29TH JUNE 2022

RIIO-ED2 DRAFT DETERMINATIONS

INITIAL REVIEW

OFGEM'S DRAFT DETERMINATION REPRESENTS A TOUGH SETTLEMENT FOR COMPANIES – ALTHOUGH THE WACC IS INCREASED SLIGHTLY FROM THE SSMD, COMPANIES FACE A LARGE TOTEX GAP AND LIMITED UPSIDE POTENTIAL

Our key observations and reflections on the DDs are as follows.

- There are significant differences between Ofgem's view of baseline totex and those of DNOs. At the industry level, **Ofgem has set totex allowances 17% below that submitted by companies.** All of the DNOs face double digit percentage gaps – and SSEN faces a gap of over 20%. The gap is driven, in part, by **Ofgem's relatively extreme position on efficiency**, with the regulator again citing innovation in its decision to set a high ongoing productivity level of 1.2% – despite an uplift for this being overturned in the GD2 appeals to the CMA. On catch-up efficiency, the glide path to the 85th percentile is kept (reflecting the CMA's decision in RIIO-GD&T2).
- **Ofgem has given limited rewards for company proposals for new outputs**, however this varies across DNOs and outputs. Of the 21 bespoke ODIs proposed, Ofgem has only accepted 3. The regulator has accepted more (15 out of 24) of the Customer Value Propositions (CVPs) proposed by companies, however, mostly these have been accepted with no reward.
- **Ofgem's view of the WACC is 3.26% for frequent debt issuers and 3.29% for infrequent debt issuers** (CPIH, real), which is higher than its previous view of 3.01%, as set out in the March 2021 SSMD. Its controversial downwards adjustment for expected outperformance has been removed after it was overturned in the GD2 appeals. However, the remainder of its approach largely reflects that taken during RIIO-GD&T2, thus several other methodological weaknesses persist, including the approach to the cost of equity. We also consider Ofgem's approach to financeability remains flawed.
- To limit the potential for financial outperformance, Ofgem has linked a significant proportion of baseline totex to uncertainty mechanisms and intends to implement its Return Adjustment Mechanism (RAM) which would take effect at 300bps and 400bps above the allowed return on equity, with respective 50% and 90% adjustments. **The addition of a 400bps threshold is a new element when compared to Ofgem's RAM in RIIO-GD&T2**, further demonstrating Ofgem's desire to limit financial outperformance.

The rest of this document sets out further details of the DDs in relation to: costs; uncertainty mechanisms; outputs and incentives; and financing.

COSTS: THERE ARE SIGNIFICANT DIFFERENCES BETWEEN OFGEM'S VIEW OF EFFICIENT COSTS AND THOSE OF DNOs – ALL COMPANIES FACE A GAP OF AT LEAST 10%

Table: Submitted and proposed totex allowances for RIIO-ED2, 2021/22 prices

	Submitted totex (£m)	Ofgem proposed totex (£m)	Gap (£m)	Gap (%)
ENWL	£2,015	£1,640	-£375	-18.6%
NPg	£3,229	£2,650	-£580	-18.0%
SPEN	£3,397	£2,928	-£469	-13.8%
SSEN	£4,232	£3,287	-£945	-22.3%
UKPN	£5,462	£4,853	-£609	-11.1%
WPD	£6,908	£5,581	-£1,327	-19.2%
Total	£25,243	£20,939	-£4,304	-17.1%

Ofgem has applied an average downward adjustment on business plan totex of over 17% of submitted costs. This leaves companies in a challenging position moving to FDs.

As shown in the following slides, the challenge is relatively consistent across the cost types.

