

# 30. Our plan is financeable

## Key messages

Our plan is financeable on a notional company basis.

We agree there is evidence for lower base returns in RIIO-2, but we do not agree it is to the extent that is being proposed by Ofgem.

Our working assumption of 5.5% provides a fair, equitable return which is lower than RIIO-1, reflecting the nature of transmission and allocates risks to the parties best placed to manage them.

The financial package we propose provides the financial capacity required to incentivise networks to innovate so we can deliver stakeholders' needs in an uncertain landscape to facilitate energy transition.

It will also allow us to continue with optimal investments in the technologies that will be key to realising the UK's clean growth ambitions and stakeholder needs such as decarbonisation of heat.

## Introduction

We have worked with our stakeholders to build a business plan that reflects their expectations and delivers the services they want. This will involve major programmes of infrastructure investment which will be funded through a combination of debt and equity, at the most efficient proportions. The financial package we are proposing provides the funding and incentives required to compensate investors for the risks held for investing in our business. At the same time our financial package will make sure that our allowed revenues and return are no higher than necessary so that we keep costs low for consumers.

We provide a full and detailed analysis of our financial package in annex A30.01. In this chapter, we provide a summary of our proposals with the focus on:

- an outline and justification of the financial parameters we have assumed in our draft business plan
- the results of our financeability assessment, testing both our package and Ofgem's working assumptions

- the impact on the average household bill of our draft plan and the methodology we have used to calculate it.

## Our activities and current performance

We are in a period where the energy system is undergoing major transformation. We are making new and different decisions so that our networks enable the move towards a low carbon economy and do not become an obstacle to delivery. There is however real uncertainty about what needs to be done and when. Networks need to be responsive and proactive to changes in how the network is used which inherently means assuming more risk, the impacts of which we are already seeing.

Transformation was anticipated in the design of the RIIO-1 framework which has adapted well to protect consumers as the energy system has changed. A range of re-openers have adjusted our allowances for specific categories of uncertain costs. RIIO-1 has also provided strong incentives for us to manage risks effectively and to deliver improved service levels. RIIO was introduced to make regulated energy networks move away from simply delivering as cheaply as possible. The RIIO framework has driven progressive behaviours where companies are incentivised to innovate, think large scale and discover what is possible. However, despite these efforts, we have been affected by the emergence of asset management risks, which have not out-turned in our favour. These are the primary drivers behind an expected c10%<sup>120</sup> underperformance in the RIIO-1 period.

We use return on regulated equity (RoRE) to assess how our networks are performing financially under the price control compared to the assumed return used in setting allowed revenues. Based on RRP18 data, our performance is:

<sup>120</sup> Based on RRP18

**Table 30.1 RIIO-1 RoRE based in real terms**

|  |        |
|--|--------|
| <b>Allowed return + IQI</b>            | 6.7%   |
| <b>Totex incentives</b>                | (0.6%) |
| <b>Other incentives</b>                | 0.3%   |
| <b>Operational RoRE</b>                | 6.4%   |
| <b>Financing &amp; tax performance</b> | 0.6%   |
| <b>Total RoRE</b>                      | 7%     |

We acknowledge there are gaps and imperfections in the current framework which have led to the perception of windfall gains and losses leading to concerns over the legitimacy of returns levels. It is appropriate therefore for Ofgem to reconsider optimal risk allocation and close these gaps in the design of the next price control, whilst maintaining its core principles which focus on incentivisation, innovation and outputs.

An incentive-based framework which encourages longer-term decision making is best aligned to the changing nature of network services and will facilitate responses to asks which cannot yet be defined. In determining our financial package for RIIO-2 we have made sure it provides sufficient funding to continue driving investment, innovation and future efficiencies which will support stakeholder-led outcomes and lead to sustainably low bills.

**Principles for RIIO-2**

An appropriately balanced financial framework is key to current and future consumers being fairly charged for the network they use and the services they receive. Careful assessment and calibration of the framework enables a balance to be struck between consumers benefitting from sustainably low bills and incentivising continued investment in long-term assets which will provide benefits over many years.

