Sector Specific Methodology Consultation response

Annex 4: Finance

September 2020

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1 Allowed return on debt questions

FQ1. Do you agree with our proposal to use the iBoxx Utilities 10yr+ index rather than the indices used in RIIO-1?

As a general point of principle, we continue to have concerns over a one-size fits all approach to setting the debt allowance. A full indexation methodology, calibrated to the expected sector debt costs, will provide cross-generational outperformance to those 'lucky and large' networks, while perpetuating financeability headwinds for others.

We believe that the suitability of any approach is best measured with respect to its outcomes. Ensuring the financeability of individual networks, through the re-distribution of the sector debt allowances towards those networks with higher embedded debt costs, would provide significant benefits over the current approach without additional costs for UK consumers.

We recognise the concerns raised previously in respect of any straight pass-through of debt costs, and although we continue to believe it is more appropriate than the full indexation approach, we also believe a modified approach that provides individual networks with pass-through of embedded costs only, can deliver incentivisation for new financing, while also protecting consumers interests through debt efficiency tests in Business Plan submissions.

With respect to estimating debt costs, either under the proposed or any alternate approach to setting the debt allowance, we raise the following points of principle:

- The cost of derivatives should be included in any estimation. A key function of derivatives is risk management. To the extent that the efficiency of derivatives cannot be understood simply, networks should be asked to provide additional information.
- We support the inclusion of all areas of financing – including transaction costs, liquidity management and pre-financing.
- To the extent that networks are exposed to RPI basis risk on financing following Ofgem's decision to move to CPI or CPIH, the efficient cost of hedging this risk should be included in the estimation of debt costs.
- Intercompany loans are not simple and should be considered for inclusion on a case-by-case basis.
- If it can be demonstrated that some networks suffer structurally higher financing costs, such as from being an infrequent issuer in capital markets, then the additional costs should be included for that network.
- Incorporating additional sectors into any calibrated average will accentuate the issues noted above, while providing minimal benefits to consumers.

Providing that the primary objective holds - being to reimburse the estimated sector debt costs - the choice of reference index is of reduced importance, as any resulting allowance can be structured to be largely equivalent through the use of a wedge or a deduction. While such adjustments can be justified by reference to transaction costs, the halo effect, or similar, this process of justification is less critical than that of delivering on the primary objective and reimbursing networks with the appropriate allowance.

We do not have a view at this stage on whether the Utilities index is ultimately more appropriate, but we look forward to working with Ofgem as part of the ENA Finance Working Group to understand the relative benefits and weaknesses of the proposal.

We note that the period covered by any index, and whether a constant timeframe or tromboning structure is adopted, is of arguably more importance than selection of the base index. If this structure is inappropriate, the allowance will not accurately match the refinancing profile of networks and would also expose those networks to significant underperformance in the event of any rate reversion.

This risk could be reduced through the adoption of a modified pass-through approach.

The RIIO-ED1 approach to setting the debt allowance has resulted in skewed and unfair rewards, purely down to exogeneous factors that systematically penalise some companies and reward others. Ofgem should ensure that the RIIO-ED2 approach is fit for purpose long-term, supporting inter-generational policy-making and providing the stability that should be the cornerstone of an effective regulatory framework.

As previously mentioned in our response to the RIIO-ED2 Open Letter, Ofgem should undertake a stress tested impact assessment on how the debt allowance will impact individual company financeability. It should be carried out before finalising the RIIO-ED2 approach and ensure that it conforms to Ofgem's financeability duty.

FQ2. With reference to paragraph 2.8, do you have a view on what debt allowance calibration should be used for business plan working assumption purposes, and why?

While we continue to believe that a full indexation methodology is inappropriate for RIIO-ED2, for the purposes of business plan working assumptions, we support an assumption based on RIIO-ED1 (10-20 year trailing average). This methodology was calibrated for distribution networks previously and the annual RFPR reporting demonstrates that it is a reasonable proxy for sector average debt costs as a whole. The financing costs of GD&T companies are not necessarily comparable to those in the ED sector and using that calibration may be overly distortive, particularly in the context of financeability assessments.