According to Ofgem, the reduction of 17%, or £4.3bn, against company submissions can be broken down as follows:

- Benchmarking and volume adjustments: -£2bn
- Demand Driver Adjustment: -£0.7bn
- Catch-up efficiency: -£0.3bn
- Ongoing efficiency: -£1.3bn

COSTS: DIRECT AND INDIRECT OPEX

Table: Submitted and proposed direct opex allowances for RIIO-ED2, 2021/22 prices

	Submitted direct opex (£m)	Ofgem proposed direct opex (£m)	Gap (£m)	Gap (%)
ENWL	£320	£259	-£61	-19.1%
NPg	£587	£486	-£101	-17.2%
SPEN	£531	£459	-£72	-13.6%
SSEN	£716	£561	-£155	-21.6%
UKPN	£997	£885	-£112	-11.2%
WPD	£1,103	£891	-£212	-19.2%
Total	£4,254	£3,541	-£713	-16.8%

Note: This includes only Network operating costs

Table: Submitted and proposed indirect opex allowances for RIIO-ED2, 2021/22 prices

	Submitted indirect opex (£m)	Ofgem proposed indirect opex (£m)	Gap (£m)	Gap (%)
ENWL	£660	£535	-£125	-18.9%
NPg	£924	£762	-£162	-17.5%
SPEN	£1,095	£946	-£149	-13.6%
SSEN	£1,476	£1,156	-£320	-21.7%
UKPN	£2,120	£1,883	-£237	-11.2%
WPD	£2,259	£1,828	-£431	-19.1%
Total	£8,534	£7,110	-£1,424	-16.7%

Note: This includes closely associated indirect costs and business support costs

COSTS: CAPEX

Table: Submitted and proposed capex allowances for RIIO-ED2, 2021/22 prices

	Submitted capex (£m)	Ofgem proposed capex (£m)	Gap (£m)	Gap (%)
ENWL	£1,035	£847	-£188	-18.2%
NPg	£1,718	£1,401	-£317	-18.5%
SPEN	£1,771	£1,523	-£248	-14.0%
SSEN	£2,041	£1,569	-£472	-23.1%
UKPN	£2,345	£2,085	-£260	-11.1%
WPD	£3,545	£2,861	-£684	-19.3%
Total	£12,455	£10,286	-£2,169	-17.4%

SSEN is proportionally most affected by Ofgem's cost determinations, with nearly a quarter of submitted capex not allowed.

UKPN is least proportionally affected, but there are challenges across all companies.

In justifying their *"tough but fair"* assessment of companies' costs, Ofgem have outlined that they can achieve *"Increased investment for net zero to be delivered without increasing network charges on consumer bills".*

COSTS: OFGEM HAS TAKEN A RELATIVELY EXTREME POSITION ON CATCH-UP EFFICIENCY AND ONGOING EFFICIENCY

CATCH-UP EFFICIENCY CHALLENGE

- In its ED2 DDs, **Ofgem proposes to maintain the use of the three-year glide path from the 75th to the 85th percentile (as applied in GD2).** This means that less efficient companies face an even larger challenge than in ED1 to catch up to the most efficient companies by the end of the period.
- The downward adjustment on sector-wide totex of the catch-up efficiency challenge is over 1% (£300m).
- In ED1, Ofgem used the 75th percentile to set the efficiency challenge, and cost allowances were reduced by up to 6.5% by the overall efficiency assessment. More recently in GD2 FDs, Ofgem initially proposed to set the benchmarking efficiency challenge to the 85th percentile, before settling on the three-year glide path to it.

ONGOING EFFICIENCY

- CEPA was commissioned to conduct an efficiency assessment to inform Ofgem's proposed efficiency challenge for RIIO-ED2, producing the below potential reference points:
  - 0.5%, 1.0% and 1.2%.
- In its ED2 DDs, **Ofgem proposes to set an efficiency challenge at the top of this reference point range, at 1.2%,** mentioning the impact of innovation funding as a contributory factor.
- Previous price controls ended up with lower efficiency challenges, as detailed below:
  - ED1 – 0.8% to 1.1% (company proposed).
  - GD2 FDs – 1.15% (opex) and 1.25% (capex) with a 0.2% uplift for innovation.
  - GD2 post CMA – 0.95% (opex) and 1.05% (capex) with no uplift for innovation.

