas of customer support. There are a number of key areas of value that appear underfunded in the draft determination, particularly those relating to vulnerable customers, health and safety and net zero.

Consequently, we request that these aspects are considered again in the final determination.

Thank you very much. Back to you, Martin.

THE CHAIR: Thank you, Mike. Can I just remind everybody that the questions are going to start in about ten minutes? If you want to ask a question, you can use the Q&A function on the side bar to get in early, so to speak. I now introduce Roger and Bob from the Ofgem Challenge Group.

ROGER WITCOMB: Thank you, Martin. Good morning, everybody. I am Roger Witcomb. I am Chair of the RIIO-2 Challenge Group. I have with me Bob Hull. The Challenge Group itself is a group of a dozen or so highly expert and well-informed and indeed highly vocal people whose job is to challenge both the companies and Ofgem on virtually every aspect of this process so thank you very much for inviting us to this meeting.

We produced a report on the company plans in January and we produced a report on the consultation on the draft determinations a month or so ago. We haven't actually spoken to the companies in any meaningful way since the turn of the year so we are a little bit behind the game, I think that's inevitable, and we are therefore at some risk of perhaps being a bit out of date in some of the things we say.

Just quickly on customer engagement, I'm not going to comment on anything that Mike has just said beyond saying that we do agree that Ofgem might have been a little bit more explicit in how they had taken account of the customer engagement.

There's not much there and we would certainly encourage Ofgem to be a bit more upfront.

The other area I would just like to deal with quickly is around incentives and output incentives in particular. We do have a concern that some of the incentives which are reputational incentives, and this is mostly around environmental performance and vulnerability, those reputational incentives may be at risk in a world where if Ofgem is successful in producing really a tight financial environment for the companies to operate in, there is a danger of some companies, and I'm not pointing the finger at WWU in any way at all, that they might conclude that reputation is a luxury they can't afford and that would be a pity, I think, in fact, a mistake. So we would encourage Ofgem to look at slightly sharper incentives particularly in those areas, engagement performance and vulnerability.

Specifically, on vulnerability, we also think that given the events of the last eight or nine months and the impact of Covid-19 on the poor in particular, that they should perhaps look again at what measures are to help customers in vulnerable circumstances going forward.

Those, I think, are the main ones before I ask Bob to talk a bit about --- I want to talk mainly about the two big items that WWU have raised over totex and finance so, with that, I will pass across and ask Bob to say a few words on totex.

ROBERT HULL: Thanks, Roger. On totex, we think it's important that the minimum necessary baseline is included in the plan, in the price control. We note that WWU were underspending by about 19 per cent during the RIIO-1 process, so very much support the efficiency challenge that Ofgem were proposing on that, and recognising that that underspend is at the same time as delivering the outputs that the company is very well performing against.

We note that there are discussions taking place on to the expenditure forecasts and welcome that new evidence is being presented and taken account of.

We've heard about changes to the cost allowances. I think one factor we think hasn't really been taken into account is a downward cost driver on network utilisation due to falling gas demand. So while there may be some evidence of increases in some areas overall, over the RIIO-2 period, we do think there is an opportunity to take advantage of reduced gas demand, but overall we welcome that the discussions on the allowance are taking place and look forward to an evidence-based conclusion coming out of that.

I will hand back to you, Roger.

ROGER WITCOMB: Thanks, Bob. Finance, a big item, I know, for WWU, and we had extensive discussions on it. I should say in passing that our interactions with WWU have been constructive and civilised and very helpful in almost every respect and, while we have managed to agree on quite a lot of things, but probably not on finance.

So where are we on finance? Clearly, the draft decision of the CMA on the water sector appeals has rather thrown the cat among the pigeons. We haven't had time to spend a lot of time thinking about it. Just standing back a bit as to where we are, there are two ways of getting at an appropriate sector rate of return. One is to do lots of clever stuff with asset betas and risk-free rates and econometric analysis, and the other is to go and ask people if they think the return is high enough to persuade them to invest in the sector and, of course, those two methods should get to exactly the same result.

