Consultation

RIIO-ED2 Sector Specific Methodology Consultation: Annex 3 - Finance			
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The next electricity distribution price control (RIIO-ED2) will start in April 2023. We are consulting on the methodology we will use to set this price control.

This document sets out our finance proposals in relation to RIIO-ED2. This document is an Annex to the RIIO-ED2 Sector Methodology Consultation Overview document and should be read alongside it.

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1. Introduction

1.1 The costs of operating and developing the electricity distribution networks include the financing costs that they incur. These include the returns that we allow for debt and equity investors. We use incentives to encourage companies to drive down costs and improve service quality. These incentives mean that a company's actual return can be higher or lower than its allowed return.

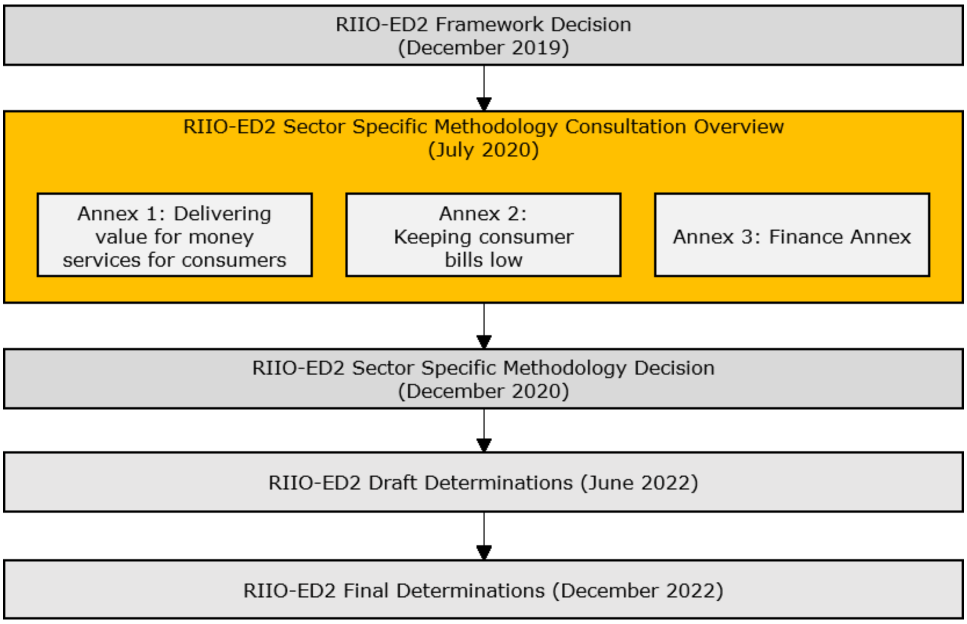
1.2 In this annex we describe and seek views on our proposed approach to setting a number of financial parameters, including:

- allowed return on debt,
- allowed return on equity,
- our approach to financeability,
- our approach to corporation tax,
- indexation of RAV and calculating returns, and
- a number of other finance issues.

1.3 We also seek views on our proposed approach to implementing return adjustment mechanisms to protect against lower or higher than expected returns.

1.4 This document forms part of our consultation on the sector methodology that we intend to apply to the RIIO-ED2 price control and this is illustrated in Figure 1 below.

Figure 1: RIIO-ED2 Sector Methodology document map



2. Allowed return on debt

Background

2.1 The cost of debt allowance is an estimation of the return debt investors expect from an efficiently run company (including both embedded debt raised prior to the price control period and new debt raised during the price control period). The current RIIO-1 price control sets an allowance for debt costs using a published benchmark index of bond yields. We assume that our notional company can borrow at a rate consistent with this benchmark index. We refer to this approach as full indexation. We consider that it has been successful in reducing forecast errors compared to previous approaches, thus reducing consumer bills.

2.2 In the RIIO-ED2 Framework Decision[1], we confirmed that we would retain full debt indexation for RIIO-ED2. We said that our view is that there are no compelling reasons to reach different conclusions for the ED sector[2], and that full indexation aligns with the principles set out in the Framework Consultation in March 2018[3].

2.3 We set out our consideration of the relative benefits of partial and full indexation (as well as also considering debt sharing) in the Gas Distribution and Transmission (GD&T) Sector Specific Methodology Decision (SSMD)[4], and consider that these same considerations are valid for RIIO-ED2.

2.4 In our view, full indexation has the following benefits:

- it references relevant independently produced benchmarks
- it provides a single allowance that covers both embedded debt and new debt
- it adjusts annually to capture changes in market conditions, thereby adjusting for the likely changes to costs of raising new debt
- it is transparent and simple
- it can be calibrated to provide a good estimate of efficient debt costs
- it strongly incentivises networks to prudently and efficiently manage debt costs, which should benefit consumers as this is factored into the calibration for subsequent price controls

[1] https://www.ofgem.gov.uk/system/files/docs/2020/01/riio-ed2_framework_decision_jan_2020.pdf, 2.127
[2] Ibid, 2.128-2.129
[3] https://www.ofgem.gov.uk/system/files/docs/2018/03/riio2_march_consultation_document_final_v1.pdf, 7.11
[4] https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_finance.pdf, 2.15-2.40

2.5 As regards the index used and how it is calibrated in RIIO-ED1, the debt allowance is calculated using a trailing average of bond market indicators (using daily data for the unweighted average of iBoxx A and BBB rated non-financial corporate 10+ year bond yields, deflated by forward inflation implied in gilt yields). The length of the trailing average lookback period extends by one year each year from a 10-year to a 20-year trailing average. The averaging period starts on 1 November 2004 and ends on 31 October 2014 for 2015-16 (10 years) and the end of the averaging period will increase by one year each year, (i.e. the length of the lookback period increases each year of the price control), until the period length reaches 20 years (which, if continued, would extend into RIIO-ED2)[5].

2.6 WPD are the exception in RIIO-ED1 as they were fast tracked and were therefore given the same index calibration as electricity transmission, gas transmission and gas distribution sectors were for RIIO-1, which was a 10-year trailing average of historical rates. The majority of Distribution Network Operators (DNOs) therefore currently have a different debt allowance index calibration to electricity transmission, gas transmission and gas distribution sectors in RIIO-1.

