

RIO-2 Draft Determination Consultation Response

Finance Annex

Table of Contents

RIIO-2 Draft Determination – Finance Annex Consultation Response	3
Allowed return on debt questions	3
Equity beta questions	7
Step-2 implied cost of equity consultation questions	11
Step-3 allowed return on equity consultation questions	16
Financeability questions	30
Corporation tax questions	32
Return adjustment mechanism questions.....	33
RAV opening balance questions	37
RIIO-1 close-out questions.....	37
Disposal of assets questions	38
Time value of money questions.....	38
Revenue forecasting questions.....	39
Base Revenue definition and ODI cap/collar questions	41

Allowed return on debt questions

FQ1. Do you agree with our approach to estimating efficient debt costs and setting allowances for debt costs?

We agree in principle with the concept of indexation in calculating the cost of debt allowance as long as it allows NGN to fully recover the cost of its efficiently incurred debt over the life of such debt instruments. In this context, it is important to recognise the limitations of the use of an industry or sector-wide debt index in defining efficient debt costs at an individual company level. It is the case that true efficient debt costs can only be determined at an individual company level after consideration of the size of the requirement for debt, its duration and the timing of accessing the market. An index can only provide an approximation of this level of efficiency at an individual company level. And the scope for deviation from the index is further exacerbated for smaller companies who access the market for new debt less frequently and in smaller tranches than larger companies. On this basis, we continue to believe that the calibration of the chosen index should compensate companies in terms of both new and embedded debt, efficiently incurred at the time it is raised.

In its calibration of the index in order to assess if it meets the stated requirement to “broadly match debt allowances with expected efficient debt costs for RIO-2”, our view is that Ofgem needs to refine the way it derives the “sector average” of expected efficient debt costs:

- We do not support the decision to pool Transmission and Gas Distribution costs in calculating expected costs. Differing risk profiles and the scale of current and future debt issuance do not make them directly comparable.
- We maintain our view that costs should be assessed including the impact of embedded derivatives. Derivatives are an integral part of a network company’s financial risk management regime (and hence financing costs) commonly used, for example, to fix the rate on floating-rate debt (to protect against the risk of rising interest rates), to swap foreign currency-denominated debt to sterling and to spread interest rate risk across time periods (rather than risk incurring costs subject to a spike in rates).

The available evidence suggests that the expected efficient costs of the GD sector are better met when the iBoxx index is calibrated in line with NGN’s Business plan assumption: 14-18 year Trombone. Under the mid-case interest rate

scenario, when the efficient additional costs of borrowing (53 bps) and the impact of derivatives are factored in, the GDN sector underperforms by 60-69 bps under Ofgem's suggested 10-14 year Trombone calibration of the index. However, the underperformance of the sector falls to just 3-12 bps under the 14-18 year Trombone of iBoxx Utilities index¹.

We do not accept that an additional allowance of 17bps is sufficient to cover the additional costs of borrowing. The attached report from NERA² details the areas where we believe that Ofgem has underestimated the costs for which an additional allowance should be provided. It robustly proves that the allowance should on average amount to 53 bps in RIIO-2. In particular, we believe that:

- A New Issue Premium of 4-14 bps is justified (depending on whether the iBoxx A/BBB or iBoxx Utilities index is used);
- Ofgem has materially underestimated the cost of carry networks are likely to experience in RIIO-2. We maintain that an allowance of c. 17 bps on average is merited in order to provide adequate compensation for the cost of being able to satisfy sufficiency of resource and rating agency requirements;
- Ofgem's consultation position fails to recognise the costs inherent in a network moving to the financeability assumption of a debt portfolio incorporating 30% of CPIH-linked debt. These costs include a CPI(H) issuance premium and /or CPI swap costs. There is no compensation for the basis risk a company would face in these circumstances. The available evidence demonstrates that the level of this compensation should be in the region of 15 bps.

In our view, NGN merits being awarded a small company premium to reflect the risks inherent in being an infrequent issuer of debt. We do not accept Ofgem's inference that a lack of evidence for smaller networks "consistently underperforming larger networks in terms of their overall cost of debt" means that infrequent issuers will be capable of raising debt at long-term average levels. Issuing two or three benchmark-sized bonds within a five-year period carries a clear risk that the issue dates could coincide with high points in the evolution of interest rates and/or credit spreads. Whilst this could be managed with derivatives (and notwithstanding our previous comment) Ofgem's approach to assessing expected efficient debt costs is to ignore the impact of derivatives. One way for a smaller network to minimise this risk would be to issue debt in small quantities at intervals during the period. Investors would require an illiquidity premium for this, typically in the region of 15bps. Assuming debt

¹ Cost of Debt at RIIO-2. A Report for Gas Distribution Networks and Transmission Network Operators. NERA – 2 September 2020.

² Review of Ofgem's DD Additional costs of borrowing, and deflating nominal iBoxx. NERA – 2 September 2020

incurred in RIIO-2 represented, on average, 40% of a company's total debt that would imply that a 6 bps premium to the base allowance would be appropriate.

Therefore, we maintain that 14-18 year Trombone calibration of the iBoxx index continues to better match efficient debt costs of a notional GDN in RIIO-2, although with certain exceptions justified in special cases. Ofgem should increase its estimate of the efficient additional costs of borrowing and allow a small company premium in RIIO-2.

FQ2. Do you agree with our proposal to use the iBoxx GBP Utilities 10yr+ index rather than a combination of iBoxx GBP A and BBB 10yr + non-financial indices?

We acknowledge that the proposed index may theoretically be a more appropriate fit for notional sector costs than the indices currently in use, but do have concerns around its use to determine the Cost of Debt allowance:

- Whilst the iBoxx Utilities Index comprises only bonds issued by utilities, only around half of those bonds have been issued by *UK regulated* utilities. The risks in the other sub-sectors and geographies reflected in the index may differ materially from UK regulated utilities over time, meaning that the average bond yields are not reflective of the cost of debt for GDNs. The tenor of bonds issued by companies in those other sub-sectors and geographies may also not be reflective of the debt portfolios of GDNs.
- The credit rating qualification for bonds to be included in the iBoxx Utilities Index is a broad investment grade. Again over time, the average rating embedded in the index could be materially different from the Baa1 / BBB+ rating compatible with the notional company.

FQ3. Do you agree with our proposal that the RAV growth profile of SHET continues to be materially different to other networks and therefore warrants continuation of a bespoke RAV weighted allowance calculation?

We do not have a strong view on the specific question but wish to make the following observation:

- The fact that SHET's funding requirements have been, and are expected to continue to be, materially different from those of other networks supports our assertion that the transmission and distribution companies should not be pooled in assessing expected debt costs (see our response to FQ1).

FQ4. Do you have any views on the model to implement equity indexation, as published alongside this document, (the “WACC allowance model.xlsx”) or on the annual update process?

We do not have substantive comments on the way market forward curves are used to derive the daily adjustments required to forecast future Gilt and iBoxx yields.

We do not have a strong view on the use of October average rates (rather than annual average rates) to derive the forecast real Cost of Equity. There are certain benefits in using longer averages (please see below), however, it is also true that a one-month average would better capture the latest market conditions.

We are not persuaded that raw index-linked Gilt yields provide a valid proxy for the real risk-free rate (RFR) and are therefore the appropriate measure to use in CAPM for the Cost of Equity indexation:

- Across shorter cycles, the yield on these instruments can display volatility due to supply and demand dynamics, which impact pricing and hence yields. For example, during times of economic uncertainty investors may sell holdings in equities to purchase Gilts, perceived as a “safe haven”. This will push up Gilt prices and yields will fall. Among other factors, demand from pension funds looking to hedge long-term inflation-linked liabilities can also push yields to levels that are not truly reflective of the long-run RFR. Care must therefore be taken to ensure that the indexation mechanism is calibrated in such a way as to smooth any short-term volatility.
- As we have described in our response to FQ 7, one of the main reasons for the Modigliani-Miller theory anomaly, initially identified by the CMA, is likely to be that the RFR is under-estimated. The solution which rectifies it, as suggested by Oxera¹, is either to add a premium of c. 75 bps to the Gilt yields or to reduce by c. 10 bps iBoxx corp. AAA 15+ index yield and add a forward premium (c.19 bps on average over the period) in either case.
- Neither are we persuaded that nominal Gilt yields, appropriately adjusted for inflation, should be discounted as a valid mechanism to determine the RFR. Whilst we acknowledge that there may be difficulty in precisely quantifying the inflation risk premium, more evidence on that may come to light.

¹ The cost of equity for RIIO-2. Q3 2020 update. Prepared for Energy Networks Association. Oxera – 4 September 2020

Equity beta questions

FQ5. In light of RIIO-2 Draft Determinations and Ofwat’s final determinations for PR19, do you believe that energy networks will hold similar systematic risk during RIIO-2 to water networks during PR19?

No. NGN does not believe there is any evidence to support the view that energy and water networks hold similar systematic risks. We believe that systematic risk has been and will continue to be higher for energy networks and, in particular, gas networks due to heightened risk of asset stranding as a result of the shift towards Net Zero.

Qualitative analysis

There are clear differences in the risk profiles of the energy and water sectors. The most important reason is the differential effects the Net Zero imperative will have on energy networks – particularly gas networks – when compared to water networks.

It is widely accepted that new solutions will need to be found to provide space and water heating for households, and for certain industrial processes, where natural gas currently plays a major role. While these needs may continue to be met by alternative sources of low/no carbon gas in future, supplied through existing networks suitably modified, there are also future states of the world where gas demand falls markedly from current levels. In these future states of the world, there would be a potentially greatly reduced role for gas networks. There are no long term future scenarios where gas demand increases.