We haven't had time to do the clever stuff with the betas and the risk-free rates but we have done a little bit of anecdotal research, talking to investors in comparable utility regulated sectors and, on the basis of what we've heard, we see no reason at all to change the view which we expressed both in our January response on the company plans and indeed in our response to the draft determinations. We think that from the information we have at the moment, the WACC proposed in the draft determinations is sufficient to allow an efficiently operated and financed company to be financed which is, of course, a slightly different thing from financeability. If it is a case you've got the right WACC but a company still regards itself as not being financeable with that WACC, that is a company-specific issue and should be dealt with at a company level. It's not a reason for raising the WACC for a whole sector. I just leave that point. I think there's clearly a lot of thinking and analysis to be done on this area. It's a big one. I note what Akshay has said about the two sectors not being perfectly comparable. We have heard a lot from WWU, all of which I'm sure we believe, I know we believe, we have every confidence in WWU, that this particular financing package gives them problems. I think we need to continue to look at that and look at imaginative ways of solving that issue for all parties.

I guess just one final point on risk, again, I think you need to distinguish between the incentive package and the underlying risk in a sector. Again, one can have fairly commercial conversations about the structure of the incentive package. The underlying risk in the sector, we think, if anything, is now lower than it was. We entirely approve of the adaptive regulation model which Ofgem are proposing for all the reasons that people have explained, the uncertain path towards net zero, and the consequent effects on what the market demand for gas is going to be, how people are going to heat their house, and so forth. You clearly need uncertainty mechanisms and reopeners there. We think that actually reduces the level of risk for the company, if anything.

I guess I should close by saying that we also recognise that this particular regime puts a huge amount of stress on Ofgem to respond, as other people have said, in an agile, in a well-informed and indeed well-governed way to what is going to be a very interesting five years.

I don't think there has ever been so much expenditure which is still up in the air at this stage of a process. It's the only way to go but it does make the business of regulation really a very demanding one.

Have I forgotten anything, Bob? He is shaking his head so I'll stop there and pass back to you, Martin.

THE CHAIR: Thank you, Roger and Bob. We now have an opportunity to ask the company questions and I'm going to hand over to my colleague, Akshay, to facilitate the Q&A.

AKSHAY KAUL: Thank you, Martin. As Martin mentioned, if you want to ask a question, please do feel free to ask it on the side bar in the chat and we will pick it up.

I'm going to start with some questions from the Ofgem Panel and I would encourage Ofgem Panel members to feel free to ask supplementaries or follow-up questions and, once you are satisfied with the overall response, then feel free to turn it back to me and I will carry on the Q&A, but please do feel free to probe as much as you feel like.

Let us begin with the first round of questions from our CEO, Jonathan Brearley. Jonathan, over to you.

JONATHAN BREARLEY: Graham, thanks for the presentation and all the information that you've shared and thanks for all your hard work with our teams.

Clearly, there's a lot to get through. Can I just check in, first of all? Do you feel you are getting the right engagement from Ofgem and are we tackling the issues that you've raised in a way that at least allows you to believe that we've got the information we need to get to where we need to get to at the end of the year?

GRAHAM EDWARDS: I think the short answer is yes, Jonathan. I think we've been very comfortable with the level of engagement since the draft determination. Clearly, there's a lot to get through. We wait to see the outcome but your basic question, are we being listened to and are we getting the right level of engagement, I would say certainly yes.

JONATHAN BREARLEY: Very good. Great. If Akshay doesn't mind, I'll just focus on a couple of questions on totex overall. I guess what I want to do is lift this up to a more macro level. We've talked in a lot of detail about different elements and, as you know, as a Regulator, I think we all want the same things. We all want a reliable network for customers, we all want a decent transition to net zero, and we all want to do that as efficiently as possible.

Just looking over RIIO-1, can you give me your understanding of why it was that the sector as a whole had such significantly higher allowances than they ultimately needed to deliver their goals and how do you think we've done at addressing that in RIIO-2?

GRAHAM EDWARDS: That's a bit of a loaded question. I think you would expect me to say this. I think certainly the sector, and certainly ourselves, have seen a step change in performance. I could spend the next ten minutes trotting out the things that have actually happened during that period. So if you're saying were some of the allowances higher than they needed to be, possibly in one or two areas, and you would probably say repex was an area and, hand on heart, we probably wouldn't disagree with that as a point of principle, but to a certain extent. What do I mean by that? Well, you will see --- I will use this as an example, a case in point, Jonathan. We have significantly outperformed on repex but what those headline numbers don't say is that actually our contract partner, because we were in a pain and gain arrangement, have actually suffered pain. Okay? I think we're seeing that now playing out when we've gone to the market with the significant increase in rates that have been quoted, coupled with the fact, I have to say, that a number of players have dropped out of the market. I think the most obvious one is Balfours who have said "We can't earn any more money in this market anymore so we're pulling out", and there are some well-known names that have pulled out.