Proposed approach for RIIO-ED2

2.7 As for the GD&T sectors, for RIIO-ED2 we propose an approach to calibrating the index that involves comparing forecast pooled network debt costs to potential calibration options. To do this we require more information from the companies, including information on the companies' plans for investment in their networks. This is expected to be provided in their business plans. After we have business plan information, we will assess expected pooled debt costs against expected allowances. We expect to set out the proposed debt allowance calibration for RIIO-ED2 at Draft Determinations in June 2022.

2.8 For business plan working assumption purposes, we are considering whether it would be more appropriate to use either a) an assumption based on the aforementioned RIIO-ED1 (10-20 year trailing average) approach, b) an assumption based on the cost of debt calibration proposed for GD&T networks (10-14 years), or c) another calibration.

[5] https://www.ofgem.gov.uk/ofgem-publications/91564/riio-ed1finaldeterminationoverview.pdf

2.9 The following paragraphs set out our proposals on index selection, additional costs of borrowing and deflating nominal iBoxx index yields to provide a CPIH real allowance.

2.10 In terms of index selection, we propose using the iBoxx Utilities 10yr+ index (ISIN reference DE0005996532) rather than the indices used in RIIO-1. Our view is that this provides a better match to network company debt costs for the reasons set out in GD&T Draft Determinations[6]. We consider this rationale applies for RIIO-ED2 because the analysis comparing issuance credit spreads to iBoxx index credit spreads included ED company issuance.

2.11 We have also recently considered additional costs of borrowing that may not be captured by an index of bond yields[7]. Our estimate of these costs is set out in Table 1.

Table 1: Ofgem estimate of additional costs of borrowing

	Ofgem Estimate	Estimate Basis
Transaction Costs	6bps	Based on NERA data but excludes one outlier
Liquidity/RCF cost	3 - 5.5bps	Based on RFPR and group account data about actual RCF holdings. Also supported by assumption of 10% RCF
Cost of carry	1.5 – 11bps	Based on RFPR and group accounts data on cash on balance sheet8
Total	17bps	Mid-point of the range, rounded to nearest basis point.

2.12 We invite stakeholders' views on the Ofgem estimates set out in Table 1 as it may be relevant to calibrating the allowance for RIIO-ED2 (because the basis of the Ofgem estimate included ED network data). However, as we are not at this stage

[6] https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_finance_annex.pdf, 2.8-2.17
[7] https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_finance_annex.pdf, 2.18-2.20
[8] There is a wide range in our estimate for cost of carry because the underlying data represented a broad range of cash held on balance sheet across networks and network group companies. The low represents the median of just regulated network data (a median is less distorted by exceptional years), and high represents the mean of a mixture of regulated network data and group data, with a higher 75% weighting given to regulated network data as group data is often for group businesses managing not only regulated monopoly businesses but also more cyclical business with higher cashflow volatility. The range of cash on balance sheet divided by debt was then multiplied by the 5yr average difference between the iBoxx index and the 3m deposit rate. This analysis may need to be reviewed closer to Draft and Final Determinations for any material changes.

proposing a debt allowance index calibration for RIIO-ED2, we will keep this under review until after business plan submissions.

2.13 We propose converting nominal iBoxx Utilities 10yr+ index yields to CPIH real allowances using a long term CPIH forecast and the Fisher equation[9]. We consider that the rationale set out in the GD&T Draft Determinations[10] also applies to RIIO-ED2 as we do not consider there to be any sector-specific reasons to apply a different conversion methodology.

2.14 As there are no long-term forecasts of CPIH available, we propose using the OBR 5yr forecast of CPI (as a reasonable proxy for CPIH) to deflate nominal index yields to a CPIH real allowance. If, prior to or over the course of RIIO-2 the Office for Budget responsibility (OBR) begins to produce long term forecasts for CPIH, we propose to switch to using OBR 5yr CPIH forecasts.

Allowed return on debt questions

2.15 We welcome stakeholder views on our debt allowance proposals, in particular on the following questions:

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

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

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

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

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

[9] CPIH real = (1+nominal yield %)/(1+CPIH inflation assumption %) - 1

[10] https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_finance_annex.pdf, 2.74-2.77

3. Allowed return on equity

Background

3.1 The baseline allowed return on equity is a significant part of the price control settlement. It is heavily influenced by the cost of equity, which itself is an estimation of the return that equity investors expect. Both the cost of equity and the allowed return on equity are important because the energy sector requires investors that are willing to invest in utility infrastructure to meet consumer needs. UK regulators normally estimate the cost of equity using the Capital Asset Pricing Model ('CAPM').

3.2 The allowed return on equity during RIIO-ED1 reflects Ofgem's assessment of RIIO-1 business plans, with WPD's baseline allowed return on equity of 6.4% (RPI-real)[11] reflecting its 'fast-track' status, while 'slow-track companies' have a baseline allowed return on equity of 6.0% (RPI-real).[12]

3.3 In July 2018, at the RIIO-2 framework stage for GD&T, we made various decisions, including:[13]

- We would use CAPM to estimate the cost of equity
- We would estimate the risk-free rate by using the current yields on long-run index-linked government debt
- We would not rule out equity indexation
- We would estimate the expected market return by considering the historical long run average of market returns alongside forward looking measures
- We would investigate further the issues involved in the estimation of beta for network companies, based on issues highlighted in the UKRN Report. We also said we would look deeper at the relationship between gearing and beta risk
- We would distinguish between the regulatory allowed return and the regulatory expected return
- We would cross-check the outcome of the CAPM calculation against Market to Asset ratios (MAR) and returns bid by investors (eg against OFTOs)

[11] https://www.ofgem.gov.uk/sites/default/files/docs/decisions/decision_on_equity_market_return_methodology.pdf#page=5
[12] https://www.ofgem.gov.uk/ofgem-publications/92249/riio-ed1finaldeterminationoverview-updatedfrontcoverpdf#page=40
[13] https://www.ofgem.gov.uk/system/files/docs/2018/07/riio-2_july_decision_document_final_300718.pdf#page=56

3.4 The December 2018 GD&T SSMC[14] provided an opportunity for the DNOs to submit views on the equity methodology, which we addressed in the SSMD[15] (see, for example, views submitted by WPD, ENWL, UKPN, NPG). In the July 2019 GD&T SSMD, we decided to implement equity indexation and to use a three-step methodology for calculating the allowed return on equity. The methodology we described included four cross-checks within Step 2, and distinguishes between allowed and expected returns within Step 3. The methodology can be summarised as follows[16]:

- Step 1 – Estimate the cost of equity using the CAPM
- Step 2 – CAPM cross-checks
- Step 3 – Distinguish between expected and allowed returns

3.5 This methodology is therefore broader than CAPM. Step 2 allows a broader set of information to inform the cost of equity estimate. Step 3 reflects our view, which is informed by the UKRN Report[17], that the cost of equity should not necessarily equal the baseline allowed return, because investors can also expect outperformance from price control incentives.

