Finance Annex

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WALES&WEST UTILITIES

DOCUMENT 58: FINANCE ANNEX

RIIO-GD3: 1 April 2026 to 31 March 2031

Legal Notice

This Annex is part of the Wales & West Utilities Limited ("WWU") Business Plan submitted to Ofgem. Your attention is specifically drawn to the legal notice relating to the whole of the Business Plan, set out on the inside cover of The WWU Business Plan. This is applicable in full to this Annex, as though set out in full here.

WWU is the claimant in a judicial review currently waiting a listing to be heard in the High Court of England and Wales. The claim is against the CMA in relation to (among other things), in its final determination of the RIIO-GD2 appeal against Ofgem: its interpretation and application of the statutory finance duty at section 4AA(2)(b) of the Gas Act 1986; its treatment of the cost of debt; and its approach to tax clawback. Ofgem is participating as an active interested party to the claim and is familiar with the legal case being advanced by WWU.

All of these matters before the High Court are of direct relevance to this Business Plan and Ofgem's assessment of it. WWU considers that Ofgem should have full regard to the detailed legal case being advanced in the judicial review proceedings – which is of equal application to Ofgem – and should act in accordance with it when making decisions for the purposes of RIIO-GD3 so as to avoid falling into legal error. WWU reserves all of its statutory and public law rights should Ofgem fail to do this.

However, it is not the function of this Business Plan to relitigate issues which are already before the Court or to repeat the detailed legal case fully pleaded in the judicial review proceedings. On the contrary, this Business Plan is prepared in accordance with Ofgem's business plan requirements and designed to be compliant with them.

It follows, however, that, to the extent that –

- compliance with any of those requirements involves inconsistency with the detailed legal case that WWU is advancing in the judicial review proceedings, and/or

- the legal arguments in that case are not fully reiterated within this Business Plan,

the Business Plan should be treated as having been submitted entirely without prejudice to the current and ongoing judicial review claim and to the remedies which are sought by WWU in that claim.

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1. INTRODUCTION

1.1. This Annex contains financeability assessments for:

a) Ofgem's notional capital structure – referred to as the "Notional Company"

b) The Notional Company with WWU's actual capital structure but using Ofgem's assumptions for allowed cost of capital – referred to as the "Ofgem Actual Company" to distinguish it from c) below.

c) The WWU actual company (referred to as the "WWU Company specific plan")

1.2. The first two assessments are required by Ofgem. [1]

1.3. Regarding the third assessment in 1.1c, Ofgem permits licensees to apply different assumptions for allowed revenues for cost of capital. We refer to projections prepared on this basis as the "WWU Company specific plan" to distinguish from the two plan versions required by Ofgem.[2]

1.4. The material differences between these assessments relate to cost of capital (at 60% gearing):

	Plan version →	Notional Company	Ofgem Actual Company	WWU Company specific plan
	Key areas of difference			
COST OF DEBT	**Cost of debt revenue allowance**	Allowance per Ofgem BP assumption	Same as Notional Company	Will match the actual efficient cost of debt (including derivatives)
COST OF DEBT	**Cost of debt input**	Same as allowance	Actual cost of debt (including derivatives)	Actual cost of debt (including derivatives)
COST OF EQUITY	**Cost of equity revenue allowance**	Per Ofgem BP assumption	Same as Notional Company	WWU specific
COST OF EQUITY	**Equity distributions, excluding return of equity**	Per Ofgem BP assumption	WWU specific	WWU specific

1.5. References to percentage rates for cost of equity and debt are in real, CPIH terms unless stated otherwise.

1.6. This Finance Annex is document number 58 to the WWU Business Plan. Documents appended to this Finance Annex are referenced in footnotes by: Document 58 [letter] and [report title] where appropriate.

1.7. This Annex includes evidence on cost of capital and customer bill level acceptability. [3]

[1] Ofgem (2024), 'RIIO-3 Business Plan Guidance', 30 September, ("RIIO-3 BP Guidance") para 7.10. "Companies should also include a financeability assessment (using our working assumptions for cost of capital returns) for both the notional and actual capital structure,…"
[2] RIIO-3 BP Guidance para 7.3
[3] Summaries of consultant reports are in Section 10, which contains their index references in the Business Plan.

2. FINANCEABILITY

2.1. Overview

a) Financeability comprises both debt and equity financeability.

b) **Debt financeability:** Ofgem outlines its position in general terms as follows:

- "… to focus primarily on whether the price control package in-the-round puts licensees (at the notional capital structure) in a position where they can service reasonable debt costs and maintain financial metrics that would be associated with an appropriate credit rating range."[4]

- "We will retain the in-the-round assessment that targets each licensee, adopting the notional capital structure and assuming efficient performance, broadly achieving comfortable investment grade credit quality."[5]

c) **Equity financeability:** Ofgem uses the revenue allowance for cost of equity as the primary basis and will add additional tests relating to "investability".[6] This is discussed in section 2.3b.

2.2. Debt financeability – specific points

a) Ofgem requires licensees to specify a target issuer credit rating. [7] We highlight three areas:

- **The need for caution.** For RIIO-GD3 there are reasons for caution:

  i. **Rating agency uncertainty** : Rating agencies have yet to explain if, how and when their thresholds for rating levels may change for RIIO-3. This uncertainty stems not just from significant speed of money adjustments in RIIO-3 relating to the cost of debt allowance and RAV depreciation acceleration from Ofgem policy decisions but also due to lack of visibility on Government policy for pathways to Net Zero Carbon.[8] [9]

  ii. **Totex risk:** WWU's Totex for RIIO-GD3 is a step change in business risk in terms of cost, workload, technical compexity and resourcing challenge. This higher business risk is compounded by regulatory risk that allowances may be less than efficient Totex in RIIO-GD3. There is a shortfall in Totex allowances so far in RIIO-GD2 notwithstanding efficient costs. [10] Our financeability assessments will give attention to stress testing adverse totex outcomes.