It's a long-winded answer to your question. So I think it's a combination of both but, look, I'm not going to undersell what we've done to have a step change in our performance.

How does that play through into GD2? Clearly, you're going to give us an efficiency challenge, we recognise that, and I think our key message here is whilst we understand you're going to give us an efficiency challenge, don't overcook it. We want to continue to deliver for customers in GD2 and I think we've positioned our allowances, proposed allowances, such that our charges will remain flat over GD2. We've still got a lot of work to do in GD2, as you well know. We talked about Repex, the capex programme, net zero, albeit that's outside of our base. So I think we are not immune to the fact that you as a Regulator are very sensitive to the outperformance in GD1. We get that but I think there has been a lot of upping of game, I think, across networks, maybe not all networks, but I think the better performing networks have really stepped up to the mark in GD1.

JONATHAN BREARLEY: That's helpful, Graham. I guess the only comment I would make is the fact, as you said, that there are some networks that have upped their game and I think arguably everyone has done something but we're asking for quite a consistent picture across all networks this time and that's what is feeding into our determination.

Can I just pick up on this comment that the Challenge Panel made around a driver of cost reduction being reduced gas demand? Is that something you accept?

SARAH WILLIAMS: Shall I take that, Graham?

GRAHAM EDWARDS: I'm going to hand over to Sarah first and I'll maybe pick up afterwards.

SARAH WILLIAMS: No problem. Jonathan, it's something that we had a discussion with the Challenge Group about actually during that process which was helpful and I think it's fair to say, and most people in the gas industry understand, that we build our network to manage a peak 1 in 20 day. So whilst you may see falling annual demands, what you don't see is a fall in peak demands. In fact, we are seeing over the next 10 years an 11 per cent increase in peak demand and I'll just explain, if I can, quickly why. We aren't just seeing that across the board but we're very specifically seeing it in peaking power generation. The gas network is playing such a crucial role in delivering renewable electricity so, thinking about it, when the sun's not shining and the wind's not blowing, actually it's the gas network that is feeding that electricity system. So we need to be very careful here when we talk about reduce in demand. In fact, it's an increase in peak demand that we need to make sure we invest for to support the reliability on the electricity network. I think the move that Ofgem are making to whole systems, and looking at things like the coordinated adjustment mechanism, will really help us to make the right whole systems decisions going forward and we shouldn't look at the gas network in isolation.

GRAHAM EDWARDS: Jonathan, you will be aware that in the last couple of weeks, the Grid have been saying "The wind hasn't been blowing enough". That's a fact and I think a lot of the public won't understand the dynamics of how this market is working, and we pick up the slack. Particularly now with the demise of coal, gas is very much picking up the demand.

So I think there is a clear issue here to understand the difference between ongoing demand and peak demand and, as Sarah said, our peak demand is actually going up.

JONATHAN BREARLEY: That's helpful. Akshay, that's all my questions on section 1. Do you want to move to Simon or shall we go on to incentives?

AKSHAY KAUL: Finish your questions, Jonathan, and then I will move on to Simon.

JONATHAN BREARLEY: Okay. Can we move on then just to the incentives and just again to pick up on --- I'm trying to tackle this at a slightly higher level than some of the discussions we've had. I get the comment around upside versus downside, particularly from your perspective as a company, but can you tell me why a downside incentive is any less in customers' interests than an upside incentive? If you're going to face a cost by not doing something, then why is that less of a benefit for a customer than you gaining for doing something?