To ensure this balance we have developed the following principles to guide our approach in delivering the most value for consumers:

**Strong incentives:** *high quality services delivered at the lowest cost to consumers*

An effective incentive framework ensures delivery of services at the price and levels consumers are willing to pay by aligning their interests with those of investors. Networks are encouraged to seek out lower costs, through the potential to share benefits, whilst still being held to account for delivering the

outcomes they have committed to with clear consequences of non-delivery.

**Transparent performance:** *Be clear how and where networks have delivered for the consumer*

Commitment to, and a clear understanding of what the network is expected to deliver are key in strengthening accountability. This in turn will allow outcomes to be measured and monitored against targets set at the start of the price control providing the transparency which is important for maintaining consumer confidence.

**Balanced risk and reward:** *risks best managed by networks are not passed to consumers*

The financial framework needs to balance risk and reward fairly between consumers and network companies.

Reducing risks for networks can reduce the cost of capital, and therefore short-term consumer bills. However, limited risk for networks also creates little incentive or financial capacity to control costs because of the limited opportunity to be retained from any reductions. This will ultimately drive higher long-term consumer bills. To avoid this the framework needs to allow a return which reflects market conditions and the risk landscape. This will provide the financial capacity needed for the networks to be incentivised to take the additional risks required to facilitate energy transition.

**Regulatory commitment and stable regime:** *will keep financing costs low for consumers*

Our costs of borrowing will depend on how our credit rating is assessed. If our credit rating deteriorates, then borrowing costs will go up. Furthermore, it is reasonable for equity investors to expect returns which are broadly stable over time so that returns which were considered appropriate at the time of investment would still be considered appropriate now and in the future. Unpredictability increases risk perception placing upward pressure on the cost of capital. Only by maintaining a consistent approach will the financial framework allow network companies to attract the required investment while keeping bills low for consumers.

In this chapter, we explain how by following these principles, we have developed a draft business plan that delivers a sustainable consumer bill reduction, in the RIIO-2 price control period.

## Overview of the plan

Our draft plan indicates the scale of investment in RIIO-2 has annual totex ranges from a low of £480m to a high of £680m, totalling £3.1bn<sup>121</sup> across the 5-year price control. We expect that funding for new expenditure will come primarily from revenues, new debt and re-invested equity return. At these levels of expenditure, we do not expect any equity injections to be required but it is important that the expected level of investment is considered in setting the allowed cost of capital. Ofgem has previously recognised that a greater level of equity investment would tend to support a higher cost of capital.

## Proposed financial package

This section sets out our proposal for our cost of capital and its components, including the cost of debt, the cost of equity and gearing. It also sets out our assumptions around tax, capitalisation and regulatory depreciation. Together these make up our financial package; a package which will retain and attract the required investment for the next price control.

For the purposes of this business plan we have followed Ofgem working assumptions wherever possible. We support immediate transition to a CPIH indexed price control but given our fundamental concerns with the policies set out in Ofgem’s sector specific decision, we have also used our own assumptions where there is strong rationale to suggest estimates should be different. We have tested the robustness of our package, details of which we go into in the financeability section of the chapter.

Where appropriate we provide a summary of both our proposals and Ofgem’s working assumptions. We quote figures on an RPI-stripped basis (i.e. after adjusting for inflation impacts) for comparability with previous price controls.

## Allowed debt funding

The cost of debt allowance is set to remunerate companies for incurred debt costs appropriate for a notional efficient network company. We support Ofgem’s proposal to maintain adoption of a full indexation mechanism. Their working assumption is based on the RIIO-1 approach albeit with a slight extension to the trailing average period to better align with the sector profile of debt issued, with a 11-15-year trombone being proposed.

We consider a more appropriate trailing average period is 20 years. Companies across the energy sectors have issued debt with broadly the same average tenor of around 20 years. This gives a basis for the use of a 20-year trailing average index which we then uplift by 15bps to allow for debt issuance costs, costs of carry and liquidity provision costs.