The wide dispersion in outcomes of potential future scenarios for gas is evident from, for example, National Grid’s recently updated Future Energy Scenarios (see page 64 onwards), but similar findings can also be found in a wider set of analysis (e.g. in the CCC’s work on achieving Net Zero).

This future demand risk in the case of gas networks is highly asymmetric. There is no equivalent risk in the water sector, i.e. there are no future states of the world in which we may reasonably expect a large drop in demand for water.

We believe it is reasonable to suppose that this future demand risk is systematic in nature.

In a future state of the world where demand begins to fall markedly, the costs of legacy networks would then need to be recovered from an ever decreasing customer base. If these costs are indeed to be recovered, and not be stranded, then this requires future policymakers to make hard decisions to make that happen, for example, through permitting large bill increases for remaining customers or agreeing to impose an additional levy on electricity customers or through central taxation. The palatability of such policies, and the willingness of policymakers to enact them, will clearly depend on wider macro factors. If at

that time the wider economy is strong and affordability concerns are consequently diminished, then the likelihood of action to support investors could be more likely than if the opposite were true. If the economy at that time was performing weakly, then the wider political acceptability of funding stranded costs in the gas sector cannot be regarded as certain and support to legacy investors may only be limited, or even entirely absent.

The likely effect of the uncertainty around the asymmetric demand risk that gas networks face, combined with concerns over the asset stranding, is systematic. More generally, it is widely recognised that political and regulatory risk generally is systematic in nature.

Therefore, there is no comparable risk like this in the water sector and this creates an in principle case to believe that the risk profile of energy networks (in particular gas networks) is higher to that of water networks.

Quantitative evidence

There is limited direct, empirical evidence on the question of whether GB energy networks or GB water networks face higher systematic risk. There are only three listed GB water companies (SVT, UU, PNN). And there are only two listed companies that own a substantial proportion of GB energy networks (NG and SSE), both of which undertake other activities. However, none of the evidence that Ofgem, or its consultant CEPA, presents on this limited set of companies supports the theory that GB water network risk is the most relevant proxy for GB energy network risk. For example:

- In Table 14 of Ofgem's Finance annex, the asset beta of NG lies above the average of the three water companies across:
 - All estimations windows; and
 - All averaging periods;
 - Except for one where it is equal (so equal in 1, higher in 21).

NG's beta is far above those of UU and SVT (two companies that Ofgem apparently considers to be particularly relevant, despite the evidence) under every single estimation method.

SSE's asset beta is higher than the three water companies across all estimations. It is noted that SSE's business footprint includes sizeable activity in competitive markets, but this still provides a further point of evidence that does not support Ofgem's contention.

- We consider CEPA's analysis on Beta estimation issues directly informative on the question of whether energy network risk is similar to water network risk. None of the evidence presented lends support to this claim.

- Figure 4.1 of CEPA's report shows that the risk of US regulated utilities has been lower than that of NG and falling over time.
 - Since over that time US regulated energy network betas are found to be below the corporate beta of NG, which is a weighted average of GB and US energy network risk, this indicates that NG's own corporate beta must be a lower bound estimate of GB pure-play energy network risk.
 - This makes our observations about the relationship between NG's beta and the water company betas based on Ofgem's Table 14 all the more relevant, i.e. this suggests the gap between GB energy and water should be higher still than the gap between NG's headline beta and the average of the water companies.
 - And it strongly indicates a sizeable gap between the systematic risk faced by GB energy networks and GB water networks.
- As can be seen in Figure 4.2 of CEPA's report, since 2014 the inferred GB energy pure play beta has been systematically higher than the average beta of the GB water companies across the great majority of that period, and only very rarely below.
- Figure 4.4 presents CEPA's analysis of the decomposition of SSE's beta, and again, highly similar findings emerge (i.e. implied GB energy network beta is systematically higher than the average beta of the GB water companies).
- Both of CEPA's beta reconstruction analyses (Figure 4.6, Figure 4.8) support exactly the same conclusion. When water companies are used as a proxy for NG's and SSE's GB energy network businesses and a group beta reconstructed, the result since 2014 is systematically lower than the observed betas of both companies. This is evidence that GB water network risk is not high enough to explain either NG's or SSE's measured beta.

In summary, neither a qualitative appraisal nor any of the quantitative evidence presented by Ofgem and CEPA supports a view that energy network risk is similar to water network risk. All available evidence suggests that the risk for energy networks is higher, particularly for gas.

**FQ6. Is there evidence of a material difference in systematic risk between:
a) RIIO-1 and RIIO-2,**

- b) distribution and transmission networks,**
- c) gas transmission and electricity transmission,**
- d) gas and electricity?**

We believe that systematic risk in RIIO-2, particularly for gas networks, is higher than in RIIO-1.

RIIO-1 represented a much more traditional price control, in which allowances and targets were largely fixed in advance, with companies given strong incentives to outperform versus ex-ante allowances. Whether companies were able to do so would have depended on a range of wider macro factors affecting demand, input prices, inflation (sector vs economy) in addition to a range of company-specific factors that are likely to be largely idiosyncratic. RIIO-1, therefore, might be characterised as having more macro risk and, owing to the fixed nature of the regime, lower levels of regulatory risk.

In contrast, RIIO-2 is based on a plethora of true-up mechanisms and ex-post reappraisals of what has been delivered, what it cost and whether this is (in the eyes of Ofgem) “reasonable” or not. This granular, more micromanaged price control will, therefore, see a substantial increase in regulatory/political risk, i.e. that Ofgem may, ex-post, deem actions to be unreasonable and clawback funding and/or apply penalties. True-up mechanisms of this kind will apply to over 50% of the cost base in RIIO-2.

This risk is exacerbated by the increased discretion that Ofgem will have to reopen the price control at any time. Again, this creates a highly asymmetric regulatory risk. If it transpires that unforeseen events lead to companies outperforming, there is now a clear risk that Ofgem will reopen the settlement and take the perceived “windfall” away. If unforeseen events lead to companies suffering losses, then the reopener is far less likely.

It is clear – and we consider widely accepted (see for example Oxera’s analysis on the subject matter¹) – that regulatory/political risk of this kind is systematic in nature, as we have suggested already in our answer to FQ5.

NGN, therefore, considers that RIIO-2 will see a large increase in systematic risk arising from extensive, subjective ex-post scrutiny of company actions and the one-sided risk of price control reopeners being deployed in a partial way. Any reduction in systematic risk from reduced exposure to macro risks arising from the extensive use of PCD/UMs will not offset this increase in regulatory risk.

Furthermore, NGN also considers that the systematic risks associated with Net Zero are now more pronounced for RIIO-2 than they were for RIIO-1 (see our answer to FQ5). Risk around future demand is particularly acute for gas networks

¹ Assessment of political and regulatory risk. Prepared for National Grid Group. Oxera – 4 March 2019.

and investors are now far more cognisant of this risk than was the case when the RIIO-1 price control was being concluded.

Overall we consider that risk for gas networks is increasing over time and will be higher in RIIO-2, owing to an increase in regulatory risk and the demand risk arising as a result of Net Zero.

Step-2 implied cost of equity consultation questions

FQ7 **Do you have any views on how we should consider further the gearing impact on beta and cost of capital estimates?**

Ofgem's attempt to test its own set of Cost of Capital parameters for consistency with Modigliani-Miller theory fails to recognise two key points:

- The Cost of Debt used for regulatory purposes is not the market cost of debt, i.e. it is not a spot rate reflecting current market conditions.
- It is highly likely that Ofgem has set its Cost of Equity too low, as it fails to recognise that yields on sovereign bonds are currently heavily distorted and therefore cannot be used as a reliable proxy for the risk-free rate (RFR).

Oxera has explored this topic thoroughly on behalf of the ENA¹ and we encourage Ofgem to consider this work.

Taken in combination, these two factors lead to an estimate of the Cost of Debt that is deviating too much from spot rates (for perfectly well understood and valid reasons) and the Cost of Equity that is too low (for well understood but invalid reasons). It is therefore entirely unsurprising that Ofgem's cross-check has failed.

Cost of Debt

For well understood and perfectly valid regulatory reasons, Ofgem has adopted a trailing average approach to determining the Cost of Debt. Hence the Cost of Debt estimate that Ofgem uses in its regulation, and in its exploration of the effect of gearing, is not the spot market Cost of Debt as required for the Modigliani-Miller theory to hold. Ofgem's number instead embodies not only anticipated new issuances, but also a substantial volume of legacy debts. Almost all of the legacy debts have been issued at coupons that, while efficient when issued, are well above spot rates.

Since a spot, the market-derived rate for the cost of debt is not used, there should be no a priori reason to expect that Modigliani-Miller will hold for the set of regulatory parameters that Ofgem has adopted.

¹ The cost of equity for RIIO-2. Q3 2020 update. Prepared for Energy Networks Association. Oxera – 4 September 2020

For similar reasons, we consider that the analysis presented by Ofgem in Table 20 and Table 21 is essentially meaningless.

Cost of Equity

Oxera, in its work on this topic, has found that correcting for the spot Cost of Debt issue would not be sufficient to yield results consistent with the Modigliani-Miller theory because there is a second bias in respect of Ofgem’s method of estimating the Risk-free rate. Ofgem proposed to infer the Risk-free rate directly from yields on index-linked sovereign bonds. However, companies are not able to borrow at this rate, and therefore using this rate unadjusted is inconsistent with the assumptions that underpin CAPM. This issue has only emerged at this price control, as hitherto Ofgem has not relied on extremely low spot rates, but has historically set the Risk-free rate above spot rates.

Oxera recommends that Ofgem should add c. 50-100 bps premium to yields on sovereign bonds to derive a realistic risk-free rate at which companies can actually borrow.