Adopting the GD&T calibration without adjustment would embed a structural sector-wide debt underperformance for DNOs in RIIO-ED2. As part of the Sector Specific Methodology Decision (SSMD), Ofgem must give a firm reassurance to all stakeholders that its primary objective for ED remains, as a minimum, to reimburse sector debt costs. In the absence of firm guidance, rating agencies and debt investors will simply assume GD&T calibration and RIIO-ED2 structural debt underperformance, leading to rating downgrades and higher debt costs.

FQ3. Do you have any evidence to suggest ED networks should or should not have a debt allowance that has a different calibration to GD&T networks?

As stated in our response to FQ1 and FQ2, we do not believe full indexation is appropriate for RIIO-ED2. Should Ofgem proceed with full indexation and seek to calibrate the ED sector debt costs, we believe it is critical that Ofgem respect that the RIIO-ED2 process is distinct from GD&T and analyse the ED sector on its own merits. We do not believe a balanced and objective assessment approach can presume that GD&T is a valid starting point.

Ofgem has data on ED network debt structures, maturities and expected financing cost for the current price control through the annual RFPR submissions. It will be clearly evident from this dataset that ED financing costs are different to GD&T.

Even if the financing duty to the individual company is disregarded, then the objective for Ofgem must remain to reimburse the sector debt costs as a whole. The GD&T equity return levels have been pushed dangerously low and this does not leave any capacity for networks to absorb under-funding on the debt allowance. GD&T data must not be used by Ofgem to justify under-funding of the ED sector in RIIO-2. This would have severe consequences on financeability and Net Zero delivery.

With 14 DNOs in the sector, Ofgem has sufficient comparator data and does not need to look outside for information on efficient debt costs.

The challenges faced by DNOs in RIIO-ED2 will be different to the other energy sectors and this will be reflected in their Business Plans in due course.

In terms of the calibration approach, we strongly believe that derivatives should be included in the estimation of sector debt costs. To the extent that the efficiency of derivatives cannot be understood simply, networks should be asked to provide additional information.

We look forward to working with Ofgem, through the ENA, to arrive at an appropriately calibrated debt allowance for RIIO-ED2.

FQ4. Do you have any views on our analysis of additional costs of borrowing that may not be captured by an index of bond yields?

We assess that Ofgem's estimate of additional costs of borrowing as presented in 'Table 1: Ofgem estimate of additional costs of borrowing' under-estimate the true costs faced by companies in raising debt finance.

In particular, the cost of carry (including use of RCF) appears to be low due to incorrect assessment of cash positions in the RFPRs. Ofgem also take no account of basis risk from CPI indexation or new issue premium costs. These are real costs that cannot simply be ignored and should be allowed for in order to avoid even further risk being borne by equity.

We fully support the principles outlined in NERA's ENA paper submitted as part of the GD&T Draft Determination response.[1]

We also believe that the financing costs of smaller networks are systemically higher than that of larger networks or Groups. Either as a consequence of accessing capital markets frequently at below benchmark size, or through the additional cash carry costs associated with infrequent issuance.

We include the Frontier Economics paper "*Transaction Cost Premium for Infrequent Debt Issuers*"[2] as evidence in support of this conclusion.

[1] Review of Ofgem's DD Additional Costs of Borrowing, and Deflating Nominal iBoxx, NERA (September 2020)
[2] Annex 5 of this consultation response

FQ5. Do you agree with our proposal to use the longest term OBR forecast for CPI to deflate nominal index yields to a real CPIH allowance and to switch to using OBR CPIH forecasts if these become available?

As detailed in our response to FQ15 we continue disagree with the move away from the use of RPI.

However, in principle we agree that use of the OBR's longest term forecast for CPI would be a reasonable proxy for CPIH in deflating nominal index yields to real. It is stable over time, close to the Bank of England's inflation target and is published bi-annually. We also agree that there should be a switch to CPIH should this forecast become available.