3.6 The August 2019 RIIO-ED2 Open Letter provided a further opportunity to capture views for ED stakeholders.[18] Based on responses to this consultation, the December 2019 Framework Decision stated our view that there were no compelling reasons to reach different conclusions for the ED sector, in terms of the equity methodology, that we reached for the GD&T sectors.[19] We therefore decided to set the baseline allowed return on equity using the same methodology that we use for the GD&T sectors.[20] In our development of the methodology as part of Draft Determination for GD&T we have found the three stage methodology proves flexible in application and can be tailored to ED sector circumstances as necessary.

[14] https://www.ofgem.gov.uk/system/files/docs/2018/12/riio-2_finance_annex.pdf
[15] https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_finance.pdf
[16] https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_core_30.5.19.pdf#page=121
[17] See for example section 8 of the UKRN Study: https://www.ukrn.org.uk/wp-content/uploads/2018/11/2018-CoE-Study.pdf#page=68
[18] https://www.ofgem.gov.uk/system/files/docs/2019/08/open_letter_consultation_on_the_riio-ed2_price_control.pdf#page=27
[19] https://www.ofgem.gov.uk/system/files/docs/2020/01/riio-ed2_framework_decision_jan_2020.pdf#page=45
[20] Ibid

Proposed approach for RIIO-ED2

3.7 We set out additional detail in the July 2020 Draft Determinations for the GD&T sectors, including on Step 1, Step 2, and Step 3. In particular, Draft Determinations for GD&T presents updated analysis for Step 1, including estimating asset and equity beta, and risk benchmarking. We also include other cross-checks within Step 2 and a refined approach to estimating expected outperformance in Step 3.[21]

3.8 At this stage we seek views from ED stakeholders as to whether the proposed approach for GD&T would equally apply to the ED sector. We recognise that, for example, it could be argued that for systematic risk, the estimation approach should differ for the ED sector. We therefore welcome views on how we could best estimate the systematic risk of the ED sector. Further, there may be cross-checks that work better for the ED sector, or there may be improvements that ED stakeholders could highlight in terms of estimating expected outperformance.

Allowed return on equity questions

3.9 We welcome stakeholder views on the following questions:

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

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

[21] https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_finance.pdf#page=30

4. Financeability

Background

4.1 Ofgem has a duty to have regard to the need to secure that companies are able to finance the activities which are the subject of obligations imposed by or under the relevant legislation. Most regulated utilities raise debt finance by issuing bonds in the capital markets. In addition, the companies have licence requirements to take all appropriate steps within their power to maintain an investment grade credit rating. These ratings are issued by firms called rating agencies.

4.2 An investment grade credit rating signals a strong likelihood that the licence holder will be able to meet its liabilities and keeps the cost of debt low for networks. In turn, this keeps network charges low for consumers.

4.3 Rating agencies use different methodologies for how they determine credit ratings. Among other things (including the stability and predictability of the regulatory regime), rating agencies use certain financial ratios (or credit metrics) to inform their rating of companies. One type of credit metric, for instance, is the interest cover ratio, which measures the cashflow available to companies to make interest payments to debtholders. All else being equal, a high interest cover ratio implies a company can comfortably service its debt, and can be awarded a strong credit rating.

4.4 If the cost of debt and the cost of equity moved in step together, there should, in principle, be little impact on credit metrics across time. However, if the cost of debt falls more slowly than the cost of equity (for instance, because of historical contracted liabilities), then the reduction to company cashflows due to a lower cost of equity may affect its ability to make interest payments. In the absence of some offsetting action from the companies or Ofgem, this could impact company credit quality.

4.5 The ED-2 Framework Decision made reference to the following design principles (among others), which are particularly relevant to financeability:

- The cost of capital allowance should be set to enable a notional efficient operator to maintain an investment grade credit rating, and generate an expected return to equity that fairly reflects the risk facing investors in the price control settlement[22].

- Notional gearing should be determined as a reference point for the notional company for the purposes of calculating the weighted average cost of capital (WACC) with consideration of the risks network companies face, rating agency views on gearing levels for investment grade regulated networks, balancing an appropriate cost of capital and the impact medium term market conditions have on debt servicing[23]
- The depreciation allowance (the rate at which the regulated asset value (RAV) is 'repaid' to investors) should be set, so that different generations of consumers pay for network services broadly in proportion to the value of the services they receive, whilst having regard to balancing affordability, financeability and the interaction between depreciation and capitalisation[24].
- The capitalisation rate (the proportion of totex that is added to the RAV each year) should reflect the broad balance between capital and non-capital expenditure (as forecast at the start of the control period), whilst having regard to balancing affordability, financeability and the interaction between depreciation and capitalisation[25].

4.6 We use a financeability assessment as a last check that, when all the individual components of our determination are taken together (including totex, allowed return, notional gearing, depreciation and capitalisation), a notional efficient operator can generate cash flows sufficient to meet its financing needs.