To illustrate the point, we demonstrate below how WACC moves with gearing when the assumptions are adjusted for just these two factors (other CAPM parameters shown as per Ofgem’s estimates for simplicity and should not be interpreted as our agreement with them). We use:

- A spot like Cost of Debt, based on current sovereign bond yields as reported by Ofgem, plus the 1.9% debt spread Ofgem reports.
- An uplift on sovereign bond yields of 100 bps as an estimate of realistic Risk-free rate.

Figure 1. Stylised example of stable WACC

Gearing	40%	45%	50%	55%	60%	65%	70%	75%	80%
Debt beta	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125
Asset beta	0.365	0.365	0.365	0.365	0.365	0.365	0.365	0.365	0.365
Equity beta	0.525	0.561	0.605	0.658	0.725	0.811	0.925	1.085	1.325
Gilt yields	-1.48%	-1.48%	-1.48%	-1.48%	-1.48%	-1.48%	-1.48%	-1.48%	-1.48%

RFR	-0.48%	-0.48%	-0.48%	-0.48%	-0.48%	-0.48%	-0.48%	-0.48%	-0.48%
TMR	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%
COE	3.18%	3.44%	3.74%	4.12%	4.58%	5.18%	5.98%	7.09%	8.77%
Debt prem	1.90%	1.90%	1.90%	1.90%	1.90%	1.90%	1.90%	1.90%	1.90%
COD	0.42%	0.42%	0.42%	0.42%	0.42%	0.42%	0.42%	0.42%	0.42%
WACC	2.08%	2.08%	2.08%	2.08%	2.08%	2.09%	2.09%	2.09%	2.09%

As can be seen from Figure 1, WACC barely moves with gearing and the Modigliani-Miller theory holds when a more spot-like Cost of Debt and more realistic Risk-free rate are used.

Therefore, higher WACC observed by Ofgem at higher levels of gearing is a simple consequence of a long-standing, valid and reasonable regulatory commitment to remunerate embedded debt, albeit at the sector level, and Ofgem's reliance on a proxy for the Risk-free rate that is too low.

FQ8 Do you agree with our interpretation of cross-checks?

No. There are flaws and weaknesses with all of Ofgem's proposed cross-checks, and heavy reliance on a set of largely irrelevant cross-checks is an error that leads Ofgem to understate the overall Cost of Equity. For the detailed analysis, we refer Ofgem to an updated study on the Cost of Equity which Oxera prepared for the ENA in September 2020¹. We would also encourage Ofgem to carefully consider an updated study by Oxera on one of the crucial cross-checks, namely the Asset risk premium vs Debt risk premium², which must be taken into account when estimating the Cost of Equity for RIIO-2.

¹ The cost of equity for RIIO-2. Q3 2020 update. Prepared for Energy Networks Association. Oxera – 4 September 2020

² Asset risk premium relative to debt risk premium. Prepared for Energy Networks Association. Oxera – 4 September 2020

Our high-level comments on Ofgem's interpretation of cross-checks are summarised below.

Modigliani-Miller cross-check

As detailed in our response to FQ7, the Modigliani-Miller cross-check was incorrectly applied by Ofgem. There is an error in the Ofgem calculation, which uses the historical Cost of Debt rather than the current Cost of Debt that is assumed in the MM model. Correcting for this error produces a WACC that is not very sensitive to changes in gearing. In addition, Ofgem has failed to recognise that it currently intends to set the Risk-free rate too low. Once both of these factors are adjusted to their appropriate levels, the Modigliani-Miller model is no longer violated. Therefore, the properly applied MM cross-check would not support a reduction of the Cost of Equity as implied by Ofgem at Step 2.

MARs

It is helpful that Ofgem has relegated its dependence on MARs down to a cross-check, compared to its original flawed proposal to adjust gearing to reflect MARs.

However, we continue to argue that Ofgem's reliance on the MAR to carry out any part of the price control calibration is misguided, even as a cross-check either for its Cost of Equity estimation or its Outperformance Wedge. The main reasons for our view include:

- The analysis that Ofgem conducts presumes that markets are perfectly knowledgeable and that instantaneous valuations in the market are informed by a perfect understanding of the fundamentals. This is a highly dubious assumption. Equity prices are known to be volatile and corporate valuations may move for very many reasons. It is a very strong assumption that one can draw strong inferences on exactly what must be the case regarding expected outperformance and/or the underlying Cost of Equity from stock prices, in particular, when:
 - there are very few companies to inform such an analysis, and those companies that are available operate different assets in a different sector overseen by different legislation and a different regulator.

As a result, findings are likely to be volatile and unreliable.

- If such a cross-check becomes established it runs the risk of introducing a new source of arbitrary volatility in WACC determinations arising from reliance on volatile stock prices of a tiny sample of largely irrelevant firms. This would increase the degree of regulatory discretion and risk in WACC setting.
- Where Ofgem has been able to derive MARs for energy companies, these must be regarded as uncertain given the steps that need to be taken to strip out

the value of other business and to properly adjust for a wealth of other factors that could drive valuation.

- Moreover, the MARs in question for energy networks pre-date the publication of Ofgem's DD, therefore this evidence is already out of date.

Similarly, the transaction premia that Ofgem now indicates it relies on as a further cross-check are very out of date, as the latest data Ofgem reports is from 2018. Such transactions were therefore conducted well before it became clear how Ofgem would execute RIIO-2 and can, therefore, tell us nothing about the design of RIIO-2.

- Notwithstanding the irrelevance of water company MARs, the evidence drawn from the three listed water companies is highly likely to give a biased view of water sector MARs anyway, as each of the three listed companies:

- received enhanced status from Ofwat; and
- have average debt costs that are markedly lower than the sector average.

For these and other reasons outlined in more detail by Frontier economics¹ and Oxera² in their recent studies current water MARs as reported are likely to be particularly uninformative.

- Also, adopting a MAR cross-check risks creating a mechanism that has the potential to remove any reward for potential future outperformance if it is predicted by the markets, hence companies would face markedly weakened incentives to seek out outperformance in the first place. This would achieve exactly the opposite of Ofgem's long-term regulatory objectives of driving efficiency and service quality for the benefit of customers.

Ofgem should not use MARs as a cross-check for all of the reasons set out above. Moreover, there is no reason to depart from the position as stated in previous CMA assessments and the UKRN cost of capital study—evidence from traded market premia does not provide a reliable guide in practice to the Cost of Equity used by investors in regulated utilities.

OFTOs

OFTOs do not provide a relevant cross-check for other regulated networks. The primary reason is the markedly different profile that OFTOs have, arising from the high degree of revenue certainty they face as the counterparty to a contract,

¹ Further Analysis of Ofgem's proposal to Adjust Baseline Allowed Returns. A report prepared for the ENA. Frontier Economics – September 2020

² The cost of equity for RIIO-2. Q3 2020 update. Prepared for Energy Networks Association. Oxera – 4 September 2020

rather than as a network subject to repeated regulatory review, with all the additional risk that results.

While OFTOs are clearly a form of infrastructure, the reliance on a contractual framework renders them an irrelevant peer for wider regulatory purposes.

Investment manager forecasts/Infrastructure fund IRRs

Neither of these cross-checks is reliable.

Investment manager forecasts are not a reliable primary source of evidence and are conceptually akin to survey data, which Ofgem has in the past decided not to rely on. In any case, the decline in TMR which Ofgem emphasises through this cross-check is largely due to a change in the investment horizon for Schroders and a change in Blackrock's estimate, which appears to be driven by factors unrelated to a decline in market risk.

Infrastructure fund portfolios share no similar characteristics to a 'pure-play' energy network business. Therefore, the infrastructure funds' discount rates are not an appropriate benchmark for the Cost of Equity in RIIO-2 due to the fundamental differences in the risk profile. Furthermore, the implied TMR and lack of consistency between their own betas and the Cost of Equity suggest that these data are unreliable for the type of cross-check attempted by Ofgem.

There is also a risk of subjective bias as regards to the selection of which cross-checks to use and what weight to put on them in deriving the Cost of Equity estimates. Should in the future a price control be conducted during a period of rapid economic growth and high investor returns, Ofgem might be tempted to no longer rely on these cross-checks at such times if they suggest that Cost of Equity should be set much higher. Therefore the proposal to use the above cross-checks now creates a further asymmetric risk skewed to the downside.

Step-3 allowed return on equity consultation questions

FQ9 What is your view on the overall in-the-round assessment of allowed returns to equity? Is our judgement of 3.95% at 60% notional gearing reflective of the combined analysis through Steps 1, 2, and 3?

We strongly disagree with the approach and conclusions contained in all three Steps which has led Ofgem to believe that 3.95% CPIH real is the correct level of return for the gas distribution networks in RIIO-2.

Ofgem has proposed to reduce equity returns from the RIIO-1 levels by almost 50%. Ofgem's estimate is materially lower even compared with Ofwat's recent determination for water networks with lower systematic risks (for details please see our response to FQ5), four of which are contesting it at the CMA.

The main contributors to such a drastic reduction in the estimate of the allowed return from RIIO-1 are the following fundamental methodological changes proposed by Ofgem for deriving the Cost of Equity allowance:

1. Moving to spot yields on government bonds, which lowers the estimated risk-free rate (RfR);
2. Restating the historical total market return (TMR) based on an experimental index for historical CPI, which results in a lower estimated TMR;
3. Increasing the weight on the geometric average historical return, thereby moving further away from the correct (Cooper) estimator, resulting in a lower TMR;
4. Using a debt beta of 0.125 where previously Ofgem used zero, which artificially deflates the notional equity beta;
5. Adding illiquid European comparators to the asset beta calculation;
6. Using biased and incorrect approach to cross-checks; and
7. Applying an outperformance wedge of 25 bps to reduce the allowed return for expected outperformance.

The combination of these changes result in the Cost of Equity estimate that is too low. This creates the potential for underinvestment and under-innovation, which is especially concerning in gas distribution in the context of the Net Zero imperative.