GRAHAM EDWARDS: I don't think we are arguing that, Jonathan. I guess what we're arguing here is the balance and the symmetry or the lack of symmetry. It seems to us skewed completely and, again, we understand the sensitivity around apparent returns, and what have you, so we get that. I think what we're looking at here is how do we strike the balance between that potential upside and the downside? Of course, if we're not performing as we should be, we would expect to be penalised. We're not looking for it only to be one-sided here. So I'm not

disagreeing with your point of principle. I think ultimately our argument is around the balance and actually making sure that networks are still incentivised to go the extra mile, if I can use that expression, and I think some of us have in GD1 without question.

JONATHAN BREARLEY: Sure, and that's great. I think the only thing I would flag is one of the judgements in upside and downside is what should be part of your business, what should we expect for the rest of the money in the price control and what should be additional, and that might frame some of our thinking in final determinations.

GRAHAM EDWARDS: I understand that.

JONATHAN BREARLEY: The other thing though you mentioned was ODIs. Do you have evidence for other delivery incentives that you've been bidding for and are there things you particularly want to highlight that we should be looking at in terms of reward?

SARAH WILLIAMS: I'll take this one. So, Jonathan, in our business plan we've consulted heavily with our customers on what it was that they wanted and, in fact, we put forward very few financial ODIs. Our view was that the reputational ODIs probably in many cases would suffice. I'll give you one example. We talked to customers about the doubling of compensation payments. Their view was that absolutely they wanted that but they didn't want that charge to be on the customer so our shareholders are willing to fund that doubling of compensation payments.

I would just draw on the point that I think it was Roger made earlier around the danger that companies relying upon reputational incentives may end up leading to being something they can't afford. I think when I look at a number of the ODIs looking forward, whether that's thing like making compensation for those that are off gas for more than 12 hours, I look at some of the work we are proposing around theft of gas and the safety benefits of that, my concern is that without some financial incentives and the right package of financial incentives, there is a risk that we wouldn't be able to achieve some of those things given the tightening of the overall package.

So we're not saying that there is a specific incentive that we feel we need more money for, that's not what we are here today talking about, but what we do want to make sure is that our customers get what they asked us for. That goes back to the question both Mike and Roger raised around your consideration of our customer views in the determination and I would encourage you to delve into the evidence just like you are on Repex and on IT, delve into the same evidence on customer engagement, and you will see the views coming through strong and clear.

JONATHAN BREARLEY: Thank you. Back to you, Akshay.

AKSHAY KAUL: Thank you, Jonathan. Let us move now to get some questions from finance from our Senior Financial Adviser, Simon Wilde.

SIMON WILDE: Thanks, Akshay, and thank you to Graham and Sarah for a very clear presentation.

I've got two questions if we've got time. The first one really relates to, Sarah, your observation that we have been insufficiently clear about how our financing duty applies to Wales & West. I want to respond to that and then ask a question around it. So, under the Gas Act, we have a duty to have regard to the need to secure that companies are able to finance their activities, so that's the statutory duty. The way that we apply that is to the notional efficient company and that notional company is informed by sector averages, so it accepts there may be outliers. Our sense is that that interpretation is first of all long-standing and, secondly, enjoys strong regulatory support across multiple regulators and multiple appeal bodies, including the CMA's provisional findings for PR19.

So I guess my question is what specifically remains unclear for Wales & West, given that this is a position that we've had in our methodology stage a year or two ago and at draft determination?

SARAH WILLIAMS: Thanks for that question, Simon. We're going to try and hand over to Ian, if we may. We did mention earlier we were having some connectivity problems. If you don't mind just bearing with us for a moment, Ian, I'm going to try and hand over to you, if that's okay. *(Pause)* It looks like we are struggling with connectivity. Neil, would you mind if I hand over to you instead? Apologies. We've had on and off issues and sadly right now is one of those off issues.

NEIL HENDERSON: Apologies for us not being able to contact Ian. He is in Dublin at the moment and I guess, as Graham said earlier, Covid is having a bigger impact on connectivity and our connectivity.

To address your question though, Simon, we think there needs to be a greater emphasis on the actual company as well as the notional company. So it's all very well looking at the notional company where you've got a wide breadth of companies. In the GDN sector we have only got four ownership groups effectively so the risk is there's a significant outlier within those companies or the sector average doesn't apply for all of the four entities' ownership groups we are looking at, so the risk there for us is that the sector average doesn't work.