REAL PRICE EFFECTS (RPEs)

- As in GD2, Ofgem proposes to apply RPE adjustments to the cost categories of labour (general and specialist) and materials for all DNOs.
- These adjustments have an impact of around 1% on totex for the years 2024/25 to 2027/28, with an impact of 0.7% in 2023/24.

TOTEX INCENTIVE MECHANISM: OFGEM INTENDS FOR CONSUMERS TO RECEIVE A GREATER SHARE OF COMPANY COST SAVINGS OVER RIIO-2

Table: Totex incentive mechanism company incentive rates by price control period and sector

Price control	RIIO-GD&T1	RIIO-GD&T2	RIIO-ED1	RIIO-ED2
Range across companies	44% to 64%	33% to 50%	53% to 57%	49% to 50%

- Across the board, Ofgem has given companies less opportunity to financially outperform on totex in RIIO-2 than in RIIO-1. It has reduced the TIM rate from 53-57% in ED1 to 49-50% in ED2.

- Although this impact varies across companies, the share of outperformance kept by companies will decrease for all. This has implications for companies, who will now be able to reap less of the rewards of efficient cost saving – dampening their incentive to make these.

UNCERTAINTY MECHANISMS: OFGEM PROPOSES 34 COMMON UMs IN RIIO-ED2, UP SIGNIFICANTLY FROM 19 PROPOSED AT SSMD – AGAIN LIMITING THE POTENTIAL FOR COST OUTPERFORMANCE

Table: Proposed uncertainty mechanisms specific to RIIO-ED2

ED2 specific UM	Type – initial view
Transmission Connection Point Charges and Ring-fence costs	Pass-through
Miscellaneous pass-through	Pass-through
Environmental legislation	Re-opener
Visual amenity	UIOLI
Polychlorinated biphenyls (PCB)	Volume driver
LRE Secondary Reinforcement and Low Voltage Services	Volume driver
Load related expenditure (LRE) - General	Re-opener
Digitalisation and DSO	Re-opener
Worst Served Customers	UIOLI
Severe Weather 1-in-20	Pass-through

Proposed by SSEN and UKPN to deal with PCB contaminated assets as a PCD. Ofgem considered this to be an UM appropriate for all DNOs.

Proposal to manage LRE uncertainty using a combination of two automatic volume drivers, for secondary reinforcement and low voltage (LV) services, and an administrative re-opener covering all other LRE.

Table continued

ED2 specific UM	Type – initial view
Storm Arwen	Re-opener
Smart Meter IT and communication costs	Pass-through
Electricity System Restoration	Re-opener
High Value Projects (HPV)	Re-opener
Streetworks costs	Re-opener
Rail electrification	Re-opener
Electric Vehicles Provider of Last Resort (EV PoLR)	TBC
Moorside – ENWL	Re-opener
Shetland – SSEN	Re-opener
Hebrides and Orkney Whole Systems – SSEN	Re-opener

Ofgem removed smart meter volume driver, but retained these.

Proposal to maintain HPV for non-load related expenditure.