The evidence disproving Ofgem's Cost of Equity assessment is vast and compelling. The detailed analysis of the conclusions made by Ofgem through Steps 1-3 are contained in the comprehensive studies on the Cost of Equity performed by Oxera¹ and on the Adjustment of the Baseline returns conducted by Frontier economics², collectively endorsed by all gas distribution and gas and electricity transmission networks in the UK. A wealth of research on the subject matter has been submitted by the ENA as part of the NATS³ and PR19⁴ CMA appeals and will be submitted as part of the DD consultation. Frontier Economics has updated its forward-looking analysis performed for NGN on the Outperformance wedge, which now takes into account new inputs from the Draft determinations⁵.

¹ The cost of equity for RIIO-2. Q3 2020 update. Prepared for Energy Networks Association. Oxera – 4 September 2020

² Further Analysis of Ofgem's proposal to Adjust Baseline Allowed Returns. A report prepared for the ENA. Frontier Economics – September 2020

³ <https://www.gov.uk/cma-cases/nats-en-route-limited-nerl-price-determination>

⁴ <https://www.gov.uk/cma-cases/ofwat-price-determinations>

⁵ Outperformance Wedge. Potential performance in RIIO-GD2 - report for NGN. Frontier Economics – September 2020.

We urge Ofgem to carefully consider these reports and submissions and take them into account before making its final determinations.

We do not intend to repeat all the arguments contained in the above-mentioned research in our response. However, it is worth emphasising that apart from the principle of the Cost of Equity indexation (albeit the methodology proposed for such indexation still needs to be refined), all other elements of CAPM, Ofgem's conclusions on cross-checks and the introduction of the Outperformance wedge have been strongly and universally rebutted based on both theoretical and empirical evidence.

Oxera's updated Cost of Equity for RIIO-2 analysis robustly substantiates a Cost of Equity in the range of 6.00 –7.08% (CPI real). Frontier's analysis concludes that a notional GDN is expected to underperform in RIIO-2 by c.20 bps in RoRe terms.

Below we analyse on a very high level individual elements of CAPM and also expand on Steps 2 and 3 of Ofgem's methodology to derive the allowed return on equity.

Risk-free rate

The CAPM assumes that firms and investors can borrow and lend at the Risk-free rate. However, it is obvious that even the AAA-rated firms cannot borrow at the same cost as governments do and consequently no utility can raise debt at Ofgem's estimate of the Risk-free rate proxied by spot index-linked government gilt yields. Although it is recognised that AAA-corporate bonds yields reflect a non-zero (but very insignificant) probability of default and a degree of systematic risk, it still means that the current government bond yields significantly underestimate a realistic estimate of the Risk-free rate for the CAPM. This underestimation creates a violation of the Modigliani–Miller (MM) proposition—that the vanilla WACC should be invariant with respect to the level of gearing.

The above facts combined with the evidence that government gilts possess a substantial “convenience premium” lead to the conclusion that to be used as a reasonable proxy for the Risk-free rate in CAPM, the yields on bonds issued by governments with a high sovereign credit rating need to be adjusted upwards by c. 75 bps or AAA-corporate bond yields at a 20-year investment horizon should be adjusted downwards by c. 10 bps. These adjustments need to be applied before accounting for the expected risk-free rate increases in RIIO-2. On balance, as per Oxera's findings, the current market evidence as of 31 July 2020 suggests that -1.00% CPIH real is an appropriate assumption for the Risk-free rate in RIIO-2.

One should be clear that this is a novel approach, which was not raised previously in the regulatory context because historically regulators used to add a material spread to gilt yields to set the risk-free rates. However, since Ofgem is proposing to use contemporaneous yields on index-linked gilts to derive an estimate of the Risk-free rate and in the context of Modigliani and Miller (MM) theory cross-check, it is imperative that Ofgem carefully considers Oxera's findings on the

subject matter¹ and hopefully accepts that an upward adjustment to the raw index-linked gilts is required to derive a realistic and robust estimate of the Risk-free rate to be used in RIIO-2.

Total Market return

Extensive analysis on the subject matter has been submitted by the ENA as part of NATS and PR19 appeals. The CMA has yet to provide its full assessment of this evidence. In the meantime, it is worth reiterating that a number of independent economic and finance experts, including Oxera, NERA, Frontier economics concur that Ofgem's approach to deflating and averaging of historical returns is flawed. In its latest study on the Cost of Equity Oxera reinforces arguments in support of the more appropriate inflation series and cross-checks to be used to derive an unbiased TMR.

Oxera's estimates using historical data, the Bank of England dividend discount model, corrected estimates of inflation, academic surveys, and Ofgem's own cross-checks continue to support a TMR estimate of 7.0–7.5% (CPIH-real).

Beta

Ofgem considers UK water companies to be the most appropriate comparators for energy companies and applies inappropriate screening when choosing European energy comparators (i.e., selects illiquid firms). Ofgem uses an unrealistically high number for debt beta.

We disagree with Ofgem that UK water companies are appropriate comparators, and Ofgem's new European comparators appear to be poor matches based on liquidity characteristics. Oxera's approach, on the contrary, appears to overcome these shortcomings: it is suggested that National Grid's five-year asset beta should be used as the low end of the beta estimate, and the more appropriate comparator average five-year asset beta as the high end. Oxera's updated findings support an asset beta range of 0.38–0.41 and a debt beta of 0.05.

Cross-checks

We do not agree with Ofgem's interpretation of the chosen cross-checks (for full details please see our response to FQ8 and Oxera's analysis on the subject matter).

It is worth noting that Modigliani–Miller (MM) model cross-check, when applied appropriately, does not suggest that a downward adjustment to the Cost of Equity at Step 2 is justified.

¹ The cost of equity for RIIO-2. Q3 2020 update. Prepared for Energy Networks Association. Oxera – 4 September 2020; Are sovereign yields the risk-free rate for the CAPM? Prepared for the Energy Networks Association. Oxera – 20 May 2020;

As far as the investment manager forecasts are concerned, the available evidence demonstrates that if the obvious outliers were discarded, Ofgem's own cross-check would support a TMR range similar to that proposed by Oxera. An analysis of infrastructure funds and OFTO bids demonstrates that both of them have different risk profiles than those of UK energy firms.

Oxera's asset risk premium relative to debt risk premium (ARP-DRP) cross-check, being arguably one of the most reliable ones, indicates that the Ofgem Cost of Equity proposal is at the bottom end of the range supported by contemporaneous data, whereas the past regulatory precedents were broadly in line with the market data at the time. Specifically, it demonstrates that the ARP-DRP differential implied by Ofgem's midpoint Cost of Equity allowance falls below the 15th percentile of the empirical distribution of the recent market evidence. This indicates that Ofgem's RIIO-2 allowances for the Cost of Equity are too low relative to contemporaneous market evidence from UK energy bonds. This conclusion remains unchanged under various sensitivity tests and cross-checks. Ofgem's risk premium allowance for equity relative to debt is so low that it raises questions about whether the networks would be financeable from the perspective of equity investors. For more details please see Oxera's comprehensive report on the subject matter¹.

As regards one of Ofgem's main cross-checks (MARs in the water sector) and without prejudice to our view that Ofgem should not place weight on MARs in the water sector for the regulatory decisions in the energy sector, it appears that the expected outperformance along with other items such as the non-regulated portion of the business, accrued dividends, expected takeover premium can more than explain the premia for Severn Trent and United Utilities. In other words, the premia can be explained without the argument that the allowed return on equity is too high².

It is important to note that just because Severn Trent and United Utilities are expected to outperform this does not mean the whole sector is systematically expected to outperform. Conversely, the fact that Moody's has recently downgraded many of the water companies leaving the sector on negative watch suggests the expected underperformance of most companies in the sector.

In summary, both the corrected Ofgem cross-checks and Oxera's cross-checks support a Cost of Equity range more in line with that proposed by Oxera in the updated Cost of equity for RIIO-2 report.

Outperformance wedge

¹ Asset risk premium relative to debt risk premium. Prepared for Energy Networks Association. Oxera – 4 September 2020

² What explains the equity market valuations of listed water companies? Oxera – 20 May 2020.

By introducing Step 3, Ofgem has proposed a fundamental, unprecedented change in the regulatory framework since the inception of the incentive regulation, which has been already considered to be credit negative by Moody's rating agency¹ and which has not found support from any other UK regulator performing the analysis and making its determinations at roughly the same time with Ofgem. The detailed rebuttal of Step 3 from both conceptual and quantitative perspectives can be found in our responses to FQ10-11, in Frontier Economics reports on Adjusting Baseline returns prepared for the ENA in September 2020² and in an updated report on the Outperformance wedge prepared for NGN in September 2020³.

In the context of the Cost of Equity adjustment, it is to be emphasised that if Ofgem believes that the level of outperformance in RIIO-2 (even if it was valid to anticipate it) should be reduced, the correct approach would be to identify and directly reduce the scope for such outperformance via the relevant mechanisms. For instance, if excessive outperformance is expected relative to cost allowances, this needs to be addressed through a higher efficiency challenge (which Ofgem already proposed to implement), not through a lower allowance for the equity return.

Proposals contained in DD suggest that Ofgem has indeed corrected (or even over-corrected in some respects) all aspects of the RIIO-1 price controls that led to outperformance directly at the source. By also introducing an additional Wedge on the Cost of Equity to correct for those same errors Ofgem clearly double-counts and hence makes an error.

