

RIO-3 Gas Distribution & Gas and Electricity Transmission

Sector Specific Methodology Consultation (SSMC)

Investor Call



14:00-15:30 – London time (GMT)

13th December 2023

Order of proceedings

Akshay Kaul

Director General for Infrastructure



- Welcome and Introduction – Akshay Kaul, Director General for Infrastructure
- Context and Headlines – Jonathan Brearley, Ofgem CEO
- RIIO-3 SSMC Overview – Steven McMahon, Interim Director of Network Price Controls
- Finance Overview – Mick Watson, Chief Financial Advisor
- Q&A – Akshay Kaul, Director General for Infrastructure
- Timeline and next steps/Close – Akshay Kaul, Director General for Infrastructure

Jonathan Brearley
Ofgem CEO



- Today we have published our **Sector Specific Methodology Consultation (SSMC) for the next gas distribution and gas and electricity transmission** price control (known as RII0-3).
- In this price control we aim to **simplify regulatory processes** wherever possible, **speed up the delivery of key infrastructure** and work with stakeholders to help the sector meet our **net zero goals**.
- We are consulting on a price control framework that will ensure that consumers continue to benefit from **robust and flexible energy networks** at the **best possible value**.

Steven McMahon

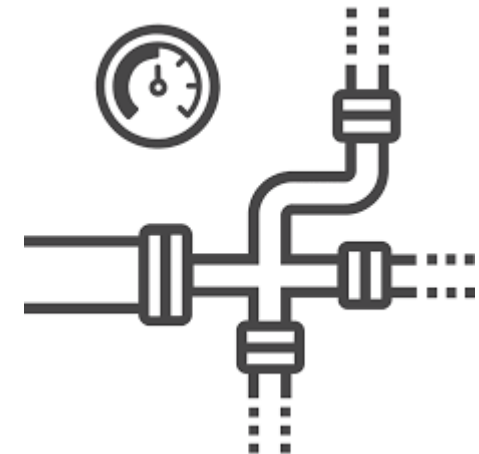
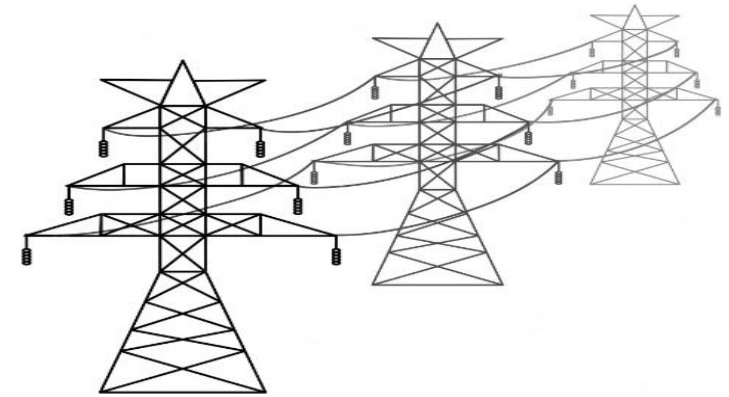
Interim Director, Network Price Controls



- The next set of price controls for the transmission and gas distribution networks begin on 1 April 2026 and will run for 5 years to 31 March 2031. This price control period will be known as RIIO-3.
- In October we set out our **Framework Decision** for the price controls.
- Today we have published our more detailed **Sector Specific Methodology Consultation (SSMC)**.
- Through this consultation we are asking stakeholders to give us their views on the methods we will use to set the RIIO-3 price controls.
- The consultation window will run to 6 March 2024.

- 1. Infrastructure fit for a low-cost transition to net zero:** Network companies must facilitate a low-cost, environmentally sustainable, low carbon energy system that enables the transition to net zero, with infrastructure built at pace
- 2. Secure and resilient supplies:** Network companies must deliver a safe, secure and resilient network that is efficient, data rich and responsive to change. Consumers should have access to gas and electricity supplies that are resilient to physical, financial, climate and cyber shocks
- 3. High quality of service from regulated firms:** Network companies must deliver a high quality and reliable service to all consumers and network users, including those who are in vulnerable situations; and
- 4. System efficiency and long-term value for money:** Network companies must deliver an efficient cost of service, minimise the costs to consumers of system transformation and ensure consumers and network users get a fair deal.