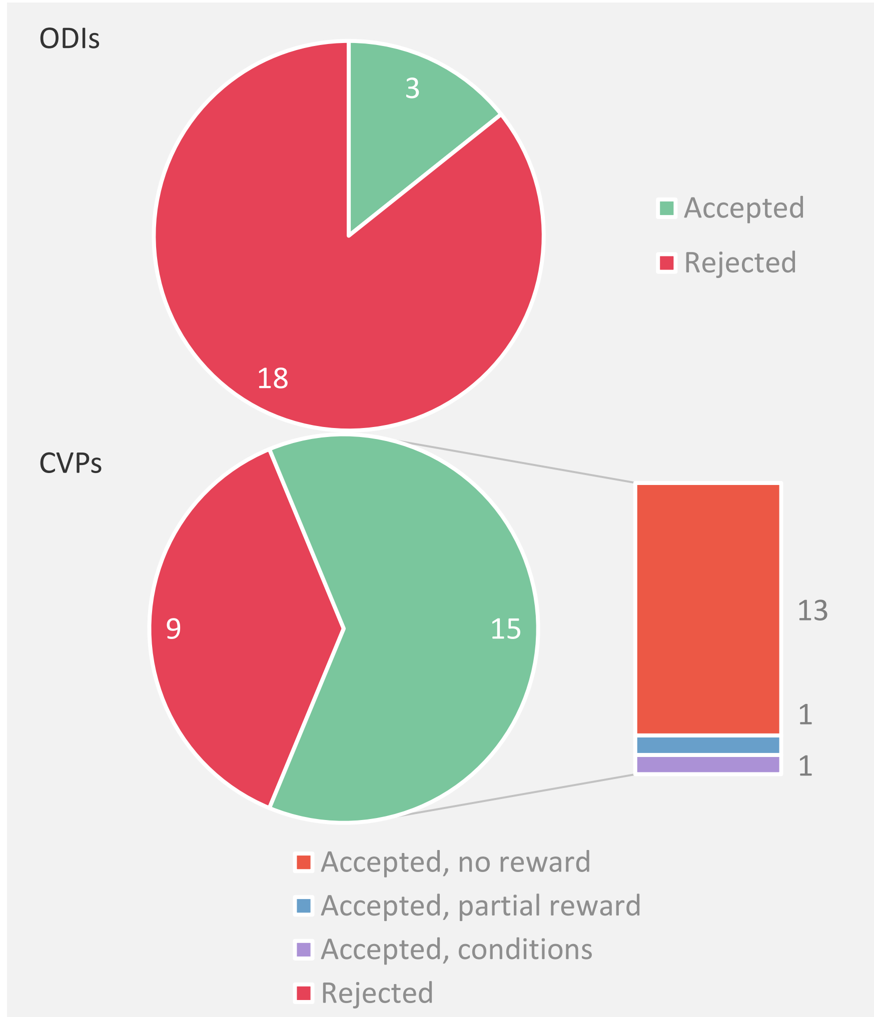
New proposal to provide funding to address obligations of PoLR either through a pass-through or directly remunerated service mechanism.

Ofgem included 3 bespoke UMs for 2 DNOs.

OUTPUTS AND INCENTIVES: OFGEM HAS REJECTED MANY OF THE BESPOKE ODIs PROPOSED BY COMPANIES, BUT HAS ACCEPTED SEVERAL CVPs, ALBEIT WITH NO REWARDS

- Ofgem has sought to set stretching targets, but detailed analysis will be required to assess the extent to which they are achievable for each DNO.
- The regulator kept the same number of common outputs as proposed in the SSMD, namely 19, and only allowed 7 bespoke outputs.
- Ofgem has rejected the vast majority of bespoke outputs, as illustrated on the right. Out of the 21 bespoke ODIs proposed by DNOs, Ofgem has accepted only 3.
- Ofgem has accepted most Customer Value Propositions (CVPs) proposed by companies, however, with no reward. Out of the 15 accepted CVPs, 13 have been accepted with no reward, one with a partial reward, and one with reward, but conditions. Thus, Ofgem recognised the benefits of the proposed CVPs and proposes to fund them, but to not provide any rewards.
- Ofgem has also rejected most bespoke PCDs but accepted one as a common UM, and another one as an ODI. Reasons for rejection vary, but there is now an opportunity for companies to provide better evidence to get outputs accepted at FD. It accepted the bespoke LO.
- As set out on the following slide, Ofgem has retained its pragmatic approach to setting caps and collars on ODIs, based on percentages of RoRE.