2 Allowed return on equity questions

FQ6. In light of the equity methodology we set out in Draft Determinations for GD&T, do you have a view on how implementation could best be applied to the ED sector?

We generally support the concept of, but not the current execution of, stages one and two (being the Capital Asset Pricing Model ('CAPM') and cross-checks on CAPM)), of the three-stage approach set out by Ofgem in the GD&T Draft Determinations.

We believe components of Ofgem's stage one approach in calculating components of CAPM is flawed regarding calculation of real TMR, equity beta, debt beta and the RFR. Our view on these matters are consistent with the Oxera update paper on the cost of equity submitted by the ENA for Draft Determinations[3] (DDs). The ENA has provided a substantive body of evidence to support the component parts of CAPM which appears to have been routinely disregarded. The latest methodological change regarding gearing born out of the NERL CMA challenge, appears to be the product of mis-calibration of other CAPM components.

As part of the PR19 CMA appeal, Oxera have looked in to this issue and it appears that the assumptions Ofgem are using, particularly regarding the RFR, are the primary cause of this effect. We believe that use of an appropriate RFR (see Annex 1 of ENA submission to CMA review of Ofwat Price Determinations for PR19)[4] alongside reasonable CAPM assumptions can overcome this issue. Oxera highlight five key areas of issue with Ofgem's approach to the Cost of Equity[5]:

- restating the historical total market return (TMR) based on an experimental index for historical CPI, which results in a lower estimated TMR;
- increasing the weight on the geometric average historical return, thereby moving further away from the correct (Cooper) estimator, resulting in a lower TMR;
- moving to spot yields on government bonds, which lowers the estimated risk-free rate (RfR);
- using a debt beta of 0.125 where previously Ofgem used zero, which artificially deflates the notional equity beta;
- reducing the allowed return below the estimate of the cost of equity.

[3] 'The Cost of Equity for RIIO-2 Q3 2020 Update', Oxera (September 2020)
[4] 'Are sovereign yields the risk-free rate for the CAPM', Oxera (May 2020)
[5] 'The Cost of Equity for RIIO-2 Q3 2020 Update', s.5.2, Oxera (September 2020)

We strongly agree with the Oxera findings on the points above and urge Ofgem to re-think its approach in these areas for RIIO ED2.

Regarding stage two (cross-checks) we continue to support the ENA position where evidence provided to date has urged caution on the interpretation of cross-checks Ofgem uses such as MARs, OFTO's and investment management forecasts. As we have previously set out, we believe there is a great deal of subjectivity which gives rise to a range of answers and thereby significantly impact their ability to provide objective support to conclusions drawn from the CAPM.

Regarding MARs, Ofgem's proposals rely heavily on water companies. We are concerned about the use and relevance of water companies in the overall analysis as we do not believe that they are good proxies for Electricity Distribution companies, particularly going forward. That notwithstanding, further evidence of why a premium could exist was presented in an Oxera paper for the ENA as part of the PR19 CMA appeal process.[6] Its conclusion is:

> *"…under a range of plausible scenarios, the current traded premia can be more than explained without any recourse to an assumption that the actual cost of equity is lower than the regulated allowed base equity return. To the extent that conclusions can be drawn, the analysis is consistent with the conclusion that Ofwat has underestimated the cost of equity"*

Given this evidence, we do not believe there is a sufficient basis of understanding of MARs premia such that weight can be given to this as a valid cross-check.

Regarding OFTOs, we maintain this is not a valid cross-check due to the significant risk and structural differences between networks and OFTOs.

For RIIO-ED2, we believe that calibration of cross-checks should be better targeted and more appropriate, and we are happy to work with Ofgem to develop valid alternatives.

We do not support Ofgem's Stage 3 (adjustments for expected outperformance) process. The stage three adjustment (allowed v expected returns) should never be necessary in a well calibrated incentive-based regulatory regime, especially one that is now likely to include RAMs as an overall check. Its inherent current and future uncertainty will result in erosion of investor confidence and increase the risk they face, as well as tempering their view of the stability and predictability of the regulatory framework for future regulatory determinations. It is also likely to have adverse impacts on the incentive regime, distorting key mechanisms that benefit customers like the Totex Incentive Mechanism (TIM).