The fact that RIIO-1 may have led to higher than expected returns for some companies does not mean that price controls, in general, cannot be calibrated fairly and symmetrically. Ofgem seems to be the only regulator with a lack of confidence in its own ability to set a symmetric price control. Other UK regulators such as Ofwat, CAA and the CMA, which must have had regard to the same historic information that Ofgem bases its judgement on and which must be facing similar challenges which Ofgem considers unsurmountable without the Wedge, do not seem to believe that there is a need to put in such dubious regulatory mechanisms at the cost of causing harm to consumers in the medium to long-term.

A new report by First Economics that contains the results of interviews conducted in August 2020 with 32 former regulators provides new and very compelling evidence, further corroborating the points made by Frontier

¹ http://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1239741

² Further Analysis of Ofgem's proposal to Adjust Baseline Allowed Returns. A report prepared for the ENA. Frontier Economics – September 2020.

³ Outperformance Wedge. Potential performance in RIIO-GD2 - report for NGN. Frontier Economics – September 2020.

economics and reinforcing our strong belief that the Outperformance wedge is unnecessary and arbitrary. In particular, this independent survey of highly experienced professionals, who previously served on regulators' boards or as CC/CMA members, or had worked at a senior level within a regulator during a price review, demonstrated the following (for full details please refer to the published report¹):

- Almost three-quarters of respondents either agreed or strongly agreed with the statement that in setting a price control, regulators should strive to set up a 'fair bet', in which the likelihood of a regulated firm earning returns above or below the cost of capital are evenly balanced;
- A majority of the former regulators considered that the toolkit that regulators can deploy during price reviews is sufficiently robust to enable the regulator to set up a 'fair bet' (if the regulator is minded to do so). After reflecting on the combined power of modern-day regulatory analysis, regulatory judgment and uncertainty mechanisms, most felt that there was no reason why price controls would generally turn out to be lop-sided in investors' favour. Instead, the feeling was that any regulator error would be symmetrically distributed over time and across the sectors;
- 78% of former regulators stated that they either disagreed or strongly disagreed with the idea that a regulator should make a final lump-sum deduction from allowed revenues as a way of securing a "fair bet". Some respondents went as far as to argue that a lump-sum deduction would necessarily have to be an alternative to and displace the kind of detailed analysis that regulators otherwise conduct, which they saw as tantamount to an abdication of a regulator's responsibilities and something that would be likely to increase rather than reduce regulatory error;
- None of the 32 people who were interviewed agreed with the proposition that the deduction from allowed revenues should be set at a fixed 5% of allowed expenditure. Such a deduction was universally accepted to be "arbitrary". Almost all of the individuals that were interviewed, including people that were sympathetic to the deduction in principle, balked at the idea it was possible to put a set value on any deduction from revenues;
- Most former regulators disliked the idea of adjusting the return on the RAB. They did not see this proposition as a Cost of Capital issue and thought that it would be unnatural to encroach on what has hitherto been a separable and self-contained part of the regulatory framework. There was also a worry that adjustments to the allowed rate of return might not be properly understood by investors and rating agencies and

¹ <http://www.first-economics.com/earwakerfincham.pdf>

so inadvertently interfere with investment hurdle rates, interest cover ratios, credit ratings and/or overall perceptions of the returns that are on offer in the UK's regulated sectors, particularly when compared to returns that are available in other industries, and

- More than three-quarters of the regulatory practitioners were very clear that outperformance leading to earnings above the cost of capital did not indicate that the regulator had failed to set the control at an appropriate level. Several made the point that outperformance will often be a consequence of companies responding positively to incentives that consciously share gains between shareholders and customers, which is exactly what a regulator would hope for.

Therefore, we would encourage Ofgem to remove Step 3 from the regulatory toolbox altogether.

Concluding remarks

It is remarkable to note that recent regulatory announcements (by Ofcom, CAA, Ofwat and the CMA) have been, on average, close to NGN's Cost of Equity value (5% CPIH real) assumed in the Business plan for RIIO-2. The high bound of Ofgem's Cost of Equity range (5% CPIH real) exactly coincides with NGN's proposal. However, we would like to caution against wrong inferences one could try to draw from these observations.

For the avoidance of doubt, even if Ofgem were to allow the Cost of Equity at its higher bound without any further reductions as part of Steps 2 and 3, no inferences about NGN's acceptance of Ofgem's estimates of the individual CAPM parameters at Step 1 should have been made. NGN's proposed financial package was accepted by our shareholders on the basis of us being the most efficient network in the sector, shifting efficiency frontier in all regards and rising to the challenges far beyond tolerable levels for a notional GDN. Moreover, our proposed Financial package for RIIO-2 was designed to work only if all of its elements, including the overall WACC and the proposed Totex levels, were to be taken in the round.

Therefore, without prejudice to our Business Plan submission, NGN supports industry-endorsed findings on the individual elements of CAPM and reiterates its disagreement with Ofgem's combined analysis and conclusions derived through Steps 1-3.

We hope that Ofgem reconsiders its allowed return on equity estimate in light of all the evidence presented in our response and in the independent economic consultancy reports, submitted by NGN and/or the ENA and would increase the allowed Cost of Equity to an acceptable level at the Final determinations.

FQ10 **What is your view on the expected outperformance estimate of 0.25% at 60% notional gearing? Do you recommend alternative analysis techniques or do you have suggested improvements to the analytical files published alongside this consultation?**

a) "AR-ER database.xlsx"

b) "Residual outperformance.xlsx"

c) "Simple MAR application model.xlsx"

Ofgem should not apply an outperformance wedge at all. The application of an outperformance wedge is wrong in principle as:

- it will erode investor confidence and increase risk;
- it will weaken incentives for efficiency and innovation;
- it will distort incentives to invest; and
- it will weaken clarity over how the price control has actually been calibrated.

All of these problems have been set out clearly in the previous work¹ and the updated report² prepared by Frontier Economics on behalf of the ENA.

For example, Frontier has found that if the annual net productivity gains were eroded by anything more than c.3%³, due to changes in the strength of the incentives regime brought about by the 25 bps outperformance-based reduction on equity returns, the present value of the productivity losses to the sector would outweigh the present value of the gains for the customers.

Beyond the in-principle objections to applying a wedge at all, we do not consider that any of the three strands of evidence put forward by Ofgem to support calibrating the wedge at 25 bps are robust or reliable. We note that a full critique of this evidence can be found in the above mentioned updated report on the subject matter prepared by Frontier Economics for the ENA. An alternative bottom-up analysis of the financial package proposed by Ofgem in RIIO-2,

¹ Adjusting Baseline Returns for Anticipated Outperformance. An assessment of Ofgem's proposals. Frontier Economics – 12 March 2019.

² Further Analysis of Ofgem's proposal to Adjust Baseline Allowed Returns. A report prepared for the ENA. Frontier Economics – September 2020.

³ Frontier's calculations are based on Ofgem's own productivity assumptions of 1.2% for Capex and 1.4% for Opex. It has approximated this by using an assumption of 1.3% for all costs. This means that if the 1.3% annual productivity is eroded by 3% (or more), such that the annual productivity improvement is only 1.26% (or less), then the impact of this productivity loss would outweigh the gains from the lower Cost of Equity.

conducted by Frontier Economics on behalf of NGN¹, further substantiates the point that the Outperformance Wedge is entirely unjustified.

Below we provide some specific comments on Ofgem's analysis on the expected outperformance in RIIO-2.

AR-ER database.xls

The historical Totex outperformance database contains a range of evidence that is essentially irrelevant to RIIO-2. The expectation that companies can outperform on Totex by 7% going forward, a conclusion that Ofgem draws from the database, is unjustified.

Firstly, Ofgem relies on ancient history to support its 7% finding, including outperformance evidence from DPCR1, 2 and 3 and PCR2002. Huge outperformance was recorded during each of those price controls, but the process through which these were set bears no resemblance at all to the current round of price controls, making evidence from this era irrelevant. It should be dropped from the analysis. If these four price controls from long ago are dropped from the evidence set, then this already reduces Ofgem's 7% average outperformance to 3.7%.

However, even this 3.7% has no relevance for RIIO-2. Because, secondly, given the extent of the changes that Ofgem is making to the regulatory framework more recent evidence on Totex outperformance (from RIIO-1, DPCR5 etc) is also irrelevant. Ofgem has not corrected for a large number of important differences in approach between RIIO-1 and RIIO-2. Including:

- The indexation of RPEs, which Ofgem agrees will remove a large proportion of Totex outperformance compared to RIIO-1, of the order of 5%;
- The widespread use of PCDs, which had they been applied previously would have resulted in ex-post removal of outperformance across a large proportion (c. 50%) of the cost base;
- The revised rules around NARM, which again limits the scope for outperformance (through the DAF and more limited scope for risk trading) and introduces extensive ex-post true-up across a further slice of the cost base;
- The use of interpolation as part of the IQI at RIIO-1, which Ofgem is now not planning to repeat at RIIO-2, which had the effect of increasing allowed Totex;

¹ Outperformance Wedge. Potential performance in RIIO-GD2 - report for NGN. Frontier Economics – September 2020.

- The marked toughening of the location of Ofgem’s benchmarking cost frontier, which has moved from its traditional Upper Quartile to the 85th percentile;
- The extremely stretching productivity target Ofgem has assumed compared to prevailing evidence, much tougher than in previous periods; and
- The large penalties awarded through the BPI to many firms, which would have a similar effect to setting a tougher cost allowance.

Since the AR-ER database does not account for any of these changes, no safe conclusions can be drawn from it regarding what a reasonable expectation of outperformance may be for RIIO-2.

Indeed if all of the factors identified above were corrected for we consider it likely that even assuming 0% outperformance might prove optimistic, i.e. a more rational view might be to expect underperformance.

Residual outperformance.xlsx

Ofgem has conducted an exercise that it claims restates RIIO-1 performance on a RIIO-2 basis. Ofgem considers that this analysis confirms that it is reasonable to assume that companies can be expected to outperform in RIIO-2 by at least 25 bps.