To address your comments on the CMA provisional findings as well, the CMA did leave this open, that there could be the need for individual company adjustments to WACC if the sector averages didn't apply. I'm paraphrasing but that is effectively the wording within CMA documents and that applies to cost of equity as well as cost of debt.

SIMON WILDE: Thanks, Neil. So what I'm hearing is not so much that we haven't been clear but that you disagree with our position at draft determination. Is that a fair summary?

NEIL HENDERSON: Yes, that is absolutely correct, and we've obviously had that conversation in the past as well. We think maybe more *(inaudible - distortion)* is needed on the specific companies.

SIMON WILDE: My second question really goes to the point and it is linked to this actual versus notional, I think, which is you make the observation that on your current estimation it will be hard for you to pay a dividend in GD2. The modelling that we've done, again, at the notional company, suggests that pay-out ratios of around 75 per cent of the allowed real return are feasible for the notional company. So my question is when we look back in history at various actual companies, some of them have paid lower dividends but many, many, many of them have actually paid much, much higher dividends than these levels. What should we as a regulator do about that? Should we be going and asking for money back from those companies that have had dividends above the average so that we can support companies that, in a particular price control, think they're going to get below the average?

NEIL HENDERSON: For me, the challenges for those companies that are below the average, the distributions that we have made since we were set up in 2005, have been below the expected return set at the time of the price controls, and that applies to GD1 and prior controls as well. So we think we've got a very, very supportive shareholder and that shareholder, as both Graham and Sarah have said earlier, has carried out some activities to try and reduce our cost of debt going forward, and that's at a significant cost to that shareholder. For example, there was a £250 million bond buy-back with a run-through into GD2. There was a £31.9 million cost to the shareholder in doing that. None of that cost was picked up by the consumer but it obviously impacts on the return that the shareholder gets.

So my concern is more about the companies where you have got a performing operational business, and I think all of the returns we've put through to Ofgem demonstrate we're one of the top performing networks, but the return that's the equity a shareholder is getting is heavily restricted, as we said, from our modelling and looking at the real company rather than the notional company and using the ratios that the rating agencies will use in any distributions going to the shareholders in GD2.

GRAHAM EDWARDS: Simon, you raise an interesting point almost like, to paraphrase, robbing Peter to pay Paul. I guess it was certainly in the minds of Ofwat when they wanted to put that threshold on highly geared companies and how much they could – I think I've got it right – distribute back to shareholders. I know that's subject to debate but I guess the only way I would put that into context is that actually, if you look at how we - we've been consistent and said we raised our debt efficiently albeit it was prior to GD1. The rules change in GD1 and we have been suffering as a result. There are others in the sector who are clearly benefiting from that.

If the question you're asking is should that be better distributed amongst companies, that is a valid question. I think all we are asking for is that debt that is efficiently incurred should be compensated for, no more, no less, really.

SIMON WILDE: Thank you, Graham. Thank you, Neil. So your answers make it clear to me that your concerns around dividend payments are a subset of this actual versus notional debate and what you're asking us to do is to think about applying our financeability duty for GD2 in a different way than we have applied to GD1. As Neil has alluded to prior conversations, I think that ask has landed very clearly and we clearly need to take that away. I would just say it would be a significant departure from regulatory precedent but the Wales & West ask, I think, is clear.

GRAHAM EDWARDS: Thank, Simon.

AKSHAY KAUL: If there are no further questions, Simon, then I will move on to a question from stakeholders, which is on this topic we were discussing earlier, Graham and Sarah, of customer engagement. This comes from Stew Horne from Citizens Advice and he is asking: the Mindset Research that you discussed, Sarah, sounds very interesting. How did Wales & West ensure that this research was carried out fairly and truly independently? Did, for instance, the Customer Engagement Group comment on this research? Do Wales & West agree with the CMA in the PR 19 provisional findings on the limits to, and I quote, "the extent to which customers can be reasonably expected to comment meaningfully on complex technical matters or evaluate between different alternative plans"?

SARAH WILLIAMS: I'll take this one. Thanks for the question, Stew. It was something that we really grappled with. We felt that we had spoken to our customers about all parts of our business plan but, equally, we recognised that one of our biggest issues was around our cost of debt and cost of equity allowance. So we got to the stage where we felt that we could try and explain it to customers in a way where we compared it in some ways to buying a house. So we decided to build, with our researchers, a storyboard which helped them to understand it from a day-to-day perspective, recognising the majority of people would not understand how a business is financed. Through that process, we also explained to them the evidence that Ofgem had put forward, we explained the evidence that we had as well, and we also talked about the other companies and the fact that the other company bills in many cases were a little lower than ours. We were very open and upfront.