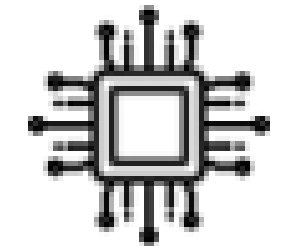
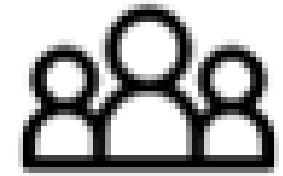
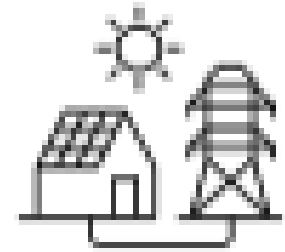
- **Strategic planning:**
 - Future System Operator and Regional Energy System Planners to define investment need
- **Electricity Transmission:**
 - Expect significant increase in demand and resulting sharp increase in scale and pace of network investment
 - Approach to funding major new ET projects builds on accelerated strategic transmission investment (ASTI) regime
 - Coherent with Winsor review and Transmission Acceleration Action Plan
- **Future of Gas:**
 - Decline in demand
 - Uncertainty around future scale of hydrogen use
 - Maintain safe and secure supply in the medium term



- **Climate resilience:**
 - Impact of more extreme and severe weather events
 - Need for proactive action to manage risk
- **Cyber:**
 - Becoming increasingly reliant on digital technologies
 - Need to ensure systems and processes are protected
- **Network Resilience:**
 - Asset base remains key to delivery of safe and reliable supply
- **Supply chain and workforce resilience:**
 - Growing importance due to competition for supply, particularly as electricity network expands



- **Reliable supply:**
 - Remains the most important aspect of service for consumers
- **Customer service:**
 - Want to build on and sustain the improvements seen in RIIO-1 and RIIO-2
- **Vulnerable consumers:**
 - Ensuring networks provide protection and support where they are best placed to do so
- **Connections:**
 - Significant challenge in electricity transmission but of importance in all sectors; work already underway, which RIIO-3 will support
- **Incentives:**
 - We will continue to incentivise where it drives performance improvement in areas consumers value most



- **Cost Assessment:**
 - Want high quality business plans that deliver the outputs consumers want through efficient, well-justified expenditure
 - Focus on stability and predictability but will evolve approach where it is appropriate to meet new challenges
- **Incentivisation:**
 - Will continue to use truth telling and efficiency incentives to encourage network companies to focus on delivering value for money
- **Innovation:**
 - Important for driving long term efficiency in the sector, and innovative approaches to achieving net zero
 - Want to optimise the approach to give the best ideas the greatest chance of success and achieve pull through to business as usual
- **Digitalisation:**
 - Critical enabler for driving sector efficiency
 - Focus is on developing data sharing infrastructure and streamlining regulatory reporting
- **Managing Uncertainty:**
 - Expect to sustain the suite of uncertainty mechanisms to adapt allowances in-period where this is the right approach to protect consumers and network companies from risk

Mick Watson
Chief Financial Advisor



Today we will cover:







- Overview of the proposals for the RIIIO-3 Finance Framework:
 - Cost of Equity
 - Cost of Debt and Inflation
 - Financeability and Investability
 - Regulatory Depreciation and Asset Lives
 - Financial Resilience



Overall themes of the Financial Framework proposals for RIIO-3:

- **Support ongoing investment** and achieve **value for consumers** through use of a broadly stable and familiar 'one-package' approach used in RIIO-2.
- Incorporate concept of '**investability**' alongside **financeability**, recognising scale of investment required in coming decades.
- Make **incremental improvements** to methodologies and policies. Updates include:
 - **Regulatory best practice** – such as adopting the UKRN Guidance and considering improvements to financial resilience measures.
 - **FSNR Framework Decision**, such as considering varying beta by sector to **better capture risks**, and updating **regulatory depreciation** approach to adapt to **net zero policy development**.
 - **Inflation Call for Input** response, such as considering improvements to the cost of debt methodology.

UKRN Recommendation (summarised)	RIIO-2	RIIO-3
2. CAPM should be the primary approach for estimating the cost of equity.	✓	✓
3. Regulators should use recent yields on the index-linked gilts to estimate RFR	✓	✓
4. The equity risk premium (ERP) should be the difference between total market return (TMR) and the risk-free rate (RFR), and based on both historical ex-post and historical ex-ante evidence.	RIIO-2 methodology used primarily historical ex-post evidence.	✓
5. Estimation of equity beta for the notional company using comparable listed companies and standard regression techniques.	✓	Potential update to comparators and/or timeframes
6. The RFR, TMR and (re-levered) equity beta assumptions should be combined using the CAPM to produce a cost of equity range.	✓	✓
7. Cross checks may be used to sense check the CAPM derived point estimate.	✓	✓