NGN does not agree. The restatement exercise that Ofgem has undertaken is incomplete. Important differences between RIIO-1 and RIIO-2, that will materially change the prospects for companies to outperform, have not been adjusted for in Ofgem’s analysis. A full analysis of the flaws in Ofgem’s analysis can be found in the Frontier Economics report on Ofgem’s Proposal to Adjust Baseline Allowed Returns¹.

The list of changes that Ofgem fails to capture is highly similar to the list provided above in respect of the AR-ER database. We repeat the list (where relevant, noting that Ofgem has made an adjustment to take account of its intention to index RPEs, albeit that this is hardcoded and cannot be audited at this time) here for completeness, and add one additional item.

- The widespread use of PCDs, which had they been applied previously would have resulted in ex-post removal of outperformance across a large proportion (c.50%) of the cost base;
- The revised rules around NARMs, which again limits the scope for outperformance (through the DAF and more limited scope for risk trading)

¹ Further Analysis of Ofgem’s proposal to Adjust Baseline Allowed Returns. A report prepared for the ENA. Frontier Economics – September 2020.

and introduces extensive ex-post true-up across a further slice of the cost base;

- The use of interpolation as part of the IQI at RIIO-1, which Ofgem is now not planning to repeat at RIIO-2, which had the effect of increasing allowed Totex;
- The marked toughening of the location of Ofgem’s benchmarking cost frontier, which has moved from its traditional Upper Quartile to the 85th percentile;
- The extremely stretching productivity target Ofgem has assumed compared to prevailing evidence, much tougher than in previous periods;
- The large penalties awarded through the BPI to many firms, which would have a similar effect to setting a tougher cost allowance and
- Ofgem has assumed that wider outperformance on a range of ODIs would continue into RIIO-2, despite the fact that certain incentives (such as Environmental emissions incentive as a financial ODI, NTS exit capacity incentive,) will not be continued into RIIO-2 and despite the fact that those incentives that will persist will now be calibrated on a much tougher basis (Customer Satisfaction Survey Incentive, Shrinkage Incentive; doubled GSOP).

We also note that a material spreadsheet error has been identified for one of the transmission companies (NGGT), and Ofgem has not taken account of the material “clawback” that has been proposed for allowances for another transmission company (NGET). This means Ofgem has significantly over-stated the outperformance these companies achieved in RIIO-1, again giving the misleading impression that companies always outperform when, in fact, they don’t.

Frontier economics calculates that once Ofgem’s backward-looking analysis is corrected to reflect the above issues, there is net underperformance of the GD sector in RIIO-2. In particular, Frontier’s restatement of the RIIO-1 performance under more appropriate RIIO-2 assumptions reveals 0.2% of expected underperformance on incentives and almost no opportunity to deliver Totex outperformance. It should be noted that this assessment is conservative, given that some potentially significant downside factors (such as the impact of NARM and PCDs) have been excluded from Frontier’s analysis. For full details, please see the mentioned above report¹.

It is therefore clear that Ofgem’s re-statement of RIIO-1 exercise provides no grounds to conclude that 25bps of outperformance can be expected in RIIO-2.

¹ Further Analysis of Ofgem’s proposal to Adjust Baseline Allowed Returns. A report prepared for the ENA. Frontier Economics – September 2020.

Simple MAR application model.xlsx

We have no specific comments on the MAR application model as a mechanical exercise, but consider that reliance on MAR crosschecks is misguided for a number of important in principle reasons (for example, given the volatility of stock market data and the challenges of drawing strong inferences from such data, reliance on a small sample of firms mainly operating in an entirely different sector, the potential to introduce further asymmetric regulatory risk into WACC determinations, the potential to further harm incentives for outperformance etc).

For a fuller explanation of our views on Ofgem's use of a MAR cross-check in general, please see our answers to FQ8 and FQ9.

Detailed assessment of the scope for outperformance for a notional GDN

As explained above, Ofgem's own evidence in support of the wedge is flawed. In addition to this, Ofgem has failed to provide any forward-looking assessment of what its RIIO-2 price control might deliver.

We commissioned work by Frontier Economics in 2019, which was submitted to Ofgem as part of our Business plan, with a view to undertake exactly this kind of forward-looking exercise. Ofgem has accepted that the Frontier's approach was helpful and, in principle, legitimate, but disagreed with some of the assumptions Frontier made. We have therefore commissioned an update of Frontier's previous work, focussing now on modelling the RIIO-GD2 Draft Determination as it stands, which has crystallised Ofgem's position and removed a number of the uncertainties Frontier faced when originally undertaking this work.

We attach this report to our response¹, but in summary Frontier's analysis points not to an expectation of outperformance at or above 25 bps, but instead to an expectation of underperformance of c. 20 bps for a notional GDN in RIIO-2. Even this, as Frontier notes, is based on a particularly cautious set of assumptions (reflecting and adapting for the specific criticisms Ofgem had of the original analysis). This means that a more balanced approach to the facts of the RIIO-2 DD would lead to a baseline expectation of even greater underperformance than 20 bps as a result of the overall package Ofgem has put forward. Frontier has also provided a number of sensitivities to demonstrate the robustness of these conclusions. In addition, Frontier calculates that in order to actually achieve an expectation of 25bps, a notional GDN would need to outperform on Totex by 6%. This is clearly implausible given Ofgem's proposed calibration of the regulatory framework, which will nullify or materially reduce the prospects for a notional company to outperform in RIIO-2.

In short, the evidence entirely contradicts Ofgem's reasoning for introducing the Outperformance Wedge, because:

- there is no reason to expect a notional GDN to outperform given Ofgem’s assumptions for Draft Determination, and
- on the contrary, an expectation of zero outperformance is much more likely, and if anything this is likely to prove conservative, i.e. the calibration in the DD is skewed to the downside.

This is driven by tougher incentives on the outputs, and reduced scope for outperformance on Totex arising from Ofgem’s approach to RIIO-2.

For all of these reasons, we urge Ofgem to drop the proposed Outperformance Wedge and set an allowed rate of return consistent with an unbiased appraisal of the evidence.

FQ11 What is your view on an ex-post adjustment for baseline equity returns? Is there an alternative mechanism or implementation approach that you think could better meet our stated objectives? Do you have specific views on averaging, pooling or suggested simplifications?

For the reasons set out in our answers to other questions, NGN does not agree with the application of an Outperformance Wedge. Ofgem should not do so and should set a Cost of Equity consistent with a balanced appraisal of the evidence.

However, if Ofgem were to decide to pursue such a policy, it is worth noting that even if an ex-post true-up were to partially mitigate the impact of this flawed return adjustment policy it does present additional problems that require further analysis.

Potential for unfair/unjustified outcomes

The ex-post true-up creates a form of yardstick competition between firms in the same pool. But a pre-condition for successful application of yardstick competition is that there should be a level playing field for all the companies.

A level playing field will be almost impossible to achieve, in particular for the gas companies as the ease/difficulty with which marginal savings are made will vary across the proposed yardstick group:

- Members of the group have different Totex sharing rates
- And different Totex:RAV ratios
- The group contains NGGT, which is subject to a markedly different wider incentive framework.

¹ Outperformance Wedge. Potential performance in RIIO-GD2 - report for NGN. Frontier Economics - September 2020.

This creates a risk that outcomes from the true-up are arbitrary.

Furthermore, there is no guarantee that each member of the yardstick group has a similarly challenging price control calibration.

- There may be regional differences that have not been perfectly captured.
- The PCDs for each firm are bespoke and could lead to arbitrary differences.
- A simple error in the calibration of the price control of any one member of the group could similarly see arbitrary differences in performance.

Deterrent to collaboration

The introduction of direct competition through the yardstick true-up has the potential to discourage needed collaboration across the sector.

Weakened Incentives

The ex-post adjustment will under certain circumstances further weaken incentives for companies to increase efficiency in addition to the primary harm to incentive effects resulting from applying the wedge in the first place. This arises because if there is a reasonable prospect of the ex-post true-up kicking in, companies will be partially insulated from the effect of any overspend.

Financeability questions

FQ12 **Do you agree with our approach to assessing financeability?**

We welcome Ofgem's acceptance that a credit rating of BBB+/Baa1 is optimal for a notional company. In our view maintaining two notches of headroom above the floor of investment-grade is critical for financial resilience and enduring access to debt funding at affordable rates of interest. At the same time, we note that Ofgem's messaging in this regard has been rather confusing for the investor community: for example, Ofgem has communicated to investors that it has calibrated the DD in line with a strong BBB rating (rather than BBB+) and that, in fact, it has no specific rating target it is aiming for¹.

We are also broadly supportive of Ofgem's approach of assessing financeability based on the notional company, provided that this "base case" is calibrated correctly.

Notwithstanding the above it is our view that the notional company has not been appropriately modelled:

¹ Ofgem RIIO-2 Finance Webinar. 12th August 2020.