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[4] Ofgem (2024), 'RIIO-3 Sector Specific Methodology Decision–Finance', 18 July 2024, ("SSMD") para 5.6.
[5] Ibid para 5.31.
[6] Ibid para 3.245.
[7] RIIO-3 BP Guidance para 7.9. The rating type required for SSC A38 is an **issuer** credit rating, reflecting the credit profile of the issuer, not a **debt** credit rating that reflects the credit profile of a single debt class. References to credit rating levels in this Annex refer to issuer credit ratings, unless stated otherwise.
[8] **Standard and Poors ("S&P")** foresee a "sharper drop in demand from 2030-2035, which heightens business risk and makes leverage reduction increasingly important for maintaining creditworthiness. As regulatory periods end, operators could face higher regulatory reset risk, depending on the pace of the energy transition. Regulatory support, including timeliness of cost recovery, tariff setting changes, and compensation for decline in gas usage, will be a major variable." S&P Utilities Handbook 2024: Western European Regulated Gas. **Moody's** consider there is "high carbon transition risk" for the GDN sector, only "partially mitigated" by its expectation of "some regulatory support". Source : Moody's credit opinion on Cadent Gas Limited 24 September 2024. **Fitch**." may consider lower debt capacity (measured in particular through net debt/RAV) of gas networks, considering the transition risk and weaker long-term sector visibility. Any adjustment would be likely to be gradual, assuming a balanced Ofgem approach, rather than sudden and material." And "We could therefore introduce new credit metrics to better reflect some project finance-like features, or adjust the PMICR calculation, or place greater reliance on Net Debt/RAV or network financial policies.: "What Investors Want to Know" issued on 14 November 2024. (No public links available for these documents).
[9] In relation to the changes to the cost of debt allowance, Ofgem acknowledges rating agency uncertainty in its SSMD para 2.120. We consider this speed of money adjustment in our debt financeability assessments.
[10] WWU (2024), '2023/24 RFPR', R1-RoRE, shows a Totex shortfall reducing RORE by 1% over RIIO-GD3.

iii. **Cost of debt allowance:** Ofgem's assumed allowance for cost of debt for Business Plan submission does not reflect RAV depreciation acceleration, which per se will reduce that allowance. This is because there will be less new debt to raise, and as new debt is expected to cost more than embedded debt, the overall cost of debt should be lower. Therefore, the financial outputs will be flattered for the Ofgem Notional and Actual Company plans.[11]

iv. 

v. **Outstanding reopener claims for Totex relating to RIIO-GD2.** There are outstanding reopener claims for material amounts of expenditure properly and efficiently incurred in RIIO-GD2. Our projections for RIIO-GD3 assume those expenditures will be fully allowed.[12]

- **Moody's Rating Agency** : Moody's methodology in Ofgem's BPFM is a global framework. For UK regulated energy and water companies, Moody's applies specific thresholds on gearing and AICR ratios.[13] We therefore place most weight on those ratios and thresholds in our assessment.

- **Other rating agencies.** Our debt financeability assessments also use ratio metric thresholds applied by S&P and Fitch. [14] Again, as with Moody's, we focus on gearing and a core coverage metric for each. In the case of S&P this is their FFO/Adjusted net debt ratio, and for Fitch their nominal PMICR ratio. In our experience, they place significant weight on these metrics, in addition to gearing.[15]

b) We focus on average ratio levels and direction, because this is generally aligned to how the three agencies assess credit metrics, acknowledging some variations between them.

c) In addition to key ratios, we also focus on qualitative aspects within rating agency assessment frameworks. For RIIO-GD3, we are focused on (i) regulatory environment and asset ownership, (ii) scale and complexity of the capital programme and (iii) financial policy.[16]

2.3. Equity financeability – specific comments.

a) Ofgem emphasises investability for RIIO-3 and provided guidance in the SSMD:

- "….investability considers whether the allowed return on equity is sufficient to retain and attract the equity capital that the sector requires. We noted that this issue is likely to be increasingly important in the coming years as the need to invest in infrastructure rises significantly (for energy networks

[11] We cannot reliably estimate the likely impact prior to licensee Business Plan submissions. Recently, Ofgem has helpfully indicated that the approximate impact may be in the region of 9 basis points p.a. but the outcome could be materially different.
[12] The amounts outstanding exceed £60m in 2023/24 prices, which is in excess of 2% of RAV at March 2024.
[13] We confirmed this position with Moody's in email correspondence.
[14] In para 5.34 of the SSMD, Ofgem states its intention to broaden its assessment to include Fitch and S&P.
[15] To avoid undue complexity, for stress testing, we will stress the Moody's ratios only and focus on their AICR and gearing ratios. Those ratios should be adequate for this purpose.
[16] For qualitative aspects, we focus solely on Moody's scorecard given its transparency. The above aspects are weighted 40%, 10% and 10% respectively, with leverage and coverage ratios accounting the balance of 40%.

across the UK and globally) and companies are required to seek 'fresh' equity from their investors over and above what they would be able to fund via retained earnings."[17]

- "We introduced the concept of 'investability' in RIIO-3 to both signal and ensure that we are conscious of the potential challenges that the sectors could face in this and future price controls - particularly in relation to the challenges associated with supporting the achievement of GB's net zero targets. "[18]

- "We must ensure that the regulatory and financial package facilitates the timely investment of capital in order to support the meeting of net zero and resilience challenges. We must also meet our primary objective to protect consumers' interests and ensure that they do not face charges that are higher than necessary. We are confident that our existing methodologies and approach to setting price controls will lead to sufficient but not excessive returns. However, we remain open to evidence on investability issues and will adapt our approach if there is sufficient evidence that this is warranted." [19]

- "We are open-minded to the requirements of investors, and we do see the potential benefit in considering issues such as the dividend preferences of investors in the utilities sectors (who often have underlying income requirements)." [20]

b) Ofgem outlined investability tests as follows:

- "Equity financeability, which we will primarily measure via cross-checks to our Step-1, CAPM-based estimate of the cost of equity;
- The need for additional checks or factors, such as those that have been suggested by the network companies;
- The assessment of additional risks factors relative to RIIO-2;
- Picking a point estimate from the cost of equity range, either in respect to individual metrics or the overall allowance; and
- Assessing equity issuance costs associated with new equity requirements over RIIO-3."[21]

c) Our key remarks are:

- There are two significant and unprecedented forces that bear on calibrating the cost of equity allowance for RIIO-3. Frontier Economics expressed them as follows: [22]

    i. "…Very material changes in capital market conditions have occurred since the RIIO-2 price controls, in particular the T2/GD2 price controls, were set. The RIIO-T2/GD2 price controls were set at a time of ultra-low interest rates and were intended to serve that low interest rate environment. But in response to a variety of global shocks, the period of ultra loose macroeconomic policy has ended. There has been an abrupt rise in interest rates and the cost of borrowing. Gilt yields have increased by c. 3.5% over a short space of time, and regulatory models that served the era of cheap money must be adapted to reflect these new conditions." And,

[17] SSMD para 3.23
[18] SSMD para 3.242
[19] SSMD para 3.243
[20] SSMD para 3.282
[21] SSMD para 3.245
[22] Frontier Economics: Equity investability for RIIO-3. Paragraphs 45-46. Submitted to Ofgem on 6th March 2024.

ii. "…Networks are entering into a phase of their development that is far from "business as usual", as they strive to support decarbonisation, and are facing heightened risk in the process. [23]Miscalibration of allowed returns now would fatally undermine the ability of the networks to meet the challenges of net zero, as it would undermine their ability to raise and retain capital"

- We welcome Ofgem's emphasis on investability: "…alongside our existing financeability assessment, to better understand whether the allowed return on equity meets the needs of the energy sectors". In our view, the essence of investability is about the incentive power of a regulatory regime to attract and retain equity capital, and where appropriate, to enable equity capital to be returned. Consequently, it must be founded in Ofgem's statutory finance duty, itself an intrinsic part of Ofgem's statutory principal objective relating to the protection of consumer interests.