Proposed approach for RIIO-ED2

4.7 For RIIO-ED2, we propose to align our approach to financeability with the approach set out in our GD&T SSMD[26]. This involves a focus on the notional company, with a detailed review following receipt of business plans. We do not consider there to be any sector specific reasons to take a different approach to assessing financeability for RIIO-ED2. This does not mean that we will make the

[22] https://www.ofgem.gov.uk/system/files/docs/2020/01/riio-ed2_framework_decision_jan_2020.pdf, page 66, Design principle 15
[23] Ibid, Design principle 16
[24] Ibid, Design principle 20

[25] Ibid, design principle 21
[26] https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_finance.pdf, 4.99

same proposals as we have for the other sectors, but that the approach to assessing financeability would be consistent.

4.8 In particular the GD&T SSMD Finance Annex[27] sets out the actions network companies could take to address any financeability concerns:

- dividend policies can be adjusted to retain cash within the ring-fence during the RIIO-1 or RIIO-2 period
- equity injections can be used to reduce gearing
- expensive debt or other financial commitments could be re-financed
- network companies can propose alternative capitalisation rates and/or depreciation rates, if appropriate
- adjust notional gearing.

4.9 We consider that these actions could also be taken by DNOs to address financeability concerns as we do not consider any of them to be sector specific.

4.10 As for GD&T[28] we propose that DNOs assess financeability, including running a common set of stress test scenarios[29], in their business plans and provide assurance in final business plans on their notional and actual company financeability. We propose that the GD&T Ofgem suggested stress tests scenarios could also be applied to RIIO-ED2 business plans as we do not consider there to be any sector specific reasons to run different stress test scenarios.

4.11 Our GD&T financeability assessment has led to some proposed notional gearing reductions compared to RIIO-1; our GD&T Draft Determinations sets out our process for assessing the potential requirement for reductions[30]. We welcome stakeholder views on whether this may be appropriate for the ED sector and/or whether the other potential financeability measures as set out in 4.8 could be used in addition or instead.

Financeability questions

4.12 We welcome stakeholder views on our proposals in respect of financeability, including the following questions:

[27] https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_finance.pdf#page=79, para 4.5
[28] Ibid, 4.99
[29] GD&T Ofgem suggested scenarios are set out in Table 19 of the GD&T SSMD
[30] https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_finance.pdf, 5.48

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

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

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

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

5. Financial Resilience

Background

5.1 We have consistently said[31] that networks are able to determine the appropriate actual capital structure for their own circumstances, so it is possible that individual actual network credit quality may be different to our assessment of notional company credit quality.

5.2 In our view, it is companies and their investors rather than consumers that should bear the risk of a company's choice of its actual capital structure to the extent that it departs from the notional capital structure.

5.3 Although we propose (in 4.7) to assess our price control with reference to the notional efficient operator, we also have an ongoing interest in networks' financial resilience as any financial failures could, in extremis, have negative consequences for consumers.

5.4 We therefore believe it is appropriate for us to bolster our checks and balances on credit quality and financial resilience. We believe some changes are required to assist us in monitoring the credit quality of all licensees and to clarify upfront the reporting expectations for networks whose actual issuer credit ratings fall materially below those generally expected for the notional company.

5.5 To address this, we invite stakeholder views on including in RIIO-ED2 a requirement for licensees to provide to Ofgem a) published rating reports, where possible, and b) a financial resilience report if their issuer credit rating falls to BBB/Baa2 (or equivalent) and is placed on negative watch (or is downgraded directly to a lower rating without first being placed on negative watch).

5.6 We would expect any such financial resilience report to be provided within 60 days[32] of the rating action and to include the following:

[31] For example, https://www.ofgem.gov.uk/ofgem-publications/89072/riio-ed1draftdeterminationfinancialissuespdf, 3.19
[32] This is our proposed timeframe, which we consider reasonable, but we are open to alternative proposals from stakeholders.

- an assessment of the licensee's current and forecast financial standing, including an assessment of resilience to downside scenarios relating to either operational performance or macro-economic events;
- financial projections[33] for the following three Regulatory Years or the remainder of the Price Control Period, whichever is longer; and
- details of potential mitigating actions the licensee could take to improve its financial resilience and an indication of whether such actions are planned.

5.7 We believe the provision of such reports will assist Ofgem in monitoring the financial resilience of companies and will provide us with valuable information on networks' considerations of and plans for mitigating financial resilience challenges.

Financial resilience questions

5.8 We welcome stakeholder views in respect of financial resilience, including the following question:

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

[33] To include forecast financial metrics and results of stress tests

6. Corporation tax

Background

6.1 In RIIO-ED1, a financial model is used to calculate a tax allowance on a notional basis, as a proxy for efficient corporation tax costs, for each of the relevant licensees.

6.2 The RIIO-ED1 allowance is supplemented by two specific uncertainty mechanisms:

a) A tax trigger mechanism that reflects changes in tax rates, legislation and accounting standards; and

b) A tax clawback mechanism that claws back the tax benefit a licensee obtains as a result of gearing levels that are larger than assumed.

6.3 In the May 2019 GD&T SSMD Finance Annex[34], we decided to retain the three options for tax allowances we had consulted on for further consideration as part of our assessment of business plan submissions. These were:

- Option A – Notional allowance with added protections
- Option B – Pass-through for payments to HMRC
- Option C – The "double-lock": the lower of notional (Option A) and actual (Option B)

6.4 In the July 2020 GD&T Draft Determinations[35] we proposed Option A for the GD&T sectors and explained the additional protections we considered necessary for the GD&T sectors, including how these would work in practice, including:

- Tax trigger
- Tax clawback
- Tax reconciliation
- Board assurance statement, and
- Tax review.

[34] https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_finance.pdf#page=103
[35] https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_finance.pdf=page=123

6.5 We also made proposals for capital allowances rates and the Fair Tax Mark. For capital allowances rates, we proposed to make allocation rates and tax rates variable values to enable updates during the price control, and we proposed how we would estimate opening balances. We also proposed not to pursue the Fair Tax Mark certification as a requirement for RIIO-2.

Proposed approach for RIIO-ED2

6.6 For RIIO-ED2, we propose to align our corporation tax approach with that proposed in the RIIO GD&2 Draft Determinations, as proposed in July 2020.[36] We therefore refer ED stakeholders to those proposals. Our current view is that we see no reason to treat the ED sector differently from the GD&T sectors. We believe aligning our approach is reasonable because the rationale set out in the GD&T Draft Determinations, in support of Option A, also holds true for RIIO-ED2. This reflects our view that the main motivation for additional protections, to improve transparency, will be as beneficial for ED as it will be for the GD&T, and that there are no distinct features of the ED sector that warrant a different approach to capital allowances or the Fair Tax Mark. Additionally, the treatment of network companies by HMRC for corporation tax purposes does not differ on a sector-by-sector basis.