- We do not see any justification for increasing the assumption on the level of index-linked debt from 25% to 30%. Basing the notional company funding structure on actual company data is irrational and inconsistent with the Ofgem approach in other areas (e.g. ignoring derivatives in assessing sector debt costs). Regardless, we do not think that funding structures within the transmission sector should in part form the basis for assumed debt structures in the notional gas distribution company.
- The 30% index-linked debt assumption is also inconsistent with the absence of CPIH issuance costs being compensated for in the Cost of Debt allowance.
- Ofgem ignores basis risk in asserting companies do not need to be compensated for the switch to CPIH inflation. Even if investors are compensated for the expected difference between RPI and CPI inflation ex-ante, ex-post variation in the outturn RPI-CPI wedge exposes companies to additional risks when some of their actual costs are linked to RPI.
- Assumptions on investment expenditure in the notional company present an artificially positive view of financial performance and financeability. We do not accept that the implied levels of investment are commensurate with running a network safely, reliably and efficiently. Large Totex disallowances and moving expenditure from core allowances into uncertainty mechanisms present an unrealistic picture: when investment levels are adjusted for what we believe are minimum requirements the network's financial health would be far weaker.
- The financeability assessment doesn't take sufficient account of sensitivity to risks such as the impact of Covid-19 on network operating costs and financial markets. For example, low inflation in the short term could hamper cash generation due to the inflation mismatch between in-year revenue adjustments and the calculation of real allowances and return.
- We do not agree that a 25bps outperformance wedge is a valid assumption for a notional company. Stripping this out from the assessment would weaken credit metrics.
- Ofgem uses over-optimistic assumptions in its credit rating simulator to derive the credit quality in the Licence Model. One of the qualitative factors (Financial policy) is assumed to have a score of 'Baa'. However, Moody's credit rating agency, whose methodology is being used therein, confirms that all GB GDNs are assigned a score of 'Ba'.

Making adjustments for the foregoing would result in the credit rating of the notional company being below the targeted level of two notches above

minimum investment grade. Therefore, Ofgem's proposed financial package could not be regarded as financeable.

FQ13 Do you agree with our approach to determining notional gearing for each notional company?

For the notional company, we acknowledge that lowering gearing will aid financeability. We understand (but do not necessarily endorse) Ofgem's desire to increase the role of equity in funding investment and supporting financeability and to halve the allowed returns at the same time.

For the actual company position, whilst the 5% allowance for equity issuance costs is welcome it is our view that moving swiftly from 65% to 60% gearing is challenging.

There may be other unwanted or unforeseen consequences of the cut in the gearing level and our view on these issues is discussed in our response to FQ17 on the Tax Clawback mechanism.

FQ14 Do you have any evidence that would suggest we should consider adjusting our notional company financing assumptions due to the impact of COVID-19?

We wish to reiterate the point made in our answer to FQ12 and highlight that the period of short-term low inflation is likely to have a negative impact on networks given the disconnect between near-term inflation applicable to revenues and RAV and long-term inflation assumptions used to calculate Cost of Debt allowances and Equity return.

Corporation tax questions

FQ15 Do you agree with our proposal to pursue Option A?

Yes, of the three suggested approaches Option A is likely to achieve a better outcome for customers.

FQ16 Do you agree with our proposals to roll forward capital allowance balances and to make allocation and allowance rates Variable Values in the RIIO-2 PCFM?

Yes.

FQ17 Do you agree with the proposed additional protections? In particular:

- a) do you have any views on a materiality threshold for the tax reconciliation? Do you think that the "deadband" used in RIIO-1 is an appropriate threshold to use?**

Yes, due to the complexity of the reconciliation a materiality level is required, the RIIO 1 dead band is acceptable

b) Do you have any views on our proposals to retain the Tax Trigger and Tax Clawback mechanisms from RIIO-1?

We have reservations about the Tax clawback mechanism and its proposed calibration in RIIO-2. The proposed reduction of notional gearing from 65% to 60% in gas distribution could create a situation when the Tax clawback mechanism would be engaged as a result of Ofgem's policy decision, as opposed to companies' own actions driving excessive levels of actual gearing. Ofgem appears to recognise this risk and proposes a transition period, whereby the notional gearing level used in the Tax clawback calculation will be gradually decreased during RIIO-2.

In the context of the halved levels of return and negatively skewed overall calibration of the price control, it appears overly optimistic to assume that the level of actual gearing in gas distribution will fall from 65% to 60% by the end of RIIO-2 with a stepped decrease between years three and four. However, should Ofgem decide to implement its proposal regardless, we would suggest that the gearing levels are decreased smoothly, i.e. on a straight line basis so that 60% is applied starting from the first year of RIIO-3 as opposed to the last year of RIIO-2. The amount of clawback should be calculated with respect to the same level of gearing as used for the gearing level test.

c) Do you have any views on the proposed process for the Tax Review?

We struggle to see the benefit of another review process, especially where the customer could end up worse off as a result. The regulatory tax figures would have been reviewed by the GDN, Ofgem and a third-party audit. The corporation tax figures will have been reviewed by the GDN, third-party tax advisors, and HMRC. Another review will come at a cost but with little benefit, other than stating that there are differences between tax for regulatory purposes and per tax legislation.

d) Do you have any views on the proposed board assurance statement?

We can provide the statement but only on the basis that complete and clear guidance of what is expected, and the assurance sought is given (the RFPR template which the reconciliation is thought to be based on is not the clearest document to a user. Due to the multitude of differences between the two systems, this could be a highly complex reconciliation.

Return adjustment mechanism questions

FQ18 Do you agree with our proposal to introduce a symmetrical RAMs mechanism as described above?

Ofgem states that “The aim of the inclusion of RAMs in RIIO-2 is to provide protection to consumers and investors in the event that network company returns are significantly higher or lower than anticipated at the time of setting the price control” and “The introduction of RAMs is necessary, as no other mechanism in the price control either separately or in combination with other mechanisms will achieve the aim set out above”. We disagree on conceptual grounds as such an ex-post adjustment contradicts the fundamentals of incentive regulation and is a major step towards the rate of return regulation, which has been proved as flawed and inefficient.

It appears that doubts in Ofgem’s own ability to set the price control correctly stem from the “legitimacy” concerns that some stakeholders have raised about the level of outperformance and returns achieved by some companies in RIIO-1. It is worth reminding in this regard that double-digit returns for the most efficient companies had been a feature of the design of RIIO-1 and were explicitly anticipated by Ofgem from the outset.

Two policy decisions were key contributors that allowed even poorer performing companies to earn relatively high returns in RIIO-1. In GDRPC1 the Repex allowance was adjusted to match the actual volume and mix of workload delivered. This was removed in RIIO-1, but is being reintroduced through a PCD in RIIO-2. Between Draft Determination and Final Determination for RIIO-1, hundreds of millions of pounds was added back into allowances for less efficient companies. Without just these two factors the spread of RORE across the companies would have more correctly reflected the different levels of efficiency companies are delivering, which has been highlighted in the RIIO-2 benchmarking. Furthermore many other features of RIIO-1 which contributed to the so-called “windfall” outperformance in RIIO-1 are being changed in the regulatory framework for RIIO-2.

Therefore, the stated aim of protecting consumers and investors from the regulatory flaws could have been justified in a counterfactual scenario if all of the features of RIIO-1 which led to the above concerns were to be preserved in RIIO-2. However, from the Draft Determinations, it is very clear that Ofgem has corrected the errors of the past and completely re-calibrated the regulatory framework for RIIO-2.

Among the main changes from RIIO-1 are indexed RPEs, the 85% percentile used in benchmarking, demanding ongoing productivity assumptions, the absence of IQI interpolation, greater emphasis on PCDs and UMs which leads to, in effect, an ex-post determination of 50% of Totex, lower sharing factors, weaker-powered incentives, etc. We don’t think there is a reason to believe that these regulatory mechanisms, particularly when taken in the round, do not provide sufficient protection to consumers and RAMs should be introduced on top of them.

We maintain that an overarching ex-post return adjustment mechanism is harmful to consumers in principle. It undermines the very foundation of the incentive-based regulation, weakens incentives to innovate and improve efficiency, erodes investor confidence. No other UK regulator decided to introduce such a mechanism and Ofgem should consider removing it from the regulatory toolbox.

FQ19 Do you agree with our proposal to introduce a single threshold level of 300 basis points either side of the baseline allowed return on equity?

Without prejudice to our disagreement with RAMs on principled grounds (see our response to FQ18), it appears very unlikely that any company would be able to outperform by 300 basis points or more given the calibration of the RIIO-2 financial package and the major changes Ofgem has proposed to make in the regulatory framework. From this perspective, an upside threshold of 300 bps appears sensible, but nonetheless arbitrary as no methodology has been set out of how this number was derived.

However, we believe that the re-calibrated framework creates a substantial probability of potentially significant underperformance. Therefore, should Ofgem decide to implement RAMs regardless of the concerns raised, a downside threshold level of 300 bps would not allow to protect companies from a distinct possibility of becoming non-financeable as a result of incorrect /overstretched calibration of the price control.

To enable companies to fulfil the licence obligations and avoid potential defaults on debt interest payments, the lower bound of their returns should not be below the allowed Cost of Debt. With the proposed single threshold of 300 bps either side of the baseline allowed return on equity, this imperative may not be fulfilled and therefore needs re-calibrating. By way of illustration, if Ofgem were to retain its Cost of Equity assumption at 3.95% and the Cost of Debt allowance at 1.74%, the threshold of RAMs should be set at 221 bps on the downside of the allowed return on equity as opposed to 300 bps threshold on the upside.

FQ20 Do you have any other comments on our proposals for RAMs in RIIO-2?

Ofgem dismissed the concerns raised about an overlap between the return adjustment mechanism and the Outperformance Wedge on the grounds that each proposal is intended to achieve separate policy goals that cannot both be met by either one of them. Without prejudice to our belief that policy goals for both of these two mechanisms are not in the customers' interests, it appears that duplication between the two mechanisms even if not probable in RIIO-2 is entirely possible in the future. It will depend on the calibration of the RAM thresholds and the quantum of adjustment of the allowed returns, should either of these levers stay in the framework. Ofgem states that RAMs are intended to operate only as a failsafe mechanism when ex-post outturns deviate

substantially from ex-ante expectations, but it does not define the term “substantially”: there is no clear methodology of how the current 300 bps threshold has been derived or how Ofgem intends to estimate it for the following price controls.