- Investability was contemplated as being an inherent feature of that duty during the House of Lords Committee stage on what became the Utilities Act 2000. The question of interpretation of the finance duty arose in the context of a concern that it could be viewed as subordinate to the principal objective. The Minister provided a comprehensive rebuttal to that concern and inter alia, stated: "Who could doubt that consumers have an interest in ensuring that utilities operate in a viable market with a long term outlook ? It is no good to them if the return to shareholders is so low that utility companies are unable to attract the capital needed to maintain the infrastructure." The duty has since remained unchanged in material terms. [24]

- By extension, investability creates and sustains a preference from existing and new equity investors to retain and provide capital when it is requested, given alternatives available to them. That preference should be present where the licensee is debt financeable at a suitable investment grade rating, and not in a distressed financeability position, implying equity investment at discounts to RAV. We agree with Oxera's view: "For a price control to be 'investable', it must be highly likely that the company can attract and retain the equity capital needed to deliver desired investment."[25]

- Investability should not impede equity divestment where asset life cycle is expected to shorten. Ofgem's policy decision to align with Government policy on Net Zero Carbon by 2050 through accelerated RAV depreciation enables earlier return of some invested capital to debt and equity investors in RIIO-GD3. There are three important issues:

  i. There should be no impediment to returning capital to equity investors, subject to appropriate financial resilience measures.

  ii. RAV depreciation acceleration mitigates, but cannot remove, asset stranding risk, which is asymmetric to the downside. Therefore, some upward adjustment to the allowed return is essential to ensure an adequate equity return. We discuss this in sections 3 and 5.

  iii. An adverse outcome for allowed equity return would send a negative signal to investors considering committing equity to sectors such as electricity that have higher growth expectations (i.e. the risk that they lose value after investment has been made).

[23] SSMD para 6.22.
[24] Utilities Bill, Committee stage, HL Deb 13 June 2000, Series 5, Vol 613, cols 1572-1574
[25] Document 58B - RIIO-3 Cost of Equity – CAPM parameters (Oxera), page 4, footnote 4. Summarised in Section 10.2

- On the first issue, we welcome Ofgem's view: "…aligning the repayment of investment in GD to the government's target net zero date provides the most certainty to investors and consumers that repayment of investments is aligned to current government policy for the sector." [26]

- On the second issue, we welcome Ofgem's focus on adjusting asset beta for gas equity returns: "We see particular value from including European utilities when calibrating the required return in gas, as we currently have no listed GB gas companies and we consider similar asset stranding risk perceptions will be present in European and GB gas networks. [27]

d) As will be explained in Section 3, on the basis of strong evidence, Ofgem's assumed Ke and dividend yield rates of 5.43% and 3% respectively are too low to attract and retain new equity. This has implications for the financeability assessments in sections 6 and 7. In section 7.2b, we set out WWU core expectations for dividends and equity for RIIO-GD3.

2.4. Assurance on financeability. Ofgem requires: "licensee Board assurance that the licensee is financeable both on a notional and actual capital structure basis. However, if any financeability challenges are identified, the Business Plan should clearly set out: [28]

- details of what these financeability challenges relate to (for example, servicing equity or debt);
- what management efforts or mitigating actions could reasonably be made to address them;
- what regulatory measures should be taken alongside the management efforts or mitigating actions;
- that all other applicable measures to aide financeability have been considered; and
- that statements and conclusions are supported by evidence and justification"

2.5. We note the above applies to equity financeability ("servicing equity"…) as well as debt financeability. We address these requirements in our financeability assessments in sections 6, 7 and 8. We also note that the assurance statements are necessarily forward looking to 2031, made under conditions of uncertainty, and based on investment and financing decisions that will have impacts well beyond 2031. Therefore, unavoidably, our assurance statements must be appropriately qualified, even if financeability would be affirmed. [29]

2.6. Legal differences. Finally, Ofgem and WWU hold different legal views on the matter of how Ofgem's finance duty should be interpreted and discharged by Ofgem and within that, its approach to financeability assessment. Our views on Notional Company financeability are provided to ensure compliance with the Business Plan requirements set by Ofgem and are entirely without prejudice to our legal position as presented in the ongoing litigation.

[26] SSMD para 8.41 and also para 8.45: "We believe that aligning asset life assumptions to government policy provides certainty to investors, as it aligns repayment of investments with current government policy objectives"
[27] SSMD para 3.306
[28] RIIO-3 BP Guidance para 7.11
[29] We recommend to Ofgem that it should review the framework and text for the assurance statements for future price controls, to provide greater clarity to Boards of Directors.

3. Cost of capital

3.1. **Overview.** We summarise below the allowed cost of capital rates across the three plan versions.

ALLOWED COST OF CAPITAL	RIIO-GD3 average		
	Ofgem Notional Company	Ofgem Actual Company	WWU Company specific Plan
Cost of equity			
Allowed cost of equity rate, Nominal CPIH	*5.43%*	*5.43%*	*6.89%*
Distribution rate	*3.00%*	*5.00%*	*5.00%*
Cost of debt			
Allowed cost of debt rate, Nominal CPIH	*2.90%*	*2.90%*	*4.96%*
Weighted allowed cost of debt rate, 30% Nominal / 70% nominal	*4.35%*	*4.35%*	*6.42%*

*Source: Finance Annex Support Workbook tab **#2.***

The WWU distribution and equity capital expectations are further outlined in Section 7.2(b).

3.2. Cost of equity.

a) WWU's rate of 6.89% is shown below alongside Ofgem's and Oxera's estimates. [30]

		Ofgem SSMD Ke **LOW**	Ofgem SSMD Ke **HIGH**		Oxera baseline Ke **LOW**	Oxera baseline Ke **HIGH**	Oxera baseline Ke **MID**		Asset beta adjustment for sector specific risk	**WWU Ke**
CAPM Inputs										
Gearing	a.	60.00%	60.00%		60.00%	60.00%	60.0%			**60.0%**
RFR	b.	1.27%	1.27%		1.54%	1.54%	1.54%			**1.54%**
TMR	c.	6.50%	7.00%		7.00%	7.50%	7.25%			**7.25%**
Debt beta	d.	0.075	0.075		0.075	0.075	0.075			**0.075**
Asset beta	e.	0.30	0.40		0.35	0.40	0.38		0.045	**0.42**
Equity Beta	f: ((e-(d*e))/(1-a)	0.64	0.89		0.76	0.89	0.83			**94%**
CAPM Output										
Cost of equity	b+f*(c-b)	4.60%	6.36%		5.70%	6.83%	6.25%			**6.89%**
Cost of equity midpoint at SSMD		**5.43%**					**6.25%**			**6.89%**

Source: Finance Annex Support Workbook tab #3. *Small rounding differences ignored.*

b) Preliminary comments:

- We appreciate Ofgem's "early view" of 5.43% and associated range of 4.60% to 6.36%. This has facilitated our preparations. Those rates have been carefully considered with our advisors alongside the evidence they have produced. We and Ofgem will remain in evidence gathering mode up to its Draft and Final Determinations in 2025.