**Table 30.2 cost of debt assumptions**

| RPI stripped          |              |               |
|-----------------------|--------------|---------------|
| Year                  | Ofgem        | National Grid |
| 2022                  | 0.97%        | 2.05%         |
| 2023                  | 0.90%        | 1.88%         |
| 2024                  | 0.85%        | 1.72%         |
| 2025                  | 0.82%        | 1.59%         |
| 2026                  | 0.80%        | 1.46%         |
| <b>RIIO-2 average</b> | <b>0.87%</b> | <b>1.74%</b>  |

## Allowed equity return

The cost of equity is an estimation of the return that equity investors expect for the risks that they take when investing in gas transmission. Value is created for investors through dividends and asset growth funded by the cost of equity allowance. In line with Ofgem’s approach, we set the cost of equity based on the capital asset pricing model (CAPM) to reflect investor expectations by combining three parameters; total market returns, risk-free rate and the equity beta. Here we summarise the rationale behind each of our parameter values, with a more detailed explanation of our approach set out in annex A30.01 and our responses to Ofgem’s consultation documents.

## Total market return (TMR)

The TMR is an estimation of the return that investors expect for taking the market-average level of risk. There is a range of evidence that can be used to estimate future TMR (historical returns, forward looking approaches, investment fund forecasts), we agree with Ofgem that using historical data is the best forecast for TMR. Despite this, Ofgem’s method represents a decrease of ~25% since RIIO-1 which is inconsistent with our observations of investor expectations and the expected returns range implied by long run historical data and the stability of TMR.

<sup>121</sup> Including real price effects

We support due weight being given to information in published sources such as the Dimson, Staunton and Marsh dataset from Credit Suisse, not only because it is a convenient and recognised source, but because it contains carefully researched and consistent equity values. We also support comparing values to cross-checks provided these are based on reasonable assumptions and are valid comparisons. Using this approach, all methods imply a range that is at least 6.2% to 7.2% relative to RPI.

### Risk free rate

In theory, the risk-free rate is the return for taking zero risk. In practice, the best proxy for a riskless UK investment is the return that investors expect from holding UK government debt (because the UK government is very unlikely to default). We have used Ofgem's working assumption on the basis that the risk-free rate will reflect market rates within the price control.

### Equity beta

The equity beta measures undiversifiable risk for which investors expect additional returns. In the context of RIIO-2, it represents the amount of risk that network owners cannot diversify away, or which is specific to the political and regulatory regimes in which the networks operate. Ofgem's approach has led to a working assumption for equity beta which implies a significant reduction in the assumed risk for transmission networks from RIIO-1 and is below the PR19 value for the water industry. This is contrary to regulatory precedent which shows transmission having higher risk.

Transmission networks are more interlinked making works more complex to deliver. There is also higher risk driven by the uncertainty from the energy transition and the influence of political factors impacting the timing and scale of investment. This combined with greater cyber risk because of reliance on digital assets and technological developments leading to changing customer usage of our networks, means a risk profile which supports a beta at least in line with RIIO-1. This is consistent with observed data which does not support a reduction. We include further detail in annex A30.01.

It should also be noted that CAPM does not capture all the risks faced by networks that investors will consider when assessing the level of returns that

they require, e.g. political and regulatory risk, so this range may still understate the value of allowed return which should be set.

We propose an equity beta of at least 0.91 for a notional gearing of 60%. However, we recognise that giving due weight to other evidence such as decomposing National Grid plc's group asset beta into a UK and US beta and relevant European comparators, could credibly lead to a higher range of 0.95 to 1.125. Whilst we have not included at this stage, we will continue to review this additional evidence and consider for future business plan submissions.

### Cross checks

We agree that cost of equity should be cross-checked against comparator data. Recognising the level of subjectivity involved in estimating the input parameters of the CAPM model there is value in sense-checking the results against those from alternative methodologies. Several direct and reliable cross-checks are available which we have considered appropriate.

These are:

- Dividend Growth Model estimates for individual listed utilities.

An alternative to CAPM, for calculating the cost of equity, is the Dividend Growth Model (DGM) which is widely used in US regulatory settlements. Considering the same sample of listed companies<sup>122</sup> used to determine observed beta values, DGM values suggest that the allowed equity return needs to be some way above 8.6% nominal (equivalent to 5.6% real assuming 3% RPI).