Ofgem proposed that any adjustments under RAMs are made following the closeout of the relevant RIIO-2 price controls and reflected in company revenues in RIIO-3. Given the increased complexity of the regulatory framework in RIIO-2 and the introduction of a number of regulatory mechanisms with ex-post adjustments (e.g. NARM, PCDs, UMs) the finalised value of RIIO-2 close-outs would not be known by the start of RIIO-3. Therefore, under this proposal, the final revenue in any given price control would not be defined until after a few years has passed from the previous one, which would introduce additional uncertainty and risk, invalidate ex-ante financeability assessment and create customer bill volatility.

FQ21 Do you agree with our proposal to implement CPIH inflation?

Yes, we support the introduction of CPIH from the start of RIIO-2.

FQ22 Do you agree with our proposals, including the policy alignment for GT and GD, and to recover backlog depreciation for GT RAV additions (2002 to 2021) over 20 years from the start of RIIO-2?

This has no direct implication for GD but we understand the logic used to align GT to GD.

FQ23 Do you agree with our proposed assumptions for capitalisation rates?

We agree with the proposed assumptions on capitalisation rates, though note these will need to be updated at Final Proposals based on the final allowances.

FQ24 For one or more of the aggregations of totex we display in Table 40, should we update rates ex-post to reflect reported outturn proportions for capex and opex?

Logically it makes sense to update capitalisation rates ex-post because of the increased use of Uncertainty Mechanisms which could materially impact the outturn capitalisation rate. However, this could increase Revenue volatility which would not be welcomed by Shippers and Suppliers.

Besides setting the rates on an ex-ante basis ensures networks are ambivalent to whether they implement an operating cost or capital cost solution, which should deliver the best long term outcome for consumers. This was the reason ex-ante rates were introduced for RIIO-1.

On balance, therefore, we would support setting capitalisation rates on an ex-ante basis only.

RAV opening balance questions

FQ25 Do you agree with our proposal to use the closing RIIO-1 RAV balances as opening balances for RIIO-2?

Yes, but the opening position should include actual Totex for 2019/20 from this year's RRP process and also the latest Totex forecast for 2020/21.

FQ26 Do you agree with our proposal to use estimated opening RIIO-2 balances until we have finalised the closing RIIO-1 RAV balances?

Yes, as per FQ25 but to include actuals for 2019/20 and the latest forecast for 2020/21 from the RRP process.

RIIO-1 close-out questions

FQ27 Do you agree with the three categories of adjustments outlined below?

Whereas we agree that the areas outlined all need resolving post RIIO-1, the existing PCFM was designed to capture many of them in accordance with the licence conditions and the financial model handbook. The incentives are all captured by the annual Revenue RRP, again in accordance with the licence. Putting the actuals for 2019/20 and forecasts for 2020/21 into these existing processes should allow a RIIO-2 opening position to be established. All of these models will then need to be updated with 2020/21 actuals when available to ensure the RIIO-1 licence conditions are met.

The key areas that need to be resolved are the uncertainty mechanisms, NOMs, asset disposals. Treatment here is not clear and this needs to be resolved as soon as possible.

FQ28 Do you agree with our approach in using estimated values for closeout adjustments until we are able to close out the RIIO-1 price controls?

Yes, as outlined in our response to FQ27 above, we support the use of forecast values and the use of the PCFM and Revenue RRP which were introduced and follow the licence to manage this process.

However, at this stage, it is unclear how the impact of COVID-19 will be treated here, in particular for areas where we potentially may not deliver all planned workload, such as Repex.

Disposal of assets questions

FQ29 Do you agree that proceeds from the disposal of assets during RIIO-2 should be netted-off against totex from the year in which the proceeds occur?

Yes, as part of the Annual Iteration Process.

FQ30 Do you agree that we should carry out a review where an asset is transferred to a holding company and then subsequently sold to a third party?

Yes, we believe a review would be appropriate to establish the circumstances and implications for the company and the customer.

Time value of money questions

FQ31 Do you agree with our proposal to apply one interest rate to revisions to PCFM inputs and charging errors, based on a short-term cost of debt?

We can see the merits applying a single rate from the point of view of simplicity, particularly given the modest values likely to be involved. It would reduce administrative time and cut the risk of error.

Nevertheless, we think there is justification for using a different rate depending on whether the adjustment is positive or negative:

- Ofgem considers the time value of money to be the “marginal cost of capital for revenues switched between years during the price control”. That marginal cost will vary depending on whether the network has more cash than planned for or has to borrow more to cover a cash shortfall;
- As a net borrower, an efficient network is likely to try to minimise cash balances and use facility drawings to manage working capital;
- A positive adjustment implies a network having received less cash than originally planned, such shortfall having been funded with debt. Applying an interest rate based on marginal borrowing costs would therefore be justified, and
- Conversely where a negative adjustment is required the implication is that the network has benefited from unexpected additional cash which will have been placed on deposit. In that case, the application of an interest rate based on deposit rates would be fair.

In our view, the foregoing should only apply to PCFM adjustments that are short-term in nature (i.e. where the cash flows have moved in time versus expectation by no more than two years). This would include incentives.

FQ32 Do you agree with the margin-based approach, and the methodology used to calculate a margin of 110bps?

Notwithstanding our answer to FQ31 in relation to negative adjustments, for positive adjustments, we are comfortable with both the margin-based approach and the methodology used to calculate the relevant margin.

FQ33 Do you have any reason why the marginal cost of capital for revisions to PCFM inputs and charging errors should remain distinct from each other, or why WACC may remain a more appropriate time value of money for a particular subset of prior year adjustments?

For any adjustments relating to RAV (as opposed to revenue) we believe that WACC would be a more appropriate measure of the time value of money given the longer-term implications of the value of RAV at any point in time. These might include instances where a network incurs expenditure which will not be recognised in revenue later in the RIIO-2 period or until RIIO-3 or conversely where a network is not incurring previously anticipated expenditure.

Revenue forecasting questions

FQ34 Do you agree with our proposal to include forecasts for most PCFM variable values for the purposes of the AIP?

We do not support including forecasts for all variable values for the AIP. We don't agree this would reduce the magnitude of true-ups and streamline reporting. The final true-up will be the same under any process, and using forecasts means you still have to true-up to the final actuals when they are available. Using forecast introduces more steps into the process, which may well introduce more unit price variability.

The current process was set up after consultation with the industry and in particular feedback from gas shippers, who require advance warning over GDN charges to set their forward looking prices and contracts. Currently they receive two years' notice of any change allowing them to factor this into customer rates well in advance.

If forecasts were introduced reducing this two-year window, shippers are likely to raise a 'Mod' for GDN's to set prices 15 months in advance. Under this scenario Allowed revenue would be calculated on a rolling forecast basis but Collected revenue would be set based on unit rates 15 months ago, a clear mismatch which places an unfair burden on GDNs to manage cash flow and financeability under the proposed RIIO-2 overall package.

FQ35 Considering re-openers as set out in these Draft Determinations, do you agree with our proposal to exclude them from any forecasting? If not, please submit

specific examples or analysis of the potential materiality of actual spend versus initial allowances.

We do not support introducing forecasting into the AIP as discussed in our response to FQ34. This applies equally to reopeners. These should be added into the PCFM when Ofgem and the GDNs have been through the appropriate consultation process, via the AIP.

FQ36 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?

It is clear that this issue needs to be considered from the viewpoint of customers and stakeholders and not companies or Ofgem.

In our extensive engagement with customers and stakeholders, we have received no feedback that reporting of this nature was required, preferable or would add value to their view of the company's performance or the regulatory framework. We note that Ofgem have only cited one stakeholder supporting this case. Against this relative paucity of feedback from customers, it is difficult to assess whether this would add value to the framework.

Our interpretation of the feedback we have received from customers and stakeholders is that the legitimacy of the framework resides firmly in the core value for money proposition. That is whether customers are receiving exceptional levels of service for the lowest possible cost/bill. This is what we believe customers and stakeholders will hold both the companies and Ofgem (as their agent in this arrangement) to account to deliver.

The issue of executive pay and reward we recognise as being an emotive issue for some stakeholders. However, executive pay and reward is not an homogenous issue. The scale and scope of individual company executives' remuneration will vary considerably from business to business and there is a danger that attempting to benchmark across companies and sectors will lead to some spurious or incorrect conclusions. We would not want that issue to detract from the core value proposition as outlined above. We are also cautious about creating another reporting requirement that is not clearly defined and adds to the very long list of such requirements that have been introduced without detailed consideration, fail to address the key issue but are never withdrawn or amended.

We would encourage Ofgem to be very clear about the level of stakeholder support that truly exists for reporting of this type of information and to be able to cite this directly. We have not seen the evidence to support the disclosure of this additional information being a key requirement of stakeholders.

On the issue of the annual publication of a company's stated dividend policy we are pleased to see that Ofgem have reached a more appropriate position going forward.

Base Revenue definition and ODI cap/collar questions

FQ37 Do you agree with the proposed definition of Base Revenue?

The main adjustments proposed are to add in other 'pass-through' items and remove tax. Whereas we would agree that the tax allowance is a secondary effect once the other elements of base revenue have been accounted for, we are not sure this is an appropriate reason to remove it from base revenue. The principle of having a base revenue was to show the amount of revenue we would earn prior to any outperformance, incentives etc, and that the annual iteration process and our revenue submissions would then trace this through to our actual income earned. The tax allowance is a core part of our income and excluding it may lead to confusion about the final level of revenue we can earn. It also appears likely it will introduce more steps in the process which aren't necessary to arrive at a final revenue value.

The other 'pass-through' items are very minor for NGN, mainly made up of Third Party Damage and Water Ingress, which is difficult to predict and forecast. For these reasons, it was previously excluded, but we have no issue with it being added in.

FQ38 Do you agree with the proposal to fix the values used for ODI caps and collars at final determinations?

We agree with this proposal as it ensures predictability, and that it should be based on the annual average Base Revenue over RIIO-2