Notwithstanding our concerns about the stage three process and its validity, it would be incorrect to base any expected RIIO-2 performance on historical information in its entirety, especially given the step change Ofgem are proposing in tightening any opportunity to outperform in RIIO-2. An alternative approach to assess the balance of the whole package, would be to assess the overall incentive package and opportunity of outperformance against the overall penalty and risk of underperformance. This should include all elements of the RIIO-2 package, including financing. Without this assessment it is impossible to justify a lowering of equity return rates against investor expectations and below the fair equity return assessed.

[6] 'What explains the equity market valuations of listed water companies? – A review of Ofwat's use of financial market evidence to support its allowed cost of capital', Oxera (May 2020)

Finally, Ofgem's introduction of an ex-post adjustment for baseline equity returns adds significantly more uncertainty and raises more questions than it answers. Given we do not see the stage three adjustment as necessary, we equally don't see this added complication as necessary. It adds more uncertainty into the mix for investors and distorts incentives, thereby adding to consumers long term costs and likely reducing the future benefits the regime to date has achieved. This proposal is flawed in principle, has been insufficiently developed, and is now being shaped with late evidence. Its inclusion further undermines investor confidence in the regulatory framework and its governance and is detrimental to customers interests.

FQ7. Do you have suggestions on how we could estimate systematic risk for ED2 or any evidence to support a difference between ED and the other RIIO sectors, GD&T?

We firmly believe that Electricity Distribution (ED) faces its own unique set of circumstances and challenges that set it apart from the wider regulated company sector as well as other energy networks.

The Government's Net Zero challenges will affect businesses across the economy to a greater or lesser extent, but for ED it will have a profound effect on how the companies are structured, how they operate, what their deliverables will be and how strategies will be formulated to meet the needs of customers in highly uncertain and fast-changing conditions. ED will be expected to act as a leader and enabler to allow thousands of businesses and millions of customers to meet their own Net Zero ambitions and targets. Given this diversity in our customer base and in the network circumstances, ED faces unique infrastructure challenges in meeting what will likely be an enormous variety of low-carbon challenges on the distribution network. It is clear that the technological and delivery challenges in delivering and spear-heading the move to Net Zero pose a far greater challenge to Electricity Distribution companies than those faced by companies in the water, or even other energy sectors.

Substantial investment in distribution networks will be required to meet Net Zero which given the relatively higher systematic risk compared to other sectors as outlined above, will require adjusting for in determining a fair equity beta and return on equity.

We are happy to work with Ofgem to develop more credible evidence for ED systematic risk.

3 Financeability questions

FQ8. Do you agree with our proposal to align the RIIO-ED2 financeability approach with the approach we have taken for GD&T?

We do not agree with aligning the RIIO-ED2 financeability approach with the approach Ofgem have taken for GD&T.

As a fundamental principle, we consider that Ofgem's legislative duty is to ensure the financeability of individual networks and not the notional company or the sector average. As such, it follows that the regulator needs to have due regard to individual company circumstances to successfully discharge this duty.

We equally accept that this cannot represent carte-blanche for networks and there should be a requirement to identify any inefficient costs to avoid customers funding these. However, this financing duty is established to ensure that the long-term interests of consumers in each licence area are met.

It also cannot be appropriate to set equity returns independently and then expect equity to simply subsidise under-funding associated with efficiently raised debt with no implications.

FQ9. Are there any reasons why this approach should differ for RIIO-ED2?

As detailed in our response to FQ8, we are in strong disagreement with the financeability approach adopted by Ofgem for GD&T.

We believe that DNOs, and the five-year period to 2028, are critical to the successful delivery of Net Zero by 2050, and in the case of ENWL and Greater Manchester, by the earlier target date of 2038.