- Asset risk premium to debt risk premium differential

Oxera Consulting<sup>123</sup> propose a further cross-check that draws on evidence from debt markets to ensure that allowed returns set by the regulator for equity are commensurate with the risk associated with operating and owning the associated assets. The premium for equity risk should be higher than the debt premium given the lower priority of equity in terms of claims on cashflow. If this differential is too

<sup>122</sup> National Grid, Penon, United Utilities, Severn Trent

<sup>123</sup> "Review of RIIO-2 finance issues: Asset risk premium, debt risk premium and debt betas", Oxera, March 2019 on behalf of the ENA

low, it would indicate an uplift is required to one or more of the CAPM parameters.

- Regulatory precedent

Investors value certainty of their future return on investment to the extent that they expect a price control process to follow regulatory commitment and established principles. Ofgem’s assumptions seem inconsistent with past regulatory precedent, both Ofgem’s own and the CMA. Furthermore, it does not seem credible that the reduction in allowed return can properly reflect any changes in the underlying network risks or market environment.

We find that these cross-checks and review of the available evidence, support our cost of equity range of 5.5% to 6.7%.

**Outperformance wedge**

Ofgem proposes to make a downward adjustment of 50bps to the allowed equity return to reflect its expectations that companies will outperform the targets that it sets, which is both conceptually and practically flawed. Conceptually the adjustment does not recognise and appreciate the consumer benefits which have been achieved through incentives-based regulation. Instead it is likely to undermine the behaviours that drive efficiency by creating an ex-post adjustment to claw back performance. Practically, the adjustment is equivalent to an arbitrary c15% reduction in allowances which cannot be justified with so little evidence.

On this basis, we make no adjustment for an outperformance wedge.

Table 30.3 summarises both the financial parameter values we have used to derive our cost of equity assumption and Ofgem’s proposals based on a notional gearing of 60%.

**Table 30.3 cost of equity assumptions**

| RPI stripped              | Ofgem  |        |               | National Grid |        |               |
|---------------------------|--------|--------|---------------|---------------|--------|---------------|
|                           | Low    | High   | BP assumption | Low           | High   | BP assumption |
| Total market return (TMR) | 5.25%  | 5.75%  |               | 6.20%         | 7.20%  |               |
| Risk Free Rate            | -1.78% | -1.78% |               | -1.78%        | -1.78% |               |
| Equity Beta               | 0.66   | 0.85   |               | 0.91          | 0.94   |               |
| Cross Checks              | 0.14%  | -0.02% |               |               |        |               |
| Cost of Equity            | 3.00%  | 4.60%  | 3.80%         | 5.48%         | 6.67%  | 5.50%         |
| Outperformance Wedge      |        |        | -0.5%         |               |        | 0%            |
| Cost of Equity            |        |        | 3.30%         |               |        | 5.50%         |

Ofgem’s proposals for allowed equity return are 3% to 4.6% RPI stripped with a working assumption of 3.8% for a notional gearing of 60%. A 50bps outperformance wedge is then applied to reduce the working assumption to 3.3%. This is significantly lower than RIIO-1 and whilst we agree that there is evidence for lower base returns, we do not agree it is to the extent that is being proposed.

Instead we propose a cost of equity of at least 5.5%, which we use as a basis for our financeability assessment. This is a fair, equitable return which is

lower than RIIO-1, reflecting the nature of transmission and provides the financial capacity required to drive the stretching outcomes stakeholders prioritise, like decarbonised heat.

**Regulatory depreciation and asset lives**

Under RIIO, the regulatory asset value (RAV) represents the balance of unrecovered investment and is repaid to us over a period aligned to the average expected economic life of the asset base. This is referred to as regulatory depreciation. We agree with the principles set out by Ofgem that the

depreciation charge should reflect the benefits consumers derive from the network services they receive. Setting an appropriate profile of regulatory depreciation is therefore key in ensuring the interests of existing and future consumers are fairly balanced.

With a changing platform and a much more uncertain outlook for the gas network, an increasing RAV set against the potential decline in customer base would result in increased RAV stranding risk and a sharp increase in charges to future customers to recover the investment. The regulatory asset life and regulatory depreciation profile require revisiting to assess the combination required to balance existing and future customer charges whilst reducing the risk of stranded investment.

We have carried out an initial high-level review and our preliminary indications at this stage are that both a reduction in the 45-year asset life assumed for RIIO-1, and a weighting of the depreciation profile towards earlier years through adoption of a sum of digits approach are required to match consumer benefit to charge and to manage the stranding risk.