- The two significant and unprecedented forces referred to in Section 2.3(c) makes setting a point estimate for cost of equity especially challenging. Ofgem has recognised the challenge in treating consumers and investors fairly:"This is a particularly difficult challenge in RIIO-3, as any new investors into the sector will require current returns to match the market cost of equity. While we normally consider likely returns on a 'through cycle' basis, this may cause issues if there is a disconnect with our 'through cycle' estimate and current market required rates of return."[31]

[30] Section 10.2-10.4 summarise the reports containing evidence for the baseline Ke rate, before sector specific risks. Reports on GDN sector specific Ke and dividend yields summarised in Section 10.5-10.6

[31] SSMD para 3.265

- WWU's rate of 6.89% is significantly influenced by the two forces referred to in Section 2.3(c). These influence our weighting of (i) very different market conditions prevailing, compared to 2020 when RIIO-2 was determined, in the context of a "stable but not fixed" approach for TMR and (ii) determination of asset beta, taking account of GDN sector specific risks.

c) Total Market Return ("TMR")

- The "stable but not fixed" approach aims to appropriately weigh (i) long run average market returns to underpin consistency, stability and predictability and (ii) prevailing market conditions.

- As noted above, this "stable but not fixed" aim is a challenging task for RIIO-GD3. Nonetheless, regulatory consistency should be transparent.[32] For RIIO-ED1 in 2014, Ofgem placed significant weighting on current market conditions, in contrast to RIIO-1 that preceded it.[33] In 2018, Ofgem's consultation on RIIO-2 referenced forward looking measures to "reinforce" recommendations to reduce TMR whilst placing "most weight" on long term TMR. [34] Yet in the SSMD for RIIO-3, Ofgem states that it did not "explicitly" change RIIO-2 TMR based on prevailing market conditions, and it "will not adjust TMR up or down to reflect market conditions". [35]

- In response to Ofgem's suggestion that is it not possible to draw a parallel with the TMR set in the past as best practice has evolved over time, we agree with Oxera that this is not a sufficient reason to ignore the implications of past regulatory decisions. [36]

- A consistent approach in the SSMD is not apparent. This creates uncertainty as to the extent to which Ofgem weights cross check evidence, now that market conditions are very different to those prevailing up to the Final Determination for RIIO2 in 2020. Therefore, we agree with Oxera's view: :…"there is the risk that Ofgem's decision of not adjusting the TMR upwards could be interpreted by investors as a signal to expect a different treatment in scenarios of increasing and decreasing interest rates. This could undermine investors' confidence as well as regulatory stability and predictability in a particularly challenging period for the electricity and gas sectors, as also recognised by Ofgem."[37]

d) With regard to the TMR estimates:

- Ofgem's midpoint estimate is 6.75% within a range of 6.5% to 7.0%

- Oxera's TMR range is 7.0% to 7.5%. [38]

- Regarding the lower bound difference of 0.5% between Oxera and Ofgem, Oxera's evidence and justifications provided in Section 3.3 of its report are robust. Ofgem's placing of 50% weight on the ex-ante approach is wrong. For example, the evidence does not support the COLI-CED and serial

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[32] Consistency being one of the "have regard to" statutory duties on Ofgem in 4AA(5A) GA 1986.
[33] Ofgem (2014), 'Decision on our methodology for assessing the equity market return for the purpose of setting RIIO-ED1 price controls', 17 February, page 4. And for RIIO-1 : Paragraph 3.34, RIIO-GD1 Initial Proposals
[34] "We note that each of these [investment managers] forecasts is significantly lower than the 8-9% nominal TMR range we derive from inflating the UKRN Study by forecast CPI. These are in line with lower forward-looking measures and further reinforce the recommendation to reduce the long-term TMR range. Ofgem (2018), 'RIIO-2 Sector Specific Methodology Consultation: Finance Annex', 18 December, para 3.78 . The subsequent paragraph 3.80 included : "Therefore, we propose to maintain our approach of placing most weight on the average of long run returns, as the most objective measure of investor expectations".
[35] SSMD paras 3.93 and 3.95
[36] Document 58B – RIIO-3 Cost of Equity - CAPM parameters (Oxera) para 3.4.1,page 40.
[37] Ibid footnote 36.
[38] Ibid, section 3.5, page 44

correlation adjustments and excluding these the ex ante TMR should be 6.85%. And for the UK, there has been a convergence between ex ante and ex post estimates.

- For the upper bound, Oxera state: "Evidence suggests that at this point in time, investors would require higher market returns than the central estimate of 7% for the 'through the cycle' TMR, and we cannot exclude the possibility that values higher than 7.50% would be required." And.."When a similar level of gilt yields was last seen, the TMR allowance was above 8.00% in CPIH-real terms". [39]

- Frontier's cross checks indicate a range from 6.97% to 7.83%.[40] Frontier conclude that the range and point estimate proposed by Ofgem is insufficient, and that this plays an important role in explaining why Ofgem's overall CoE is too low. The proposed uplift by Ofgem of 25 bps from 6.5% used for RIIO-2 to 6.75% is inconsistent with the scale of change seen in wider market evidence.

- Our position:

  i. We have considered Oxera's and Frontier's evidence and arguments and provided challenge in discussions at ENA level. Overall, we find the evidence and arguments are strong and well made respectively.

  ii. We agree with Oxera's well evidenced and justified 7.0% to 7.5% TMR range.

  iii. Oxera's range is supported by Frontier's TMR cross check range of 6.97%% to 7.83%

  iv. A mid-point of 7.25% of the well supported 7.0% to 7.5% range is appropriate. This reflects a moderate weighting to the significant change in market interest rate levels since 2020 and in the lower half of the TMR range indicated by Frontier's cross check range. [41]

e) Asset beta of 0.42

- There are no listed pure play regulated UK gas networks.

- In its SSMD, Ofgem used a range of 0.30-0.40 and a midpoint of 0.35, based on National Grid, 2 listed UK water companies United Utilities and Severn Trent, and 5 European energy companies, Enagas and Red Electrica in Spain and Italgas, Terna and SNAM in Italy.