It is essential that the financeability of all DNOs is secured, together with a well balanced incentive package that is aligned to the long-term interests of consumers and stakeholders.

We look forward to working with Ofgem on developing the financeability assessment for RIIO-ED2.

FQ10. Do you have a view, supported by evidence, regarding the appropriateness of different measures to address any financeability constraints?

The results of the financeability assessment should not be used to justify the choice of notional gearing.

Notional company gearing is a determining factor in the long-term financing structure of networks. Regulatory consistency is critically important here and any decision to move from previous price controls needs to be carefully considered and well-justified.

The actual gearing levels of networks is an important consideration. If it can be demonstrated that these are consistently below the current notional gearing level and any change can also be justified with regard to customers interests then a well-signalled change, with transitionary arrangements may be appropriate.

The financeability assessment at the existing notional gearing level should be sense-checked as to whether the equity return, and debt allowance proposals are viable. The notional gearing level should not be used as a lever to make the assessment workable.

FQ11. Do you have any views on the proposed scenarios to be run for stress testing?

Ofgem has stated: *"…we would suggest that scenarios are designed to cover realistic high and low cases, rather than extreme scenarios."*[7]

[7] RIIO-2 Sector Specific Methodology Decision – Finance, paragraph 4.72, Ofgem (May 2019)

Given the widespread economic impact of COVID-19 and its future uncertainty on demand, we believe the Ofgem scenarios (particularly the macro scenarios) have insufficient ranges to capture potential downside scenarios.

We also believe that the current severe tightening in the GD&T price control introducing significantly higher probabilities of under-performance, penalties and restricted incentives, alongside RAMs and treatment of financing costs, means that the downside RoRE scenario is insufficient for stress testing.

4 Financial resilience questions

FQ12. Do you agree with our proposal to place additional requirements on licensees in RIIO-ED2 to provide Ofgem with a) published ratings reports, and b) a financial resilience report if their issuer credit rating falls below specified levels?

We support the principle of effective regulatory oversight to ensure companies remain financially resilient. However, the timing of this request is curious in so much as this is aligned to the severe tightening of the "notional" regulatory regime to such a point where actual well-managed companies may now suffer, through no fault of their own, financial distress as a direct consequence of the new framework; as we have mentioned in FQ9, Ofgem has a financing duty to each of the actual companies.

5 Corporation tax questions

FQ13. Do you agree with our proposal to align the RIIO-ED2 tax approach with RIIO GD&T including; to pursue Option A; the approach to additional protections; the approach to capital allowances; and not to pursue the Fair Tax Mark certification as a requirement for RIIO-2?

We agree with Ofgem's approach to align tax methodologies with GD&T for RIIO-ED2. Out of the options put forward for consideration, we would agree that Option A is the most suitable.

We agree that there should be a level of materiality in place. The current RIIO-ED1 deadband affects allowances, rather than being a tool for an assessment of materiality for a tax reconciliation. Therefore, at this stage, we would need to undertake further analysis to determine what would be an appropriate materiality threshold,

For the Tax Trigger and Tax Clawback mechanisms, we are mindful of certain instances where the clawback mechanism might have the following unintended consequences, for example:

- The impact of Ofgem changing notional gearing
- Where interest costs are disallowed for tax
- If there is a timing difference, i.e. where the associated tax benefit was not received for the period in question.

We believe these consequences should be taken into consideration when ascertaining whether the tax clawback should be applied.

Regarding the Tax Review, we have concerns about the structure and balance of the proposed wording, especially when considered alongside the drafting for other such re-opener mechanisms.

This has been underlined by Ofgem's response where they have stated that they do not necessarily expect this tax review mechanism to result in positive adjustments to the tax allowance (albeit they have stated that the drafting will remain silent on this). We believe there should be safeguards put in place that are in line with other re-opener mechanisms. We would like to see further guidance and clarification on the process that stakeholders must follow to notify Ofgem of a concern.