Corporation tax questions

6.7 We welcome stakeholder views on our corporation tax proposals, particularly the following questions:

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

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

[36] Ibid

7. Indexation of RAV and calculation of allowed return

Background

7.1 For previous price controls, including RIIO-ED1, we decided to use the Retail Prices Index (RPI) to index the RAV and to allow returns in real terms.

7.2 However, RPI is no longer seen as a credible measure of inflation.[37] The Office for National Statistics (ONS) has now adopted CPIH as the lead measure for household costs. ONS prefers CPIH as a measure of consumer prices because it is more comprehensive than CPI. CPIH includes owner occupiers' housing costs and council tax and therefore significant elements of household spend.

7.3 Other regulators are using RPI less heavily within their respective price control frameworks. In 2014, Ofcom concluded that CPI was preferable to RPI. In 2015, the Water Industry Commission for Scotland (WICS) started to use CPI. More recently, Ofwat determined in December 2017 that it would use CPIH. In March 2018, ORR proposed to use CPI instead of RPI.

7.4 In the ED2 Framework Decision[38] in December 2019, we confirmed that we would use either CPI or CPIH for inflation measurement in calculating both RAV and allowed returns.

Proposed approach for RIIO-ED2

7.5 We propose to align RIIO-ED2 with the GD&T approach. This involves implementing an immediate switch from RPI to CPIH from RIIO-ED2 onwards for the purposes of calculating RAV indexation and allowed returns. We do not see any reason to treat the ED sector differently to the GD&T sectors.

Indexation of the RAV questions

7.6 We welcome stakeholder views on our proposals in respect of RAV indexation and the calculation of the allowed return, in particular the following questions:

[37] https://www.statisticsauthority.gov.uk/archive/reports---correspondence/current-reviews/uk-consumerprice-statistics---a-review.pdf Summary and recommendations
[38] https://www.ofgem.gov.uk/system/files/docs/2020/01/riio-ed2_framework_decision_jan_2020.pdf, 2.127

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

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

8. Other finance issues

8.1 In this section we consider the following financial issues:

- Regulatory depreciation and economic asset lives
- Capitalisation rates
- Notional gearing
- Notional equity issuance costs
- Pension scheme established deficit funding
- Directly Remunerated Services
- Amounts recovered from the disposal of assets

8.2 We discuss each of these areas in turn below, outlining the relevant background, setting out our proposals and seeking stakeholder views thereon.

Regulatory depreciation and economic asset lives

Background

8.3 Our existing policy in RIIO-ED1 is to depreciate the RAV at a rate that broadly approximates to the useful economic life of the network assets and incentivises investment efficiency.

8.4 It is important to understand that, following the introduction of the totex approach in DPCR5/RIIO-1, the RAV no longer precisely corresponds to physical assets. Rather, the RAV represents simply the balance of unrecovered financial investment in the networks and also the licensee's share of incentivised out- or underperformance.

8.5 A return is paid on the RAV through the allowed cost of capital, and the RAV is repaid through depreciation allowances. Therefore, in our view the rate of depreciation should be set so that different generations of consumers pay network charges broadly in proportion to the value of network services they receive.

8.6 For RIIO-ED1, the depreciation approach is currently transitioning from a 20-year straight-line asset life (as at 31 March 2015) to a 45-year straight-line asset life (by 31 March 2023)[39]. In response[40] to the GD&T SSMC in December 2018[41], Northern Powergrid (NPg) suggested that it may be appropriate to fine tune the asset life assumption to maintain a steadier level of charges across time.

Proposed approach for RIIO-ED2

8.7 We are open to exploring further changes in the depreciation methodology in line with the principle of using economic asset lives, as set out in the July 2018 Framework Decision.[42]

8.8 We are not at this stage consulting on any ED sector-specific proposals but welcome views from respondents on ED-specific arguments relating to the useful economic lives of their assets.

Regulatory depreciation questions

8.9 We welcome stakeholder views on the following questions:

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

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

Capitalisation rates

Background

8.10 Capitalisation rates refer to the level of company expenditure paid for by consumers over time, rather than immediately.

8.11 The December 2018 GD&T SSMC proposed to consider capitalisation rates following receipt of company business plans.[43] The DNOs generally supported this

[39] https://www.ofgem.gov.uk/ofgem-publications/91564/riio-ed1finaldeterminationoverview.pdf
[40] https://www.ofgem.gov.uk/system/files/docs/2019/05/responses_f_-_r.zip See "Northern PowerGrid" folder, response to finance questions file, p25
[41] https://www.ofgem.gov.uk/publications-and-updates/riio-2-sector-specific-methodology-consultation
[42] https://www.ofgem.gov.uk/system/files/docs/2018/07/riio-2_july_decision_document_final_300718.pdf#page=49
[43] https://www.ofgem.gov.uk/system/files/docs/2018/12/riio-2_finance_annex.pdf#page=71

view, and the May 2019 SSMD confirmed the approach to review the appropriate rates after receiving business plans. The SSMD also stated that network companies should provide evidence that their proposed capitalisation rates are appropriate and justified.[44]

8.12 Reflecting this, the December 2019 RIIO-ED2 Framework Decision sets out a design principle that the capitalisation rate should reflect the broad balance between capital and non-capital expenditure.[45]

8.13 The July 2020 Draft Determinations for GD&T seeks stakeholder views on whether we should update rates ex-post to reflect reported outturn proportions for capex and opex, for one or more aggregations of totex.

8.14 We note that NpG, in response to the December 2018 SSMC, suggested that Ofgem should set a notional capitalisation rate for the ED sector.[46] NpG argued that this would reinforce Ofgem's approach of equalised incentives between different categories, because the capitalisation rate would not depend directly on network companies' own decisions to favour one type of cost over another.