How did we ensure it was independent? Well, all we did was provide the information. What then happened was it was all based on one-to-one interviews. Those of you that know anything about customer engagement know if you get a group of customers in a room, you have one person who has a strong opinion, and all of a sudden the conversation tends to move towards their view. The beauty of doing the individual interviews meant that we could really understand individuals' concepts, they could ask further questions to understand it further, and actually we got direct engagement from an individual rather than from a group. We spoke to

over 200 customers. I say "we". It was actually Mindset Research on an independent basis who did that.

Our CEG were involved, yes, so they were involved in the material that we pulled together. They, in fact, helped us to develop the material and they influenced us to change it in a way that made it even more independent. If anyone is interested, we can certainly provide that information for anyone else who might like to go away and do the same thing.

The point around the CMA provisional findings, it is difficult for customers to be engaged meaningfully on complex topics. I am not a finance guru. In fact, my background is clearly in the regulatory space and I felt that we were able to bring it down to a real layman's perspective in, as I say, comparing it to something they would understand.

So I think it's unfair to think that customers can't understand complex topics. I just think that with good research partners it's amazing actually what you can do with customers. It goes back to my question earlier around, you know, I think for Ofgem I would really encourage you to have a look at some of that engagement. We all spent many months and, in our case, a couple of million pounds on customer engagement and we have been really pleased with the level of engagement from our customers and the quality of the analysis, as the CEG commented on, which definitely improved throughout the period.

AKSHAY KAUL: Thank you, Sarah and Graham. We just have enough time for one final question so I'm going to turn to Michael Wagner, our Deputy Director for Gas Distribution, for any final questions before going back to Jonathan for closing remarks. Michael?

MICHAEL WAGNER: Thanks, Akshay, and thanks, Graham and Sarah, for your presentation. You discussed the need for more flexibility around the mechanisms that we've put in place support net zero. I just wondered if you could just talk a little bit about any design suggestions that you do have, the types of projects that that would facilitate, and I suppose also the important aspect of how Ofgem can ensure that there is sufficient regulatory oversight to ensure that that spending really is going to create value for consumers.

SARAH WILLIAMS: Shall I take it initially, Graham, and if you want to add anything, you can?

GRAHAM EDWARDS: Yes.

SARAH WILLIAMS: So, if I heard the question, the first question was around what type of design could be built into the mechanisms to support agility and flexibility. I think from our understanding of the way the mechanisms work at the moment, it is lacking an upfront allowance which means that we would be able to invest in some of the upfront scoping studies, some of the upfront feasibility studies, before it gets

to the stage of a reopener. So I think that is one thing that could be done in terms of the design of the mechanisms.

Equally, the thresholds as they stand are very high, and I'll give you an illustration. For Wales & West, the threshold as it stands would be at £8 million. We have no projects, other than potentially one which would be our industrial cluster in South Wales, that would ever hit that threshold. It's really important that that threshold is removed so that we can ensure that any project, however low cost, if it delivers value and the benefits, that they should be funded, in our opinion.

The other question you asked was around different types of projects. There's a variety so I would use the South Wales industrial cluster example, which is around building a hydrogen pipeline. That's the type of project we would be looking at making sure that we can fund. Equally though, there's some very different projects, working with local area energy planning departments to make sure that we really know what the local and regional solutions are. Some of that isn't always about building assets, it's about engagement, and actually there's a cost to delivering that engagement and the modelling capability that's required, and our pathfinder model actually enables us to support that modelling.

I've talked about two different ends of the spectrum. There's many in the middle like connecting more power gen, increase in biomethane connections, supporting green transport, and I could go on, a significant number of projects and some of those are actually quite low cost, but actually deliver real benefit.

I know, Michael, you and I alongside the other networks have been having some great conversations in the last couple of weeks. I would really encourage those mechanisms to be as flexible as they can be but also I recognise the need absolutely to protect customers' money. We don't want a blank cheque book here, I totally understand, but we do need to make sure we can expedite this spend, particularly in light of the green recovery as a result of Covid.