For capital allowances, although we agree in principle to making allocation and allowance rates Variable Values so that they are more aligned to actual results, we would like to see further guidance on how this will work in practice. In particular, for the change in allocation percentages, could the allocations be different for individual years and would the onus be on the company to calculate and revise the allocations on an annual basis? Would it be a requirement for companies to perform this calculation annually, even if they are not expecting the outcome to be materially different to the previous allocation? What methodology would be put in place to ensure a consistent approach is taken across the network operators? Furthermore, we would like to ensure that the simplification does not result in unintended consequences which have a detrimental effect on the calculation of the tax allowance.

Having just gained the Fair Tax Mark accreditation, we see no reason why this shouldn't be a requirement to further advance the credibility of the UK regulatory regime.

FQ14. Are there any reasons why this approach should differ for RIIO-ED2?

We are comfortable with the principles of the overall approach. Please refer to FQ13 for specific concerns.

6 Indexation of the RAV and allowed return questions

FQ15. Do you agree with our proposal to implement CPIH inflation?

The problems inherent in the Retail Price Index (RPI) are well understood. However, steps are underway to reform the index, with changes potentially introduced from 2025, two years into RIIO-ED2.

Any move away from RPI is problematic for networks. Adopting RPI-linked financing, either directly as index linked bonds or through the use of derivatives, has helped manage inflation risk in networks for many years. Much of this RPI-linked financing is structural and long-term, it cannot be restructured easily without cost. If CPI or CPIH is adopted, then this could not have been foreseen by networks and debt allowances should be adjusted to include the cost of removing any resulting basis risk.

While there was a strong rationale to implement an alternate measure of inflation in RIIO-2, we believe this rationale has diminished following the reform proposals. Noting the negative impact associated with the change, we do not believe the 'ends' justify the 'means' and we request that Ofgem reconsiders this strategy for RIIO-ED2.

FQ16. Are there any reasons why this approach should differ for RIIO-ED2?

Please refer to FQ15.

7 Regulatory depreciation questions

FQ17. Do you have any specific views or evidence relating to useful economic lives of ED network assets that may impact the assessment of appropriate depreciation rates?

We welcome the fact that Ofgem are open to exploring further changes in depreciation policy, subject to the economic principal of intergenerational fairness.

Depreciation policy and asset lives are levers that can impact key ratios, including FFO to net debt. To the extent that other changes to the framework for RIIO-ED2, once seen together as a complete package, may negatively impact the future financeability of the network companies, changes to asset lives and depreciation should be considered.

FQ18. During RIIO-ED1, the assumed asset life is being increased. Do you consider another change is required in RIIO-ED2 to reflect the expected economic asset life? If so, do you have supporting evidence and proposals, at this stage?

Prediction of an aggregate useful economic life across the entire asset base will become increasingly uncertain as technological advances accelerate and the move to Net Zero picks up pace. It may well be that certain existing assets could become obsolete in a shorter timeframe and that new types of network assets have significantly different profiles to existing assets. As such, we need to monitor this alongside the business plan to ensure the correct intergenerational balance is maintained. As noted in FQ17 above, we also see this, subject to intergenerational fairness, as a lever to manage future financeability constraints.

8 Capitalisation rate questions

FQ19. Do stakeholders support licensee specific rates for the ED sector?

Yes. As a starting reference point, we would agree with estimating capitalisation rates from accounting distinctions. However, if deviations can be justified and agreed by networks and Ofgem, we also support moderate deviations from this natural rate if in the wider interests of consumers. However, excessive deviation will become an issue if the ratings agencies view it as an artificial construct.

FQ20. For one or more aggregations of totex, should we update rates ex-post to reflect reported outturn proportions for capex and opex?

There are a number of approximations in the assessment of capitalisation rates and it will never be perfectly accurate, neither does it need to be. The benefits of predictability and certainty over capitalisation rates are significant and, in this area, they should not be disregarded in the pursuit of greater alignment with historic accounting distinctions.

The scope for a material restatement of RAV following an ex-post adjustment is a real concern and this could inadvertently lead to breach of financial covenants and financial distress.

For these reasons, we do not support the use of ex-post adjustments for capitalisation rates.