Figure: Bespoke ODIs and CVPs accepted/rejected



OUTPUTS AND INCENTIVES: OFGEM HAS SOUGHT TO SET STRETCHING OUTPUT TARGETS AND PROVIDES LIMITED INCENTIVE FOR OUTPERFORMANCE

ODI	SSMD – target	SSMD – incentive (RoRE equivalent)	DD – target	DD – incentive (RoRE)
Customer Satisfaction Survey (CSS)	Static common targets based on average performance in last 4 years of RIIO-ED1	+0.40% / -0.40%	Static common target of survey score based on average performance data from the last 4 years of RIIO-ED1	+0.40% / -0.40%
Complaints Metric (CM)	Static common targets based on average performance in last 4 years of RIIO-ED1	0% / -0.20%	Static common target of survey score based on average performance data from the last 6 years of RIIO-ED1	0% / -0.20%
Time to Connect (TTC)	Static common targets based on average performance in last 4 years of RIIO-ED1	+0.15% / -0.15%	Static common targets based on average performance in most recent 4 years	+0.15% / -0.15%
Major Connections	Baseline expectations with ex-post review	+0.35% / -0.35%	Introduce Major Connections Customer Satisfaction Survey (MCCSS), weighted average target based on major connections strategies' customer satisfaction target, and annual reporting	0% / -0.35%
Vulnerability	Baseline expectations with ex-post review	+0.20% / -0.20%	Ex post assessment of performance against targets set against five metrics, underpinned by an independent assurance check process	+0.20% / -0.20%
DSO	To drive DNOs to more efficiently develop and use their network, considering flexible and smart alternatives to network reinforcement	N/A	Based on ex post review of DNO's delivery of their DSO activities through three evaluation criteria: (i) stakeholder survey (mechanistic); (ii) performance panel assessment (evaluative); and (iii) outturn performance metrics (mechanistic)	+0.20% / -0.20%
Interruptions Incentive Scheme (IIS)	Retain RIIO-ED1 approach: rolling three-year average, with a two-year lag	N/A	Different elements of ISS: value of lost load; unplanned interruptions; and planned interruptions have different targets	+1.00% / -2.50%
Network Asset Risk Metric (NARM)	On-target delivery of NARM output delivery	Deadband around NARM output delivery	Deadband around the NARM output at +/-5%	Penalty, up to 2.5% of avoided costs associated with unjustified under-delivery

FINANCING: OFGEM HAS INCREASED THE WACC TO 3.26% – 3.29% (CPIH, REAL), UP FROM 3.01% AT THE SSMD

Table: Summary of key WACC parameters and changes

Parameter	RIIO-GD&T2 FD (Dec 2020)	RIIO-GD&T2 CMA (Oct 2021)	RIIO-ED2 SSMD (Mar 2021)	RIIO-ED2 DD (June 2022)
Debt beta	0.075	0.075	0.075	0.075
Asset beta	0.35	0.35	0.35	0.35
Notional equity beta	0.76	0.76	0.76	0.76
Total market return	6.5%	6.5%	6.5%	6.5%
Risk-free rate	-1.58%	-1.58%	-1.16%	-0.74%
Cost of equity	**4.25% - 4.55%**	**4.25% - 4.55%**	**4.65%**	**4.75%**
Expected outperformance	0.22% - 0.25%	0%	0.25%	0%
Allowed return on equity	4.02% - 4.3%	4.02% - 4.3%	4.40%	4.75%
Cost of debt	**1.59% - 1.88%**	**1.59% - 1.88%**	**2.09%**	**2.26% - 2.32%**
Notional gearing	55% - 60%	55% - 60%	60%	60%
WACC	**2.69% - 2.85%**	**2.79% - 2.95%**	**3.01%**	**3.26% - 3.29%**

Note: Changes from previous position highlighted in blue.

FINANCING: THE CONTROVERSIAL DOWNWARDS ADJUSTMENT FOR EXPECTED OUTPERFORMANCE HAS BEEN ABANDONED – BUT ASIDE FROM THIS OFGEM'S APPROACH TO THE COST OF CAPITAL IS CONSISTENT WITH ITS RIIO-GD&T2 FD

In light of the CMA's determination on RIIO-GD&T2 (which for the most part did not find error in Ofgem's approach to the cost of equity), the regulator has taken a very similar approach to ED2 with the exception of the 'outperformance wedge', as set out below.