- Ofgem considers that changes to the beta comparator sample (i.e. the inclusion of European energy networks) and to the depreciation profile of the GDNs' regulated asset value (RAV) (i.e. accelerated RAV depreciation) are sufficient to reflect changes in the GDNs' risk profile between RIIO-3 and RIIO-2.[42]

- Oxera was commissioned by the GDN's to establish an evidence base for Ofgem to set an appropriate asset beta for RIIO-GD3, based on empirical evidence and regulatory precedents. Oxera narrowed down a gas-sector range of 0.29 to 0.50 to 0.40–0.44.[43]

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[39] Ibid section 3.5, page 43
[40] Summarised in Section 10.4
[41] The moderate weighting is reflected by comparing the increase to the risk free rate from the RIIO-2 FD of (1.58)% to the Oxera estimate of 1.54%, an increase of 197%. The change from the RIIO-2 FD TMR of 6.5% to our proposed 7.25% above is 11.5%.
[42] SSMD para. 3.305.
[43] Document 58C - Cost of Equity for RIIO-GD3 (Oxera). Summarised in Section 10.5.

i. Systemic risk : Oxera considers that Ofgem's beta comparator sample in the SSMD does not properly reflect gas-specific, forward-looking risks. Gas sector-specific data produced by Oxera supports a range of 0.40–0.44. [44]

ii. Non-systemic risks. Oxera consider that proposed changes to the depreciation of network assets are.."not sufficient to fully eliminate the asymmetric stranding asset risks, as uncertainty remains around networks' future ability to recover their costs. Besides, Ofgem's proposed changes to the depreciation schedule of the GDNs' RAV might create other risks that would need to be compensated." [45]While Ofgem indicated in the SSMD that it was considering aiming up within the asset beta range, Oxera note the regulator's intention in doing so is to improve the accuracy of its asset beta estimate, and not to compensate for asymmetric risks. In light of the fact that asymmetric risks are not adequately addressed by the proposed regulatory package, Oxera view aiming up within the proposed cost of equity range as a mechanism that Ofgem may use to compensate GDNs for these risks. We agree with Oxera. We discuss such risks in section 5.

- Accurate calibration for aiming up in relation to non-systematic risks is challenging. However, we note that the 0.40-0.44 range falls within a wider range of 0.38-0.50 drawn from European regulatory precedents and which to some extext reflects aiming up adjustments for non-systematic risks. On that basis, we therefore conclude that 0.40-0.44 to some extent reflects those risks, and adopting a mid-point of 0.42 is a reasonable and balanced approach in that regard.

- We adopt an asset beta of 0.42 to capture systematic and non-systematic risks.

f) Risk free rate ("RFR").

- Ofgem's approach to estimate the RFR is broadly consistent with the methodology in the RIIO-3 SSMC Oxera report, with the exception of the inclusion of the convenience premium by Oxera.

- The convenience premium reflects the difference between government bond yields and yields on zero-beta assets (which premium reflects special properties on government bonds).

- We note Ofgem's arguments for excluding a convenience premium.[46]

- We note that the convenience premium is positive, and therefore must be added to the gilt yield to avoid downward bias and provide an accurate estimate of risk-free rate. [47]

- Oxera concluded: "Ofgem's alternative approach is characterised by a series of methodological issues and it has also been superseded by the CMA's, CAA's and UR's past determinations, which undermine the robustness of this approach. Specifically, we consider that Ofgem should not adjust the yield on AAA non-government bonds for credit and liquidity risk premia, but it should estimate the convenience premium on the basis of a methodology aligned with the CMA, CAA and UR past determinations with duration-matched bond indices." [48]We agree with Oxera.

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[44] Ibid, Executive Summary, page 3."We observe that while the level of asset betas varies among companies, most asset betas in our analysis follow a similar pattern over time. The co-movement of gas network companies' betas in the international sample we have assessed, supports our hypothesis that the risks of these companies are reasonably similar and representative of the gas network sector."
[45] Ibid, pages 6-7
[46] Document 58B - RIIO-3 Cost of Equity – CAPM parameters (Oxera), section 2.1, box 1 page 12.
[47] Ibid, section 2.1 figure 2.2, page 17
[48] Ibid, para 2.1, page 22

- We agree with Oxera's conclusions and its rate of 1.54%.[49]

g) Cross check evidence on cost of equity.

- Frontier's five cross checks evidence show a range of midpoints from 6.6% to 8.0%. [50]
- Frontier conclude that Ofgem's cost of equity range in its SSMD is too low. Furthermore, the midpoint of Ofgem's range will not satisfy its equity investability objective. A key reason is that Ofgem's TMR range and midpoint is too low, revealed by Frontier's TMR cross checks.

h) Our conclusions:

- Our 6.89% rate is strongy supported by Oxera's CAPM and Frontier's cross check evidence.
- It is drawn from the midpoint of Oxera's baseline range of 5.7% to 6.83%, i.e. 6.25% before account is taken of GDN sector specific risks, including both systematic and non-systematic risks. To account for those risks, we apply a mid-point of the Oxera 0.40-0.44 range, representing a moderate 5% increase to the upper bound of 0.4 of Oxera's baseline asset beta range, moving the rate to 6.89%.
- It strikes a reasonable balance within the "fixed but not stable" approach for TMR, placing a moderate weighting on prevailing market interest rate conditions and TMR cross checks. This reflects our position that our rate should be adequate but not excessive for existing and potential new equity investors, and thus protect existing and future consumers.
- Finally, the 6.89% rate is approximate to average Ke rates from 2005 to 2026 of 7.0%. In that context and for the generation of consumers covering that timeframe and including RIIO-GD3, the proposed 6.89% allowed rate is not a material factor to bill increases over that period. [51]

3.3. Equity distribution rate.

a) Ofgem's working assumption for Business Plan purposes is 3%, unchanged from GD2. We note:

- Higher, and rising, dividend yields in European Gas comparators from 5.4% to 7.4%.[52]
- Higher dividend yields of 4% to 6% in listed UK regulated energy and water companies.[53]
- 10 -20 yr gilt yields average 4.0%-4.4% since Nov. 2022 supporting a lower bound of 4%. [54]
- We welcome Ofgem's view that: "We are open-minded to the requirements of investors, and we do see the potential benefit in considering issues such as the dividend preferences of investors in the utilities sectors (who often have underlying income requirements)."[55]
- Investors would expect distribution rates to trend to the Ke rate where RAV growth is expected to trend lower over time. [56] Average growth in real RAV over RII0-GD3 is (0.8%) p.a.[57]

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[49] Ibid, page table 2.2, page 23
[50] Document 58D - Updated cost of equity cross check evidence (Frontier economics). Frontier's cross checks on cost of equity and TMR summarised in Section 10.4
[51] Based on 6.25% from 2005-2008; 7.25% from 2008-2013, 6.7% for RIIO-GD1 and 5.0% for RIIO-GD2, and using an average 0.73% RPI/CPIH realised wedge from 2005-2021. (Support for that realised wedge is in the Finance Annex Support Workbook (Document 58A), RPI-CPIH wedge tab # 13, cell E7)
[52] Document 58F - Gas distribution networks dividends in RIIO-GD3 (Oxera), summarised in Section 10.6 - see section 10.6(i).
[53] Document 58A - Finance Annex Support Workbook, Gilt yields and dividends tab # 11, row 38.
[54] Ibid footnote 53.
[55] SSMD para 3.282
[56] Oxera's view in Section 10.6(g) to this Annex.
[57] Document 58A - Finance Annex Support Workbook. RevenueEbitdaCashflow Tab 10, cell c58.