To the extent that additional totex awarded through uncertainty mechanisms has a materially different natural capitalisation rate, the specific capitalisation rate for this spend should be agreed ex-ante as part of the award, if the individual or cumulative amount is significant.

9 Directly remunerated services questions

FQ21. Are there any reasons why the RIIO-ED2 approach to directly remunerated services should differ from RIIO-ED1?

We are comfortable that RIIO-ED2 approach aligns to RIIO-ED1 however, as we explain in our response to Q24 of the Overview document, we have recently identified some limitations when it comes to whole system approaches.

There are recent examples of DNOs meeting Transmission or System Operator needs which have been arranged on a commercial basis, such as the Accelerated Loss of Mains project. It was agreed with Ofgem that DRS9 would be used to manage costs associated with the programme. However, as this is a miscellaneous category which could contain a range of activities that don’t naturally fit within one of the other DRS categories, we suggest the categories are reviewed, with the potential of creating a tenth DRS category which is specifically to accommodate commercial transactions across networks. The goal would be to ensure there are no barriers to using DRS as a route where projects do not merit Co-ordinated Adjustment Mechanism (CAM) applications. This will further support the aim of transparency and ensure activities are not mixed in with other reported costs.

10 Disposal of assets questions

FQ22. Do you support our proposal to continue the RIIO-ED1 approach to disposal of assets for RIIO-ED2?

We agree with this approach.

11 Dividend policy questions

FQ23. Do you agree that additional reporting on executive pay/remuneration and dividend policies will help to improve the legitimacy and transparency of a company's performance under the price control?

We do not agree that additional reporting on executive pay/remuneration and dividend policies will help to improve the legitimacy and transparency of a company's performance under the price control. We believe that current reporting requirements, under various statutory provisions, provide a level of disclosure that is both sufficient and consistent. We believe that there will be insufficient consistency and context available in the public domain (due to commercial sensitivity, data protection, etc.) to enable fair comparison and assessment of such disclosure. It should be noted that disclosure of executive pay creates a barrier to promotion and recruitment/retention of talent which the industry needs to be able to attract. Regarding reporting of dividend policies, having set an expected rate of return and an incentive/penalty regime around this, coupled with a gearing limitation, we fail to see the purpose of publishing dividend policies. If the purpose is to restrict dividends, then this represents a restriction on equity earnings and needs to be factored into the overall equity return allowance.

12 Return adjustment mechanism questions

FQ24. Do you agree with our proposal to introduce a symmetrical RAMs mechanism?

As a principle, we do not support the inclusion of RAMs within the RIIO-2 framework as these are not required if Ofgem sets an appropriate price control at the outset. RAMs distort the working of incentives, whose property has been one of the cornerstones of the success for consumers of Ofgem's regulatory regime.

The justification for the introduction of the RAMs appears to be two-fold. Firstly, as a failsafe to cap any perceived excess returns generated by strongly performing networks and secondly, to protect the cash flows and financeability of underperforming networks.

While a symmetrical RAMs mechanism is attractive from a simplicity perspective, it does not accurately reflect the weight of consequences at each boundary. The shape of the RAM ought to be informed by the package in the round of the regulatory mechanisms, and what scope Ofgem wants to allow for company performance to drive the level of returns achieved. The design of the RAM might need to be company specific, and the elements included and not included in how the RAM's work might impact how it is designed symmetrically or otherwise.

We believe that Ofgem needs to give greater consideration to setting an appropriate floor level for the RAM, ensuring that it is triggered at a level, and in a manner, that limits distress of the affected networks in a way that is proportional to those networks impacted at the RAM ceiling. This will be an important factor both in assessing downside financeability and in discussions with ratings agencies.

FQ25. Do you agree with our proposal to introduce a single RAM threshold level of 300 basis points either side of the baseline allowed return on equity?

A single threshold level benefits simplicity, but noting our response to FQ18, we do not necessarily support a symmetrical threshold either side of the baseline allowed return on equity.