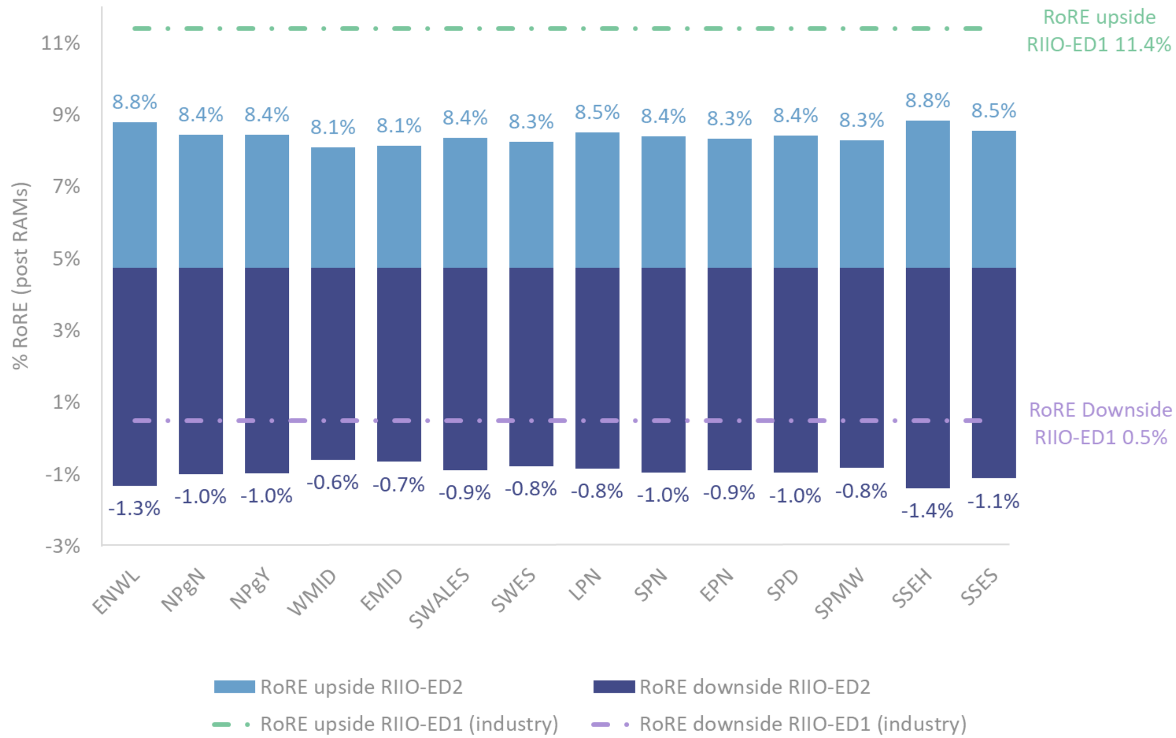
- The regulator considers its approach to the asset beta has been confirmed by the CMA and has not made any changes. **However, Ofgem's proposed asset beta is likely to continue to be an area of debate**, given the subjectivity surrounding the: (i) weighting of the five listed companies; (ii) balance of estimation time periods and techniques; (iii) relative risk of energy versus water companies; and (iv) approaches to gearing / re-gearing.
- **Ofgem's position on TMR is unchanged from the SSMD and consistent with the approach it took in RIIO-GD&T2**, with a range of 6.25% to 6.75% (CPIH, real). Ofgem took the view that company evidence did not address its issues and referenced the CMA's position on RIIO-GD&T2 as confirming its approach.
- Ofgem continues to propose the RfR is based on only real gilts, to avoid the need for an adjustment for the inflation risk premium. In our view, this position remains flawed, as it **fails to recognise that neither real gilts, nor deflated nominal gilts, provide a 'perfect' measure of the RfR**. The regulator also notes that there will be changes to the definition of RPI gilts in 2030, and has proposed two options for calculating the RPI-CPIH inflation wedge for consultation.
- Ofgem has **abandoned the use of its controversial 'outperformance wedge'** and has made no explicit downward adjustment to the allowed return on equity. This reflects the decision made by the CMA in relation to RIIO-GD&T2. However, it appears the matter is not quite 'case closed' – as the regulator considers the scope for operational outperformance remains a "*risk*" and sets out that "*there is general agreement that the baseline allowed return on equity can differ from the cost of equity*". Furthermore, Ofgem states it is open to proposals as to how this perceived risk could be addressed in the FDs.