GRAHAM EDWARDS: Can I just add to that because we had a discussion only just yesterday, didn't we, Michael, and I think we understand the *(inaudible – distortion)* on all of this, particularly using Sarah's example. We are at the small end of the scale and then you will have somebody like maybe National Grid whose projects would be enormous in some instances. I think that's part of the dilemma I fully understand your sensitivity about. You don't want to allow lots of big sums of money upfront that then either don't get spent or don't get spent efficiently. So it's work in progress. We're all on the same page, I think, in terms of what we're looking for here. I look forward to the discussion with Jonathan next week in terms of how do we get a mechanism that actually works for us all that gives you comfort that we're not splashing the cash and actually the projects are sensible projects, but they don't slow up the process? Therein lies the rub and more discussion to take place on all of this.

AKSHAY KAUL: Very good. Unfortunately, we are out of time so I'm going to hand back to our CEO, Jonathan Brearley.

GRAHAM EDWARDS: One afterthought, and it's very brief, it's picking up on Simon's point, I guess, and just reflecting on it, your comment that we're asking you to change the wholesale rules around how you view finance. I guess the only supplement to that, Simon, and actually it's interesting, we note the CEG themselves had this in their report, that actually we made a strong case for a bespoke cost of capital. We think we are unique. There's a tightening issue in all of this so I don't think you need to compromise your own principles but I think there is an argument, I would say that, wouldn't I, for helping us, given all the circumstances. Thank you for that. Akshay, back to you.

SIMON WILDE: Noted. Thank you.

AKSHAY KAUL: Back to you, Jonathan, for closing remarks.

JONATHAN BREARLEY: Thank you, Akshay. Given the time, I'll keep these brief. First of all, thank you to everybody involved in today, particularly to the WWU team and all the effort that they've put into preparing for the open meetings, both to the Customer Engagement Group and the Challenge Groups, all stakeholders who are attending and indeed the Ofgem team. These events are really important for us because we do want to make sure we have sufficient engagement before we come to final determinations.

Equally, I do want to thank everyone involved for the hard work they've put into these price controls. We do recognise these are fundamental decisions we are making on behalf of UK customers and indeed to support the UK economy so we are all keen to make sure we get these right.

To reiterate some of the points that have been made earlier, we do see these price controls as critical to supporting a green recovery and hitting net zero. As I have mentioned before, I do think that strategically we are all in the same place. We want to see overall lower returns to shareholder, greater efficiency for companies, and we Ofgem with many in this virtual room recognise that there is significantly more investment we will need to put in place to get to net zero.

Equally though, I recognise that through this process we do differ in the extent of this change.

We have received a huge amount more evidence from the draft determinations so we will be actively considering this as part of our final determinations.

Coming off the conversation today, again, I think there is a huge amount where there is consensus. I think we all agree and accept the case for net zero investments and indeed we have support around a more varied price control that flexes according to the way the energy system will change due to the transition to net zero. Equally, I shall reiterate, we all want a safe and reliable network and I do note what Graham said about WWU's own history in this regard.

Finally, it was mentioned that we all support differentiation between companies, particularly when you play in performance. In terms of working together, we are clearly working very hard on the engineering analysis underpinning the final determinations, on the econometric modelling, accepting that different companies have different views on these things, and indeed the incentives behind the price control.

Equally, as Graham has pointed out we are discussing this next week, we need to shape that net zero reopener so that it supports and is robust but make sure that it doesn't block investment that we need to get towards net zero.

Clearly, there are areas where there is more to do and further debate to be had. I'm sure we're going to continue to talk about the engineering analysis that underpins the final determination. Equally, we will need to have a robust conversation together around efficiency, and I note the comments made by the stakeholder group on this.

Clearly, there is a big discussion around finance and I note WWU's comments but also the comments of the Challenge Group that fed into this. Overall, I just want to reiterate my thanks to everybody involved in this process. Just to mention before we go, there is an online feedback service so please fill this out and we will make both recordings and transcripts available of today's session.

Finally, I just want to say thank you to all of you for being involved. It is great to have so much engagement in this process and we recognise its importance and all of us want to get to the right place for the final determinations. Thank you.