8.15 However NPg's suggestion has not, thus far, been proposed by other DNOs or by the GD&T companies. We note that a single rate for the ED sector could result in undercapitalisation for some companies and overcapitalisation for others, which could have knock-on impacts on financeability. Further, in the draft determinations for GD&T, we propose capitalisation rates on a licensee specific basis. It is not clear to us that there would be significant incentive benefits to outweigh the potential drawbacks of inconsistency and inaccuracy, when comparing ED to other sectors, or when comparing DNOs with each other. We also note WPD's view that capitalisation rates should be viewed in terms of overall financeability of the companies.[47]

Proposed approach for RIIO-ED2

8.16 Therefore, we propose a consistent capitalisation policy for ED as used for the GD&T sectors such that rates reflect each licensee's proportions of opex and

44 https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_finance.pdf#page=112
45 https://www.ofgem.gov.uk/system/files/docs/2019/12/riio-ed2_framework_decision_dec_2019.pdf#page=68
46 https://www.ofgem.gov.uk/system/files/docs/2019/05/responses_f_-_r.zip See "Northern PowerGrid" folder, response to finance questions file, p25
47 https://www.ofgem.gov.uk/system/files/docs/2019/05/responses_s_-_z.zip See "WPD" folder, response to Ofgem file, p96

capex. We are also open to views on whether rates are updated ex-post to reflect outturn capex and opex proportions, for one or more categories of totex.

Capitalisation rate questions

8.17 We welcome stakeholder views on the following questions:

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

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

Notional gearing

Background

8.18 Notional gearing represents the assumed percentage of net debt to RAV for the notional company. This in turn impacts the percentages of RAV that attract debt and equity allowances.

8.19 Notional gearing was set at 65% for electricity distribution during RIIO-ED1.

Proposed approach for RIIO-ED2

8.20 There are a number of issues to be considered when setting notional gearing, including:

- cashflow volatility (as affected by totex spend and fast/slow money split, incentives and uncertainty mechanisms);
- the companies' business plans (including proposed transitional arrangements and notional equity injections); and
- financeability.

8.21 We will continue to review notional gearing in light of the riskiness of the overall price control settlement and the ability of the notional efficient company to fund its required investment and to sustain downsides. As with the GD&T sectors,[48] we

[48] As set out in https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_finance_annex.pdf, 5.37- 5.51

may consider reducing notional gearing if the notional company is not expected to exhibit sufficient headroom in credit metrics or if there are other features of the price control that would suggest lower notional gearing would be appropriate. However, we will keep this under review and invite the DNOs to assess the overall risk of their business plans and make proposals and justifications for notional gearing within business plan submissions.

Notional equity issuance costs

Background

8.22 Notional equity issuance costs are transaction costs associated with notional equity issuance during a price control period. The RIIO-1 assumption is an allowance of 5% of the value of any notional equity raised.

Proposed approach for RIIO-ED2

8.23 We propose to align our approach in RIIO-ED2 with that proposed in the GD&T Draft Determinations, which is to continue to allow 5% for equity issuance in the absence of evidence to the contrary. We propose to review this assumption after receipt of business plans, in line with the approach we have taken to the GD&T sectors: we see no current reason for a distinct approach to ED in this respect.[49]

Pension scheme established deficit funding

Background

8.24 We have a long-standing commitment to consumer funding of deficits in defined benefit pension schemes, which were generally in existence before the energy network sector was privatised. To reflect this commitment, our price controls provide a form of pass-through funding by consumers of 'Pension Scheme Established Deficits' (those attributable to service before certain specified cut-off dates).

8.25 We updated our policy on this in April 2017.[50]

[49] https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_finance.pdf#page=114
[50] Decision on Ofgem's policy for funding Pension Scheme Established Deficits

8.26 We review the allowed revenue the network companies can recover on a triennial basis and completed the last review in November 2017[51]. The next triennial review will be undertaken in November 2020 and will set the established deficit pension allowance from 1 April 2021. This review will sit outside the RIIO-2 price control review.

Proposed approach for RIIO-ED2

8.27 For the business plans, we expect ED network companies to assume pension allowances for RIIO-ED2 that reflect the outcome of the triennial review.

Directly Remunerated Services

Background

8.28 Directly Remunerated Services (DRS) are specific activities of the network companies that are settled outside of the normal regulatory price control. Companies are allowed to charge their customers directly for certain services performed. For instance, a network company may enter into a commercial agreement with a third party such as a telecoms provider to lease out unused space on its grid infrastructure for the placement of satellite dishes or pylons. The telecoms provider will then pay a rental fee directly to the network company, according to the terms of that agreement. These services are “directly remunerated” by the customer rather than through Distribution Use of System charges.

Directly remunerated services questions

8.29 We welcome stakeholder views on the following question:

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

Amounts recovered from the disposal of assets

Background

8.30 Where network assets are no longer required, network operators may dispose of or relinquish operational control, subject to consent. They may also recover from

[51] Revised pension allowance values and completion of 2017 reasonableness review

third parties any costs in respect of damage to their network. Some of these transactions can include the disposal of land.

8.31 The financial impact of disposing of assets includes the following:

- cash proceeds of sale at an arm's length transaction to a third party external to the licensee group
- transfer at an arm's length fair market value of assets within the licensee group
- cash proceeds of sale of assets as scrap
- amounts recovered from third parties, including insurance companies, in respect of damage to the network

8.32 In RIIO-ED1, the policy on the treatment of financial proceeds is that cash proceeds are netted off against totex from the year in which the proceeds occur.

Proposed approach for RIIO-ED2

8.33 We propose a continuation of the RIIO-ED1 approach for RIIO-ED2, namely that proceeds from the disposal of assets should be netted off against totex from the year in which the proceeds occur. As discussed in the May 2019 SSMD, the ED1 approach maintains incentives and is well supported by DNOs.[52]

8.34 We propose the DNOs include as part of their business plans clear forecasts of, and sufficient detail on, any asset disposals during RIIO-ED2. Further, any proposed change from the ED1 approach should be clearly explained in terms of consumer benefit.