- We have considered our distribution policy and the principles within that.[58]

b) Market evidence supports a range of 4%-6%. We apply a midpoint 5% base yield, less than the proposed allowed Ke rate of 6.89% and notwithstanding negative growth in Real RAV. This supports financeability and is before return of equity through special dividend payment.

3.4. Cost of debt:

a) [redacted]

b) [59]

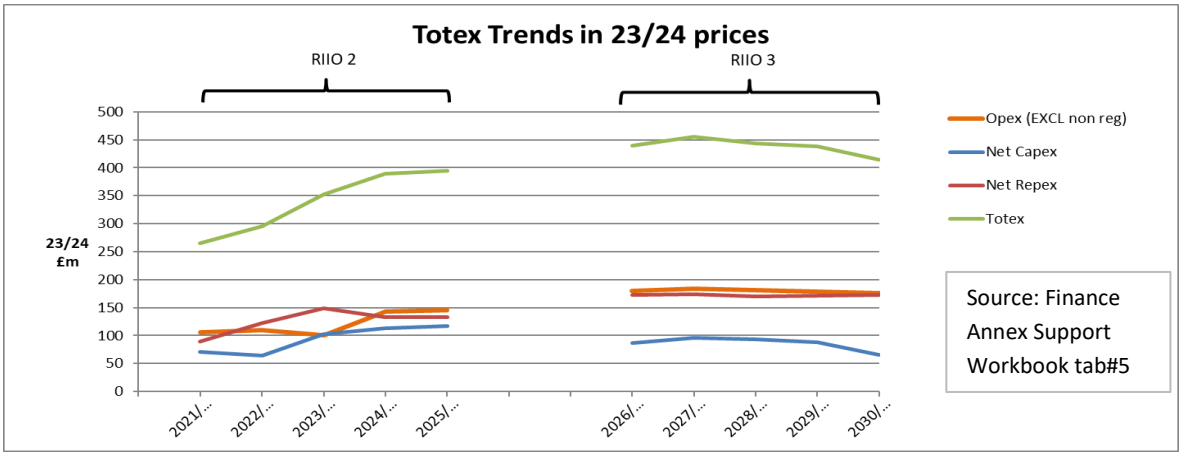
c) WWU's approach[60] is: (i) grounded in observable market rates when transactions are undertaken, (ii) subject to efficiency assessment and controlled for factors, with scope for out/underperformance for every transaction, and (iii) applies prudence at all times represented by an investment grade environment. It is not a "pass-through" approach. We discuss further in section 9.1.

d) The shortfall in the allowed rate impairs financeability of the Ofgem Actual Company structure plan.

[58] Section 11.1 in this Annex.
[59] Document 58A - Finance Annex Support Workbook. CostofDebt Tab #4, cell J98.
[60] Document 58E - Efficiency Assessment of WWU's debt and derivatives and comparison against Ofgem's revenue allowance for cost of debt – November 2024 update – summarised in section 10.7

4. TOTEX

4.1. Totex is WWU specific and identical across the plans. Higher Totex is expected in RIIO-GD3 over RIIO-GD2:



2023/24 prices (£m)	RIIO-GD2						RIIO-GD3						
	2021/22	2022/23	2023/24	2024/25	2025/26	Average	2026/27	2027/28	2028/29	2029/30	2030/31	Average	% change to GD2
	Actual	Actual	Actual	Forecast	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected
Opex (EXCL non reg)	105.3	109.8	100.9	143.0	144.9	120.8	179.8	184.5	180.8	178.6	176.6	180.1	49.1%
Net Capex	70.7	63.8	103.0	113.0	116.7	93.5	87.4	96.1	92.8	88.1	65.0	85.9	(8.1%)
Net Repex	89.4	122.3	149.0	133.5	132.8	125.4	172.4	174.4	169.7	171.7	172.5	172.1	37.3%
Totex	265.4	295.9	352.9	389.6	394.4	339.6	439.6	455.1	443.2	438.5	414.1	438.1	29.0%

Source: Finance Annex Support Workbook tab#5. For RIIO-2 the figures are Totex inputs; for RIIO-3 the figures are Totex allowance and inputs

4.2. Key points:

a) RIIO-GD3 Totex is 96 % mandatory, i.e. to comply with legal requirements and to ensure ongoing robust safety, reliability, gas leakage reductions and customer service at all times. [61]

b) WWU continues to deliver on all regulatory outputs, standards of service and other obligations.

c) Totex for RIIO-GD3 is a step change in terms of cost, scale, technical complexity and resourcing. [62] As noted in section 2.2(a)(ii), this challenge, combined with regulatory risk of shortfall in allowances, compel us to give particular focus to stress tests on Totex in financeability assessments in sections 6-8 below.

d) Totex is set at efficient levels. Ongoing efficiency is set at 0.6% p.a. on applicable Totex. RPE's are excluded, as required by Ofgem, and will be subject to regulatory adjustments in GD3. There are no reopener claims for RIIO-GD3 in our business Plan submission, although claims may eventually be submitted during GD3. Therefore, our plan represents baseline Totex including the impact of GD2 reopener claims where appropriate.

[61] For more details, see Document 60: "Cost assessment and Benchmarking Approach", section 1.3.
[62] Ibid, footnote 61.

5. TRANSITIONING TO NET ZERO CARBON BY 2050 – non-systematic risks

5.1. Transitioning a comparatively stable, investment intensive, energy distribution network to be compatible with the government targets for Net Zero Carbon creates risks for WWU.

5.2. In Section 3.2e, we referred to non-systematic risk in our discussion on asset beta. In this section, we describe those risks in more detail.

5.3. Ofgem considers the presence of individual asymmetric risks is not a reason to provide additional returns - it is the aggregated balance of the whole price control that should influence the balancing of overall risk and reward. [63] We and Oxera agree with this position. [64]

5.4. We note Ofgem will consider this balance of risk in its Draft and Final Determinations. [65] Again, we and Oxera agree with this approach. [66]

5.5. However, in its SSMD, Ofgem considers that changes to the beta comparators and accelerated depreciation sufficiently reflect any changes to the risk profile of RIIO-3 relative to RIIO-2 both in terms of accounting for the systematic risks of energy networks and accounting for any residual asymmetric risks.[67] We and Oxera disagree with this position.[68] In Section 3.2e, our asset beta estimate covers both systematic and non-systematic risks. We outline below a number of non-systematic risks which must be taken into account by Ofgem's in its Draft and Final Determinations in 2025.