Clearly this will have an impact and increase the consumer bill in the short term, but this is balanced by the risk of having stranded assets and prevents future generations from being impacted by the potential of larger consumer bill hikes as we seek to recover the RAV over a shorter period.

### Capitalisation rates

This parameter refers to the level of company expenditure paid for by consumers over time ('slow money'), rather than immediately ('fast money'). This will be calculated with reference to the baseline expenditure projections over the price control period and reflect the proportions of capital and operating expenditure which we propose to fix for the period.

Based on current plans, this results in 66% of totex being treated as slow money and 34% as fast.

### Taxation

Allowances to pay corporation tax are calculated on a notional basis as a proxy for efficient costs. It is expected that these allowances will be broadly equal over time to payments made to HMRC.

The RIIO-1 notional allowance approach has been an effective mechanism and propose its continuation for funding in RIIO-2. We adopt this assumption in our business plans, but with an adjustment to include incentives to allow closer approximation to the actual charge.

### Stakeholder feedback

Our proposals have been informed by our primary financial stakeholders, investors, who we have engaged with about the financial package, including the technical aspects.

Their views have been gathered through an extensive investor engagement programme, which includes:

- an annual investor survey compiled by KPMG Makinson Cowell during August 2018. The survey comprised detailed interviews on a range of topics including those related to the RIIO framework
- the views expressed by shareholders in the c500 meetings we have conducted in the past year, the seminar on our UK business in September 2018 and during several site visits in both the UK and US
- city views based on analyst reports and feedback received from both debt and equity investors
- market reaction to regulatory announcements through share price analysis

This engagement has identified that:

- our shareholders assess that the risk of investing in UK regulated utilities has increased significantly compared to earlier in the RIIO-1 regulatory period and there has also been a significant increase in political and regulatory news which has triggered share price falls in the current regulatory period, relative to previous regulatory periods;
- investors are concerned that the level of return proposed in the RIIO-2 working assumptions does not reflect our underlying business risks;
- as investors are focused on future cash flows they want to understand the potential impact on the cash generation of the UK regulated businesses in the RIIO-2 period and the consequences for balance sheet strength and returns to shareholders; and
- our investors will make comparisons with other regulated sectors both in the UK and internationally as part of assessing the relative attractiveness of the final RIIO-2 outcome.

We have also undertaken initial engagement with a wider stakeholder base including customers and

Citizens Advice who are interested in the absolute level of our charges as well as their predictability and volatility. We have developed educational materials designed to make clearer the services consumers are paying for<sup>124</sup>. We appreciate that energy bills are complex and have worked with stakeholders to make the financial factors affecting bills more accessible to consumers.

This feedback has been considered when determining our financial package which ensures that returns are set at level which continues to retain and attract investment without changing the risk profile of our investors who value long term growth of the business.

We will continue to engage with stakeholders and test our and Ofgem's financial proposals against their expectations and priorities, particularly in the context of the consumer bill and ensuring stakeholders understand what it is they are getting for their money. The results of this process will inform our submission.

### Financeability assessment

#### Approach to financial assessment

Our network is financeable if we can maintain an investment grade credit rating because it provides adequate resilience in the event of economic downturn and outturn of downside risk. We have tested to see what effect our decisions will have on our credit rating. We also recognise Ofgem's duty to have regard to ensuring we are financeable by allowing us to recover revenues that are sufficient to pay interest and dividends to our finance providers. If the allowed return, depreciation profile and capitalisation policy are set appropriately and there is consistency in future determinations, the notional company should be financeable.

We have adopted the following approach to assess the financeability:

#### Focus the assessment on a notional company

The onus for ensuring financeability of the actual companies lies with networks. However, the regulator has a duty to have regard to the need to secure that the price control is set at a level which would allow an efficient notional company to finance its licenced activities. The methodology which is

adopted therefore needs to be robust, replicable and relevant for both of these company views.

Whilst the parameters and particulars of actual companies may be of some interest to the extent that they inform estimates for a 'notional efficient company', the financial parameters (such as cost of debt, gearing, cost of equity, and financial metrics) should be estimated for the notional efficient company. The financeability of the actual company can only be assured on a sustainable basis if supported by a package which delivers a financeable notional company.