Disposal of assets question

8.35 We welcome stakeholder views on the following questions:

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

[52] https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_finance.pdf#page=118

9. Transparency through RIIO-2 reporting

Transparency issues

9.1 We have identified two areas where we consider there could be improved transparency through reporting. These are:

- Executive pay/remuneration; and
- Dividend policy

9.2 Our focus on these two issues reflects a recommendation to Ofgem from the January 2020 National Audit Office (NAO) report on electricity networks.[53] This recommended that Ofgem should ensure network companies make it clear how much tax they pay; how executives are rewarded and how this links to quality of service for customers, and how dividend policies ensure companies remain sustainable.

Background to executive pay/remuneration and dividend policy

9.3 In our Open Letter on the RIIO-2 Framework for the transmission and gas distribution sectors in July 2017[54], we highlighted that a number of commentators (such as Citizens Advice) had drawn attention to high levels of returns and had made suggestions for reform.[55]

9.4 In the GD&T SSMD,[56] we said that that as part of dealing with the concept of legitimacy of the price control, we proposed to require disclosure of executive remuneration to a similar level to that required for UK-listed public limited companies and to require companies to publish their sustainable dividend policies.

[53] See paragraph 22d here: https://www.nao.org.uk/wp-content/uploads/2020/01/Electricity-networks.pdf#page=13
[54] https://www.ofgem.gov.uk/publications-and-updates/open-letter-riio-2-framework
[55] https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/EnergyConsumersMissingBillions.pdf
[56] https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_core_30.5.19.pdf , see paras 12.143-12.144

Executive pay/remuneration

Background

9.5 When developing the Regulatory Financial Performance Reporting (RFPR), we discussed these proposals with the companies. Concerns were expressed regarding these proposals, and as a result these were not implemented for reporting for 2018-19 or 2019-20. A summary of stakeholders' concerns is set out in the GD&T Draft Determinations[57].

9.6 However, we continue to consider there is a need for licensees to report their executive pay/remuneration and have set out our proposals and accompanying rationale in the GD&T Draft Determinations[58].

Proposed approach for RIIO-ED2

9.7 For the same reasons set out in the GD&T draft determinations, we propose to require licensees to report annually on executive roles in relation to the regulated business, and how executive pay reflects the company performance and adds value for consumers. This reporting should provide the same level of disclosure for executive remuneration for each executive director, as found in Statutory Accounts in line with the UK Corporate Governance Code, with regard to fixed pay (eg, salary, benefits, pension), variable pay (eg performance-related incentives), and additional governance (eg share ownership). This should include a narrative explaining the allocation of executive remuneration to the regulated business and how the variable pay relates to performance outcomes and benefits consumers. We will also look to introduce this as part of the RIIO-1 RFPR before the start of RIIO-ED2, consistent with any reporting by Gas Distribution and Transmission licensees.

Dividend policy

Background

9.8 We had originally proposed that companies provide details of their dividend forecasts as part of the licensees' RFPR. Stakeholders expressed concerns, so

[57] https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_finance.pdf, 11.74
[58] https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_finance.pdf, 11.77

these were not implemented for reporting for 2018-19 or 2019-20.[59] A summary of stakeholders' concerns is set out in the GD&T Draft Determinations.[60]

9.9 However, we continue to consider there is a need for licensees to report their dividend policies and have set out our proposals and accompanying rationale in the GD&T Draft Determinations[61].

Proposed approach for RIIO-ED2

9.10 As natural monopolies and regulated companies, we consider it appropriate for licensees to explain their approaches to dividends over the RIIO-2 price control period along with any factors that will influence these policies. In our view, this would provide evidence that these are in consumers' interests and would support the legitimacy of their regulatory performance and efficiency over the price control period. We propose to require licensees to report this annually. We will also look to introduce this as part of the RIIO-1 RFPR before the start of RIIO-ED2, consistent with any reporting by Gas Distribution and Transmission licensees.

Dividend policy question

9.11 We welcome stakeholder views on the following question:

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

[59] https://www.ofgem.gov.uk/publications-and-updates/direction-introduce-regulatory-financial-performance-reporting-rfpr
[60] https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_finance.pdf, 11.83
[61] https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_finance.pdf, 11.84

10. Return Adjustment Mechanisms (RAMs)

Section summary

In this chapter we propose a Return Adjustment Mechanism, before seeking views on this proposal.

Return Adjustment Mechanisms (RAMs)	
Purpose	The purpose of RAMs 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.
Benefits	Consumers and investors will benefit from the introduction of RAMs as they would be protected against the possibility of unreasonably high or low returns in the RIIO-2 price controls. RAMs would help to ensure the fairness of RIIO-2 by protecting consumers and investors against ex post overall returns from network price controls deviating greatly from ex ante expectations.

Background

10.1 In the Open Letter, we said that we intended to implement a sculpted sharing return adjustment mechanism in RIIO-ED2.[62] A sculpted sharing mechanism involves applying an adjustment to individual companies' returns if performance deviates from predetermined thresholds.

10.2 In the RIIO-ED2 Framework Decision[63] in December 2019, we confirmed that we will apply the sculpted sharing factor RAM.

Consultation position

Parameter	Consultation position
Threshold level	300 basis points either side of the baseline allowed return on equity
Adjustment rate	50% of returns above or below the threshold

[62] Open Letter, paragraph 2.136
[63] https://www.ofgem.gov.uk/system/files/docs/2020/01/riio-ed2_framework_decision_jan_2020.pdf (para, 2.127)

Parameter	Consultation position
Symmetry	RAMs will be symmetrical, allowing for adjustments for both under- and outperformance
Combined or separate totex and ODI performance	Combined totex and ODI performance

Rationale for consultation position

Overarching rationale for RAMs

10.3 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.

10.4 Through the RIIO-2 policy development process in the gas distribution and transmission sectors, we have discussed a range of options for achieving this aim. This has included: a hard cap and floor, zero sum incentives, fixed incentive pots, discretionary adjustments and anchoring. We have sought and acted upon stakeholder views on these options and believe that the mechanism that we are now proposing is the most appropriate of the options that we have considered. 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. In our view, the sculpted sharing type RAM is equally applicable in the electricity distribution sector and is also likely to be the most effective of the RAM options that we have considered.