5.6. Asset stranding risk

a) In its SSMD, Ofgem has recognised the "perceived risk" of asset stranding faced by the gas networks and decided to accelerate depreciation of RAV.[69] Ofgem chooses mitigation through accelerated RAV depreciation instead of compensation through higher allowed cost of equity.[70]

b) Accelerated depreciation alleviates some of the cashflow risk associated with recovery of historical investment but does not eliminate the risk of asset stranding as a whole, given the uncertainty over the exact pathway and timing of energy transition.

c) NESO's scenarios show significant reductions to gas demand by 2050. Its "Clean power by 2030" report suggests a reduction from 30% to 5% by 2030 of UK power from gas plant power generation using unabated gas.[71] Although Ofgem does not expect significant changes to domestic gas demand until RIIO-4 at the earliest, what matters is the impact of uncertainty on (i) *decision making* up to and during RIIO-GD3 by licensees in GD3 for operational, investment and financing purposes impacting RIIO-GD3 and beyond, and (ii) *investor willingness* to invest and/or retain their existing investment during GD3. These could be adversely affected, particularly if demand destruction would exceed expectations in GD3 in real time, prospectively or both. [72]

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[63] SSMD para 3.302
[64] Document 58C - Cost of Equity for RIIO-GD3 (Oxera) para 5.3, page 53, summarised in Section 10.5
[65] SSMD para 3.304
[66] Ibid, footnote 64.
[67] SSMD para. 3.308
[68] Ibid footnote 64, section 5.6, page 54
[69] SSMD para. 8.19
[70] SSMD para 3.307
[71] NESO 2024 Future of Energy Scenarios : here. NESO "Clean Power by 2030" report here
[72] Ofgem (2024), 'RIIO-3 SSMD GD Annex', 18 July, para. 1.9

5.7. Operational costs

a) Under normal, steady-state operating environments, one would expect that the combination of Ofgem's cost models and uncertainty mechanisms would provide sufficient cost allowances for all efficient and necessary expenditures.

b) However, WWU's GD3 programme requires a step change to value and technical complexity. This is primarily driven by (i) the increased complexity and sparsity of the remaining, HSE mandated mains replacement workloads and (ii) increased cyber security and related IT requirements.[73]

c) Unit costs are thus increasing, whether measured per unit of the current composite cost drivers (Composite Scale Variables ; "CSV") or simpler measures of scale (e.g. per customer, per unit of gas supplied). Further, as the costs to maintain the network are largely fixed, GDN costs per customer/unit of gas supplied will increase further in future—given the impending loss of demand.

d) There is thus an increased, asymmetric risk that Ofgem's Totex allowances will be insufficient—especially if Ofgem's cost assessment approach is not updated to account for these developments. However, Ofgem has indicated in its SSMD that the GD2 cost assessment approach will largely form the basis for GD3.[74] It is seemingly only considering minor alterations, such as using some combination of throughput, network length or customer numbers as alternative scale drivers (in addition to, or instead of, MEAV).[75]

e) There are thus two main sources of benchmarking risk, both asymmetric, based on Ofgem's current cost assessment considerations:

- Not accounting for increased workload complexity and cost: The current cost drivers do not account for (i) the increased complexity and more remote locations of mains replacement workloads (as it has already proved true for WWU's GD2 Rexpex programme) or (ii) the step change in IT and Cyber costs.

- Cost–cost driver disconnects: The vast majority of GDNs expenditure is non-load related, but required to meet legislative safety requirements (e.g. Repex and emergency) and maintain asset health for safe and resilient networks, irrespective of customer numbers or volume of gas transported. A scale driver that remains stable or decreases over time, like customer numbers or throughput, would thus be inappropriate in an environment where workload complexity and real costs are increasing.

5.8. Workforce

a) The uncertainty over the pathway of the energy transition and the time horizon over which gas networks will remain in operation puts pressure on workforce resilience, in an already competitive labour market environment. Uncertain prospects over the sector's future are likely to make it increasingly challenging to attract new talent, especially, as other network industries, such as electricity or water, are undertaking massive investment programmes that require broadly similar specialised labour. An increasing concern is the risk of loss of critical experienced front line operating staff and inability to recruit suitable new staff to support operational workload commitments.

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[73] Document 60E - Oxera (2024), 'Review of Ofgem's proposed approach to cost assessment at GD3' – see Sections 2.2.1 (Repex), section 2.2.2 (IT & cyber)
[74] Ibid footnote 72, section 5.
[75] Evident from the cost assessment working groups (CAWGs), e.g. Ofgem (2024), 'RIIO-GD3 Cost Assessment Working Group 7. Totex modelling and BPDT development', 10 April 2024.

b) Maintaining a competitive labour market position will require investment in a combination of higher wages, benefits, training programmes and potential reskilling programmes to ensure that working in the gas network industry remains an attractive career choice for new entrants and existing staff. This results in an asymmetric labour resilience and cost pressure risk.

5.9. Debt capital

a) The presence of asymmetric risks is particularly impactful in affecting the perceptions of debt investors. Debt investors are primarily concerned with downside protection when pricing instruments, thus, expectations of asymmetric loses and significant uncertainty over the sector's future is likely to affect the cost of debt. The effect is likely to be more pronounced when long term debt capital is sought. The maturity of most debt raised by the GDN's to date in GD2 is not long term.[76]

5.10. Rating Agencies[77]

a) Similarly to the general perceptions of debt investors, asymmetric risks faced by the gas networks are likely to be reflected in the assessments carried out by the credit rating agencies. Apart from financial metrics and company structure, credit rating agencies commonly evaluate the general trends of the industry in which a company operates in order to determine the relevant credit rating thresholds. For example, Moody's methodology for assessing regulated electricity and gas networks places 40% weight in the Regulatory Environment and Asset Ownership model of the industry in which the network operates.[78] This includes stability and predictability of regulatory regime, cost and investment recovery (ability and timeliness) and revenue risk. The uncertainty over the pathway of the energy transition and the associated asymmetric risks indicate that gas networks may score lower in the sub-categories in the future.

b) All other things equal, these issues imply more demanding levels of financial metrics in order to maintain the same credit rating. Given the expectation that credit metric requirements are likely to become more stringent (with no current expectation of requirements easing) this presents an asymmetric risk to the financial needs of gas networks.

5.11. Political and institutional risk

a) Given the uncertainty over the pathway of the energy transition, GDN's are exposed to policy choices that may strongly affect their financeability. For example, the UK government is still due to make a decision on the role of hydrogen in 2026. When that decision is made, it will have implications on gas networks in terms of both potential asset repurposing, as well as labour force reskilling. Additionally, there is a risk of a policy reversal or recalibrated as new information over the preferred transition pathway materialises. Unpredictable or reversed policy is likely to increase uncertainty and cost for gas networks.

b) Until a transition pathway is crystallised, gas networks may have to invest in innovation and maintenance of the network to ensure that optionality is retained, with no guarantee that this expenditure will be treated as 'efficient' in the future.