#### Target a strong credit rating consistently across the financial package

We have assessed our credit rating against a target rating of A- and BBB+, consistent with both the cost of debt indices and the regulatory approach in the RIIO-1 period. We consider these credit rating levels remain appropriate into RIIO-2 because they ensure the right balance between the financial resilience of the network and consumer bill impacts, particularly given the uncertainties related to the political landscape, increased competition and the likelihood of lower returns in the RIIO-2 period.

#### Consider a range of financial ratios for both debt and equity investors across several future price control periods.

We have primarily followed Moody's rating methodology for regulated electricity and gas networks which considers both credit metrics and qualitative factors. Ofgem has favoured this approach in the past, which we support. We have applied the Moody's approach flexibly to allow our assessment to be in line with how Moody's themselves apply the methodology.

This involves:

- putting an additional focus on the core metrics: adjusted interest cover ratio (AICR) and net debt/RAV
- stress testing the qualitative factors, in the light of the evolving political and regulatory landscape, given they can materially influence rating outcomes.

A financeability assessment also requires consideration of the requirements of the equity investor. Shareholders see energy networks as

<sup>124</sup> <https://www.nationalgridgas.com/about-us/breaking-down-your-bill>

income stocks and invest in National Grid with an expectation of receiving a consistent and reasonable dividend yield, which the business' earnings need to be able and to support. At this stage, we will focus on the financial ratios and RAV growth and carry out initial assessment of trends but will, as part of next steps, combine with RoRE performance ranges to inform the overall investor proposition.

We do not expect to achieve all the ratios in every year. We have highlighted where sustained downward trends give rise to financeability concerns. We have considered these trends across several price controls (up to and including RIIO-5) to assess the long-term sustainability of the financial package. This helps us to avoid short-term fixes to address immediate cashflow issues that might create financeability problems in the future.

Financeability is not just a consideration of short-term liquidity ratios but considers the long-term sustainability of the company's financial position which is important in safeguarding future investment.

**Results of financeability assessment**

We have explained our financial package assumptions which underpin the financeability assessment. The modelling results presented in this section are also based on the following:

- an immediate transition to CPIH, CPIH inflation assumed to be 2% p.a.
- 25% inflation linked debt throughout the RIIO-2 period with RPI debt switched to CPIH
- a dividend yield of 5%
- qualitative factors consistent with Moody's most recent publication with exception of scale/complexity which we have reduced in line with nature of the RIIO-2 plan, which together contribute 60% of the overall weighting.

**Table 30.4 Moody's qualitative factors and ratings**

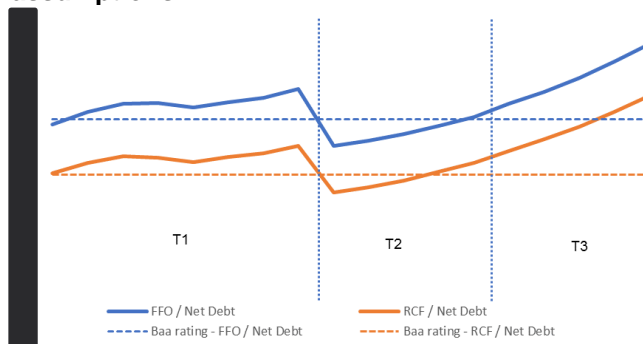
|  |     |
|--|-----|
| <b>Stability and predictability of regulatory regime</b> | Aaa |
| <b>Asset ownership model</b>                             | Aa  |
| <b>Cost and investment recovery</b>                      | A   |
| <b>Revenue risk</b>                                      | Aa  |
| <b>Scale /complexity of capital programme</b>            | Baa |
| <b>Financial policy</b>                                  | Baa |

Our initial analysis shows that the current investment plan would be financeable under our financial

package and assumptions at notional grade. The AICR and FFO/net debt ratios show deterioration into RIIO-2 which can be attributed to the drop in the cost of equity and re-setting of the gearing levels to align to 60% at the start of the price control, after which the ratios become stable for the remainder of the period.