In relation to the cost of debt, key points include:

- Ofgem is proposing to use the iBoxx GB Utilities 10yr+ index. The regulator has not proposed an explicit adjustment for any **'halo effect'**, as it considers this index better reflects energy networks' actual cost of debt.
- On additional borrowing costs, Ofgem is allowing an **uplift of 25bps** (unchanged from the SSMD), which is intended to reflect transaction costs, liquidity costs, costs of carry, and a CPIH basis risk. We note, the networks have previously stated such an allowance is not sufficient.

FINANCING: THE RoRE RANGES ARE TIGHTER AND LOWER THAN THEY WERE FOR RIIO-1 – HOWEVER THESE FIGURES MAY NOT REPRESENT THE TRUE UNDERLYING RISK

Figure: RIIO-ED2 ex ante RoRE ranges (Pre-RAMs – see following slide)



Sources: Finance annex: Figure 6 and Table 35.

The ranges published by Ofgem are largely driven by its assumed mean, min and max incentive performance levels. Overall, these RoRE ranges reflect an 'additive' methodology. **Between now and the FDs, there is an opportunity for companies to provide a more robust assessment of overall RoRE risk.**

This is essential to: (i) help further influence Ofgem; (ii) inform Board decisions around whether to appeal; and (iii) in the event of a CMA appeal, ensures you have strong evidence as to your assessment of the risk you face.

FINANCING: FINANCEABILITY IS A KEY AREA IN WHICH OFGEM'S APPROACH REMAINS MATERIALLY FLAWED AND OPEN TO CHALLENGE AT THE CMA

FINANCEABILITY

Ofgem's overall approach to financeability remains largely unchanged. Therefore, the main issues of controversy also remain as follows:

- the approach seems removed from that used by ratings agencies;
- potential tensions between target investment grades and the assumptions that underpin the cost of debt; and
- whether revenue advancement / capitalisation can meaningfully resolve financing constraints.

Most critically, it is **Ofgem's underlying working assumptions** (which pre-suppose that the rest of the price control is correctly set) that still **primarily drive its conclusion that the notional firm is financeable**. This remains questionable factually, but moreover in our view, is questionable even in terms of an approach.

In our view, financeability is therefore a key area in which **Ofgem's approach remains materially flawed**.

RETURN ADJUSTMENT MECHANISM

Ofgem plans to introduce a **sculpted sharing mechanism** that would adjust DNOs' RoRE when they deviate from a pre-determined collar. Under this mechanism, the more an individual company outperforms / underperforms the threshold, the more their outperformance / underperformance will be shared with consumers.

Key features of these mechanisms include:

- RAMs will be **symmetrical**, allowing adjustments for both under- and outperformance.
- They will have **dual thresholds of 300bps and 400bps**, relative to the baseline allowed return on equity.
- Returns outside of the **300bps threshold** will be adjusted upwards / downwards by **50%.**
- Returns outside of the **400bps threshold** will be adjusted upwards / downwards by **90%.** This is different to GD2 where only the 300bps threshold was used.

Company performance will be assessed using **combined totex and financial ODI performance**.

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