10.5 As a mechanism for ensuring that energy consumers do not pay in full for levels of return that are only achievable by companies due to errors or information asymmetry, our RAMs proposals will further our principal objective to protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems. In developing our RAMs proposals, which include moderating the effect of returns being very low due to factors outside of companies' control, we have had regard to the need to secure that licence holders are able to finance their licensable activities.

Symmetry of the mechanism

10.6 In the development of our policy on RAMs in the transmission and gas distribution sectors, we have described the purpose of the mechanisms as being to protect against both significant levels of outperformance and underperformance. For example, we have previously said that "Our intention is that RAMs will be symmetrical and offer downside protection to investors as well as protecting consumers from higher returns."[64]

10.7 The position that we are now proposing for RIIO-ED2 is that we would introduce a symmetrical RAMs mechanism, as we believe that this represents a fair balancing of the interests of consumers and investors and is consistent with previous descriptions of RAMs mechanisms, such as in the SSMD.

Exclusion of financial performance

10.8 We propose not to consider financial or tax performance as part of the RAM.

10.9 Our reasoning for this proposal is that:

- a return adjustment mechanism serves as a failsafe mechanism when returns are well outside ex ante expectations. A material potential cause of unexpectedly high returns is information asymmetry between the regulator and the network companies when setting totex levels and incentives. In contrast we rely on external, outturn indices for setting the cost of debt (and have expanded our requirements for reporting embedded debts). As such we do not see the same asymmetry around financial performance and therefore consider it more appropriate to use a pre-financing measure of profitability for our return adjustment mechanism calibration.
- Financial out/under performance is largely known ex ante (due to the companies' embedded debt costs). If we were to set return adjustment mechanism boundaries on post-financing profits, companies' ability to perform against operational targets (our main area for concern), could vary widely.

10.10 We also propose to exclude performance through the BPI from RAMs. The rationale is provided in the BPI section.

Threshold level

10.11 In the draft determinations in the gas distribution and transmission sectors, we are consulting on a threshold of 300bps either side of the allowed cost of equity. This proposal was made in light of having reviewed company business plans and with a substantially complete picture of the overall price control package. In those

[64] RIIO-2 Sector Specific Methodology, paragraph 10.56

sectors, the lower RAMs threshold would be lower than our allowed cost of debt with an additional margin of error and the upper threshold would be higher than our upper estimate of the total market return. In the draft determinations, we said that we considered returns materially lower than the allowed cost of debt or materially higher than our upper estimate of the total market return to be significantly outside our expectations in setting the price controls and therefore appropriate threshold levels for RAMs. Although we have not reached the equivalent stage in the RIIO-ED2 process, if the same reasoning were to apply in RIIO-ED2 a 300bps threshold may be appropriate. However, we will keep this under review and will consult again on a proposed threshold in the draft determinations for RIIO-ED2.

10.12 We propose that the measure of company returns for the purposes of RAMs will be the performance of each company, measured using a combination of the RoRE metric, under the totex incentive mechanism and financial ODIs. As previously set out, we do not propose to take into account financial or tax performance or rewards or penalties arising from the BPI.

10.13 As we stated in the SSMC in the gas distribution and transmission sectors[65], for asset-rich organisations such as regulated energy networks, the return that investors earn on their regulatory equity (RoRE) would be an appropriate metric for use in setting the RAMs threshold as it is directly linked to the RAV. Additionally, Ofgem has consistently used RoRE as a preferred measure of company performance in the setting and monitoring of price controls and we believe it is appropriate to use it in this context. Further, given that we are proposing that RAMs should encapsulate both TIM and ODI performance, a threshold expressed in RoRE terms is appropriate as it can accommodate this (including any trade-offs between TIM and ODI performance). The use of a RAMs threshold expressed in RoRE terms means that the level of combined TIM and ODI performance required to meet that threshold may vary from company to company. For example, because two companies underspending by the same % amount may have different TIM incentive rates and different totex:RAV ratios or and/or different notional gearing. As we have set out above, we believe that it is appropriate to set the upper and lower thresholds for RAMs with reference to the baseline allowed return on equity, the cost of debt and the total market return, respectively. The relevant financial metrics do not in general vary between companies and as such we believe that the RAMs threshold should also not vary

[65] Paragraph 10.88

between companies. In any event, we do not believe any company will trigger RAMs without this being due to errors in the setting of the price control. In our view, setting the threshold in RoRE terms is appropriate.

Adjustment rate

10.14 The adjustment rate is the rate at which company returns are adjusted upwards or downwards in the event that the threshold is breached.

10.15 At the Framework decision stage in the gas distribution and transmission sectors, we ruled out introducing RAMs via a hard cap and floor regime.[66] We said: "While the hard cap and floor provides absolute assurance against higher than expected returns, it has a potentially distortive effect on incentives. When a company reaches the cap the power of positive incentives is completely eliminated as a company cannot earn any higher. When companies reach the floor, it removes responsibility from companies to take mitigation action to prevent any further decline in performance."

10.16 In our view, the nearer the adjustment rate is to 100%, the more the mechanism resembles a hard cap and floor regime, which we ruled out for the reasons above. The nearer the rate is to zero, the less effect it will have in limiting extreme levels of return.

10.17 As such, and as we have identified no compelling reason for an adjustment rate closer to either zero or 100%, we propose setting a single adjustment rate of 50%. Returns outside of the thresholds would be adjusted upwards or downward by 50% if the downside or upside thresholds are breached, respectively.

10.18 We have previously indicated that the design of RAMs would incorporate multiple threshold levels, with adjustment rates that increase as each threshold is breached. In our view, the proposal set out here will achieve the aims that we have set out for the introduction of RAMs without introducing multiple thresholds.

Implementation

10.19 We propose that any adjustments under RAMs would be made following the closeout of the relevant RIIO-2 price controls and reflected in company revenues in RIIO-3. The rationale for this is that we consider it to be the simplest approach

[66] See RIIO-2 Framework decision, paragraphs 6.138-6.140.

and the approach that is least likely to result in inaccuracies as a result of partial information.

Return adjustment mechanism questions

10.20 We welcome stakeholder views on the following questions:

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

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

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

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