However, risks remain around the RCF/net debt and FFO/net debt metrics which fall below investment grade thresholds within the RIIO-2 period. Our proposal to reduce asset lives to 25 years and adopt a sum of digits depreciation profile from RIIO-2 onwards is a contributing factor for the improvements observed in RIIO-3.

**Figure 30.5 key debt metrics using National Grid assumptions**



Turning to equity metrics, at this stage we focus on our investment proposition. Which is to generate shareholder value through both dividends and asset growth by investing in essential assets. We assume a dividend yield of 5% on notional equity, which is in line with RIIO assumptions and consistent with the water company submissions for PR19 which range from 3% to 5%. It is also similar to asset growth across the period, which is c4% per annum, as there is an expectation from investors that asset growth should be translated into earnings growth. At this level, dividend is sufficiently covered over the RIIO-2 period but we see a decline in the metrics which are a proxy for price/earnings ratios which are likely to present challenges going forwards.

We have focussed on the financeability of the notional company at this stage. However, based on a preliminary view of the actual company which reflects our actual gearing levels and financing costs, we expect a marginal improvement in the results of our financeability assessment. For later submissions, we will continue to build the detailed underlying data and justification of our business plan, which along with the release of Ofgem's financial model will enable us to explore the financeability of the actual company in more detail.



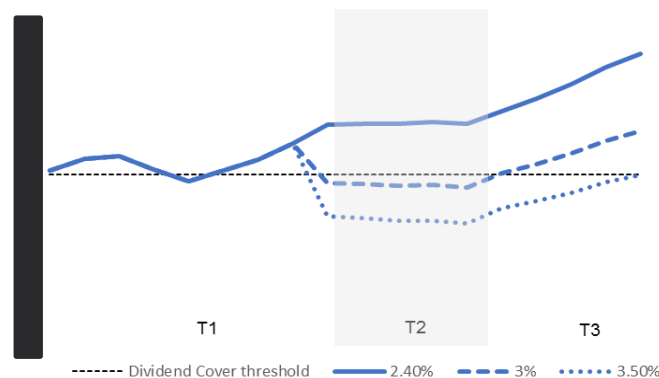
We have also run our analysis using Ofgem’s financial package (which includes depreciation set on a straight-line basis with a 45-year asset life) and the following assumptions:

- an immediate transition to CPIH, CPIH inflation assumed to be 2% p.a.
- 25% inflation linked debt throughout the RIIO-2 period with RPI debt switched to CPIH
- a dividend yield of 2.4% (as used by Ofgem in their May decision document)
- qualitative factors in line with Moody’s most recent publication which together contribute 60% of the overall weighting

The notional company should be financeable without the need to rely on assumed outperformance. Therefore, we have not assessed financeability using a 0.5% outperformance adjustment to the base allowed return. Taking this into account, our analysis shows we are not financeable. The equity investor offering under this framework sees dividends reduced significantly below investor expectations.

Ofgem assumes a 2.4% yield which does not align with stable dividend growth and is less than the dividend proposition set out by quoted water companies in their PR19 submissions and represents a falling investor return against inflation. There is a critical sensitivity around dividend yield assumptions and switching to just 3.5%, which remains below investor expectations, causes a deterioration in dividend cover well below the 1.5 level needed to sustain the dividend yield.

Figure 30.6 dividend cover using Ofgem assumptions



Furthermore, a 3.5% dividend yield would lead to a deterioration in the debt investor proposition. Under this assumption, the Moody’s rating grid falls below the Baa1 credit rating during the RIIO-2 period, resulting in an investment grade inconsistent with the index used to set cost of debt allowances.