Proposals	RIIO-2	RIIO-3
1. Index selection - iBoxx Utilities 10yr+ index (ISIN reference DE0005996532)		
2. Trailing average weighting	Unweighted	Weighted by RAV & refinancing assumption
3. Allowances for additional costs of borrowing – Transaction costs, liquidity/RCF costs, cost of carry and CPIH basis mitigation		Sizing to be reviewed
4. Infrequent Issuer Allowance – Previously referred to as the smaller size/ less frequent additional allowance		Sizing/ qualifying criteria to be reviewed
5. Inflation Treatment – Detail included on next slide	Allowance deflated by long run assumption – OBR 5 th year forecast	3 policy options under consideration
6. Calibration Exercise – Comparing forecast efficient pooled debt costs for all GD&T networks to potential calibration options		

	Nominal allowance for fixed rate debt	Match indexation of the RAV to the long run assumption (in proportion to FRD assumption)	Unchanged methodology - review of the long run assumption
Cash allowance	Nominal allowance for FRD + Real allowance for ILD	Unchanged	Unchanged
RAV indexation	Indexed only in proportion to ILD & equity notional assumption	RAV indexed by a combination of long run assumption + outturn	Unchanged
Eliminate real equity returns correlation to inflation	✓	✓	✗
Transition mechanism under consideration	✓	✓	✗

Financeability:

- We expect the approach to assessing Financeability to be **broadly in line with RIIIO-2**.
 - We are consulting on potential **incremental improvements** to the existing methodologies.

Investability:

- FSNR Framework Decisions introduced this broader concept – based on feedback from stakeholders.
- Investability relates primarily to the **costs and challenges** of raising new capital.
- We welcome evidence on the costs of raising significant amounts of capital and the potential **ways to support large-scale investment** whilst ensuring **value for consumers**.

ET Sector:

- We propose to refresh our current assumptions on appropriate asset lives.

Gas Sectors:

- Gas [Open Letter](#) and FSNR [Framework Decision](#) flagged potential issues for the gas networks associated with 2050 net zero targets – and potential ways to manage these challenges.
- We are considering whether perceived **risks to investors** and **costs to customers** in the gas sectors could be **better managed** through updates to:
 - Asset life assumptions.
 - Depreciation schedules.
 - Reopener mechanisms within the price control.
- We also note the need to consider future funding of **decommissioning costs and** the potential for **repurposing assets**.
- We are looking to work with stakeholders on how these issues can best be addressed.

- We are considering potential proactive steps to ensure Ofgem’s approach remains in line with best practice.

Topic	RIIO-2	RIIO-3
Credit Ratings	Licensees must “use reasonable endeavours” or “take appropriate steps” to maintain an investment grade rating.	Amend language to “ require ” an investment grade rating.
Availability of Resources	Every year, the licensee's board must certify that it has sufficient financial resources for 12 months .	Require cover of the entire price control or a minimum of 3 years .
Dividend lock-up trigger	Pre-dividend certificate of compliance with licence conditions including credit rating.	To be the earlier of reaching: 1. BBB- with a negative watch / outlook; or 2. 80% regulatory gearing .

- We are also calling for evidence / views on the potential risks associated with the use of MidCo/HoldCo financing approaches.
- We will consult separately on additional information requirements on Licensee distributions.



Overall themes of the Financial Framework proposals for RIIO-3:

- Stable overall approach to **support ongoing investment** and achieve **value for consumers**.
- Incorporate concept of '**investability**' alongside **financeability**.
- Make **incremental improvements** to methodologies and policies.

Akshay Kaul

Director General for Infrastructure



- To ask a question, please use the hand raise function.
- If you are joining via phone, please type *5 on your keypad to raise your hand.
- When it is your turn, your microphone will be activated. You will need to unmute yourself.
- Please type *6 on your keypad to unmute yourself.
- Before asking question, please say your name and your institution.

RIIO-3

October 2023

Framework
Decision

Q1/2024

Business Plan
Guidance

Q4/2024

Final Business
Plan

Q4/2025

Final
Determinations

2023

2024

2025

2026

March 2023

Framework
Consultation

December 2023

Methodology
Consultation

Q2/2024

Methodology
Decision

Q2/2025

Draft
Determinations

April 2026

RIIO-GD&T3
Starts

Further information

<https://www.ofgem.gov.uk/about-us/contact-us/investor-relations>

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

Jamie Tunncliffe
Head of Investor Relations

Steven Alcorn
Head of Strategic Financial Planning & IR

Raz Anghel
Investor Relations Manager

Ofgem is the Office of Gas and Electricity Markets. We are a non-ministerial government department and an independent National Regulatory Authority, recognised by EU Directives. Our role is to protect consumers now and in the future by working to deliver a greener, fairer energy system.

We do this by:

- **working with Government, industry and consumer groups to deliver a net zero economy at the lowest cost to consumers.**
- **stamping out sharp and bad practice, ensuring fair treatment for all consumers, especially the vulnerable.**
- **enabling competition and innovation, which drives down prices and results in new products and services for consumers.**