Any RAM should be structured so that does not disincentivise networks from continuing to strive for innovation and further efficiency. The threshold level should be set in this context.

We note that the Output Delivery Incentive (ODI) package outlined in this consultation would appear to provide outperformance potential above the 300bps threshold. This is before any outperformance generated through operating and capital efficiencies.

In our view, setting a single RAM threshold cap at 300bps is too restrictive and would undermine the legitimate strength of incentives when these are considered as a collective package, potentially curbing a company's ambition to drive outcomes for consumers. Ofgem needs to provide confidence to stakeholders if companies are successful in delivering what customers value across several incentives.

Should the RAM be introduced, we propose a two-stage approach to the thresholds, resulting in a banding. On a post-financing and tax basis, for returns 300bps-500bps above the required equity return, companies should demonstrate that customers are receiving the benefits intended by the incentives and also contribute funding worth 1 in every 10 bps over this 300 bps threshold up to 500 bps to a vulnerable customer support fund for their region.

For returns of 500bps plus, the full RAMs mechanism would be introduced with Ofgem then confident that legitimacy will be secured.

FQ26. Do you have any other comments on our proposals for RAMs in RIIO-ED2?

The current RAMs proposal is structured around equity returns, with adjustments triggered as those returns deviate materially from the baseline. If the core argument in support of RAMs is to prevent 'excessive' outperformance, then we do not see how it can be justified to base the RAMs assessment on an incomplete view of equity returns, which excludes financing and tax performance.

Excluding some elements of outperformance in this way does nothing to support the legitimacy of returns to shareholders.

If the secondary argument for RAMs is to support the credit metrics of underperforming companies, we also do not see how this is achieved if financing underperformance is excluded. It is of no comfort to investors that a licensee had an underpin on penalties, if it has just gone bust on financial underperformance.

This serves to identify the consequence of the policy to set the debt allowance based upon sector average, rather than on a needs basis. It is this policy that will create permanent winners and losers.

We also believe the RAMs proposal is open to undesirable outcomes. It is not unfeasible for a network that is poorly performing operationally to be granted additional effective subsidisation from customers, while also being overfunded in respect of its debt costs. This cannot be in the interests of customers.

In addition, if a licensee is certain to outperform on debt costs, it may not have the same incentive or management drive to outperform on ODIs, which would be to the detriment of its customers. This is in contrast to ENWL, where we are delivering operational outperformance of 4.3 percent, benefitting customers directly through improved reliability and cost sharing, but then overall losing around half of this on financing and tax underperformance.

It is essential for the technical integrity of the mechanism that RAMs include financing and tax performance, i.e. include all net returns to equity and not some. If the debt allowance was instead structured to cover efficiently incurred embedded debt costs on an individual company basis, then financing performance would then relate only to that which was generated in the current price control, and not on issuances in previous periods when your issuance timing happened to be lucky in hindsight.

The price control mechanism already includes various existing measures to control the levels of out and under performance in specific areas. The rationale to include another measure in respect of certain specific items only is limited, while it is misleading to present it as a solution to perceived excess returns while it remains an incomplete view of excess returns itself (i.e. excludes tax and financing as currently proposed).

In the context of a price control including RAMs, we also do not see the justification for also including an adjustment to equity returns for allowed versus expected returns. Ofgem is introducing layers of complexity into the price control in areas such as uncertainty mechanisms, while refusing to consider alternate approaches elsewhere on the grounds of regulatory consistency and simplicity.

Should Ofgem continue with both RAMs and an adjustment to equity returns, the baseline equity return must be set at the expected return level and the RAM should be set around the baseline equity return pre-any adjustment. The logic of this is clear if one considers a situation with a larger allowed versus expected adjustment was proposed – say 200bps. In this scenario, Ofgem would be setting allowed returns 200bps below the return level required by investors on the basis that they will outperform. However, if the current RAM proposal was also adopted with baseline returns set at the allowed return level, returns would then start to be adjusted when they were only 100bps higher than the expected level (or indeed 500bps below). This is clearly an undesirable outcome.