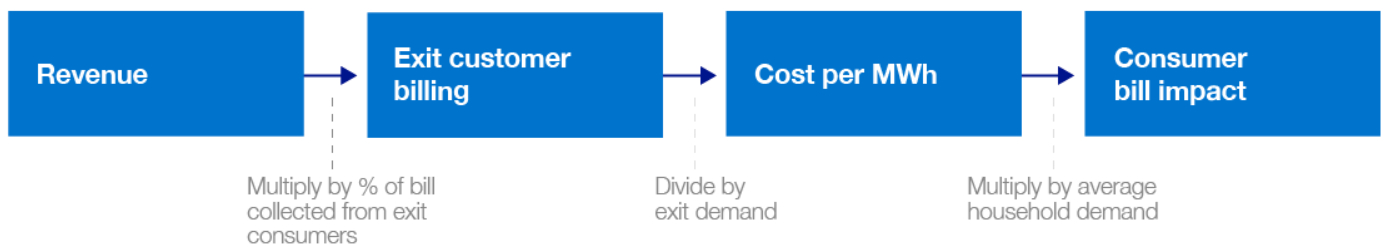
The impact of lower allowed returns is being partially mitigated by accelerating cash flows from future periods through the transition to CPIH. Whilst improving the short term financeability of the notional company, this should not be used as justification for a setting an allowed return which is too low, as based on our analysis, a continuation of an RPI indexed price control would not be financeable beyond RIIO-2.

Ofgem’s proposals which accelerate cashflow to mitigate low returns and reduce the value of the investment proposition will provide protection to debt investors, but only by shifting material risk to equity investors. This risks the likelihood that RIIO-2 will provide a fair return to shareholders. Setting a low return and curtailing the level of dividend creates a mis-alignment which the risk investors bear, which ultimately decreases the attractiveness of investment in the sector.

### Consumer bill impacts

We have set out an efficient financial package that funds the investment we need to make for consumers in RIIO-2. In this section, we set out the effect this will have on consumer bills and the methodology we used to calculate it. The revenue that we are allowed to recover under the price control is paid by all network customers in Great Britain (households, businesses and generators). The process for recovering revenue is complex. We have therefore used a simple top down approach that follows the methodology described by Ofgem with four steps:

Figure 30.7 Methodology for calculating gas bill impacts



This approach is based on the charging methodology and inputs from 2018-19, so our forward-looking estimates do not include potential future changes to these variables. Based on our RIIO-1 averages, National Grid direct charges account for c2% of the average household gas bill, this is around £9 a year.

Using the methodology described, our business plan leads to a flat to declining consumer bill over the RIIO-2 period. However, we must caveat this position as without a working Ofgem financial model and the detailed plan and package still to be finalised, this view could change for later submissions.

We have engaged with stakeholders to ensure that they understand the consumer bill implications. We have explained how the bill impacts reflect value for the network they use and the services they receive while being fair to current and future generations. We are confident that our proposed financial package is efficient and in terms of costs to consumers, delivers best value in the long-term.

### Customer bill impacts

It is not just domestic consumer bills which will be impacted by our plan. We have built this plan with the help of our customers and have incorporated their views in our proposals. The impact of our plan on their charges will however differ depending on their location, the type of contract they have with us and their level of energy demand. When we have engaged with our customers on how we can help them understand their bill impacts for RIIO-2 they have told us that we should give them visibility of our revenue trends over time. This will allow them to calculate their own specific bill impacts based on their circumstances. Ofgem have not finalised the financial model which will calculate revenue for RIIO-2 but using the figures set out in this plan, we estimate that our underlying revenue in RIIO-2 will be broadly flat compared to the average level in RIIO-1. There will be annual fluctuation from the underlying trend due to regulatory framework items such as uncertainty mechanisms and true ups. We are proposing changes to the framework which will

reduce this fluctuation so for this draft plan we have focused on explaining the underlying revenue trends. We will engage further with our customers on these plans and our framework proposals to test their acceptability

### Next steps

It is important to carry out sensitivity testing to assess the resilience of financial ratios under different scenarios to justify that our financing package is not just efficient, but also robust. The scenarios which we will consider in more detail when assessing the financeability of the notional company include:

- totex ranges developed from an assessment of the business risk borne by the network across the RIIO-2 price control;
- potential market scenarios, such as alternative interest and inflation rate forecasts;
- the impact of totex and incentive underperformance based on our assessment of potential outcomes and business risk; and
- interaction with other proposed financial mechanisms, such as the returns adjustment mechanism.

Based on a range of plausible outcomes we will evaluate the subsequent impact on both our cashflow and returns using RoRE analysis. This will allow us to test the risk and reward balance to ensure the ranges are deliverable and offer a fair balance for investors. We will also test there is sufficient financial capacity such that the incentives package is unlikely to lead to financial distress when coupled with adverse macro-economic shocks.