5.12. **Past practice.** In the past, Ofgem took account of non-systematic downside risks. For GDPCR1 it said:

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[76] The only long term debt issued by GDN's in RIIO-GD2 so far are the WWU 20 year PP Notes for £150m.
[77] See footnote 8 for further details.
[78] Moody's (2022), 'Rating Methodology. Regulated Electric and Gas Networks', 13 April 2022, p.3.

a) "We continue to take the view that the allowed return on equity should reflect the balance of all risks that will be faced by companies under the price control proposals, including both systematic and non-systematic risk, to provide appropriate incentives to manage these risks effectively and to invest efficiently in maintaining and developing their networks." [79]

b) "…and having regard to the additional cost allowances we have decided to make which will, to a degree, reduce the non-systematic risk faced by companies."[80]

c) We expect regulatory consistency on this matter to be reflected in Ofgem's Draft and Final determinations in 2025. [81]

5.13. Our conclusions:

a) The risks highlighted in paragraphs 5.6-5.11 above do not have adequate mitigation or compensation in Ofgem's SSMD.

b) Given Ofgem's view noted above in paragraph 5.5, WWU must therefore qualify its financeability statements for the Ofgem Notional Company and Ofgem Actual Company basis.

c) In Section 3.2e, we propose an asset beta to take account of non-systematic risks and therefore included in our adopted Ke rate of 6.89% for the WWU Company specific plan.

[79] Ofgem (2007), 'Gas Distribution Price Control Review Final Proposals', 3 December, para 9.18
[80] Ibid, paragraph 9.22
[81] Ofgem's statutory duty in section 4AA(5A) GA86 to have regard to the principles of best regulatory practice including "consistency".

6. FINANCEABILITY ASSESSMENT – NOTIONAL COMPANY

6.1. This section is structured as follows:

a) Target credit rating
b) Gearing for WACC determination
c) Key credit ratios
d) Stress tests
e) Remediation
f) Consumer bill impact
g) Conclusions

6.2. Target Credit Rating

a) Ofgem requires a target issuer rating level to be proposed by Licensees. [82]

b) For RIIO-2, Ofgem concluded BBB+ was appropriate. [83]

c) Our approach is as follows:

- **Lower bound : This should be BBB flat.** A target level of BBB- would leave no material headroom before a licence breach, with dividends blocked and increasing risk of entry to sub-investment grade with significant adverse implications for access to capital at affordable costs. The target rating level should therefore be at least one notch above BBB-.

- **Upper bound : This should be BBB+.** Targeting a rating level in the "A" rating band would require materially more equity for debt reduction to drive gearing sustainably below 60% and to comfortably meet more demanding key coverage metrics. [84] More generally, targeting the "A" level space, requiring equity to replace debt, seems directionally inconsistent for a sector which is likely to trend towards disinvestment, i.e capital outlfows over time, subject to appropriate financial resilience measures.

- **In deciding between BBB flat or BBB+,** we have considered:[85]

  i. If a target of BBB flat could be justified with reference to :
     1. Comparatively lower investment growth to other UK regulated sectors
     2. Return of capital through accelerated RAV depreciation revenue

  ii. If a BBB+ target could be justified with reference to :
     1. Lower cost of debt[86]
     2. Lower risk of migration to sub-investment grade or default
     3. Better access to capital, particularly in times of market disruption

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[82] RIIO-3 BP Guidance para 7.9.
[83] Ofgem (2020), 'RIIO-2 Draft Determinations – Finance Annex', 9 July, para 5.18
[84] For an A2 rating, Moody's require gearing to be less than 60% and AICR above 1.8x. S&P require a minimum threshold of 13% based on their A- ratings of NPg and UKPN. Fitch ratings of those utilities imply gearing less than 60% and nominal PMICR above 2.2x.
[85] We apply a similar approach to Ofgem for RIIO-2 – see RIIO-2 Draft Determinations – Finance Annex paragraphs 5.16-5.17 – and add in additional factors relevant for RIIO-GD3.
[86] Ofgem estimated a range of 15-30bps for RIIO2 (Draft Determination paragraph 5.17). Yields on some GDN bonds in the secondary market since April 2021 suggest a spread approximate to the lower bound of that range. Document 58A, Finance Annex Support Workbook, Bond Spreads tab# 16, cells C7-C8.

4. Greater financial resilience, as energy transition risks intensify, combined with a more challenging totex programme for GD3
5. RAV depreciation acceleration does not offset the funding required to repay expiring debt and to finance investment, so new debt will still need to be raised
6. Supports regulatory consistency allied with most UK regulated energy businesses rated in the BBB+ space as illustrated by Ofgem.[87]

d) Regarding qualitative rating aspects as noted in 2.2c, these are skewed to the downside. The step change in scale and complexity of the RIIO-GD3 Totex programme noted in Section 4 could add some negative pressure to the rating. We have concerns regarding regulatory consistency, underpinning stability and predictability, in the category for regulatory environment and asset ownership. However, we assume Ofgem will resolve these concerns in its Draft and Final Determinations in 2025. [88]

e) On balance, the factors above support a BBB+ rating as appropriate for RIIO-GD3.

6.3. Gearing for WACC determination

a) Since 2008, gearing level for WACC determination has moved within a narrow 60%-65% range:

- For GDPCR1 (2008-2013) and RIIO-GD1 (2013-2021) Ofgem set gearing at 62.5% and 65% respectively.

- For RIIO-GD2, Ofgem reduced gearing from 65% to 60% following its financeability assessment and taking account of market data.[89]

b) For RIIO-GD3, Ofgem's SSMD position is: "Given a lack of evidence to suggest that gearing levels of the notional capital structure should change, and subject to further assessment of business plans, we are minded to set the gearing levels of the notional capital structure in line with RIIO-2."[90]

c) Ofgem requires licensees to consider appropriate gearing levels for RIIO-3. [91]

d) Our approach is as follows:

- WACC must reflect a target gearing level to weight the cost of equity and debt. That gearing level should be consistent with the gearing range implied by the target rating for debt financeability.

- Having set a target rating of BBB+ for debt financeability, an appropriate gearing range is estimated within which a single point estimate of gearing for WACC is determined. We apply 2 steps:

    i. First, determine an appropriate gearing range that is explicit or implied by rating agency thresholds.[92] These thresholds are central to debt financeability assessment and indirectly

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[87] SSMD para 6.69. In the bar chart, the gearing level for WWU are correct at March 2023, however that gearing level has materially reduced following equity investment in October and November 2023. See footnote 120 on WWU's issuer rating of BBB flat with Fitch, where WWU considers the appropriate level should be BBB+.
[88] For example, regulatory consistency is not apparent in the SSDM in Ofgem's stance on TMR as noted in Section 3.2c And likewise with regard to aiming up for non-systematic risks as noted in para 5.5.
[89] SSMD para 4.6, table 14. Ofgem RIIO-2 Final Determination – Finance Annex para 5.45.
[90] SSMD para 4.16
[91] RIIO-3 BP Guidance para 7.10
[92] Ofgem considered rating agency views in setting gearing for RIIO-2 (Draft Determination para 5.39). And for RIIO-1: RIIO-GD1 Final Proposals, paragraph 3.37, which references rating agency gearing ratios and company gearing levels. We say "implied" because transparency is not uniform across the three agencies. We use gearing level boundaries for BBB+ from Fitch and S&P using their existing ratings on UK energy regulated utilities.

relevant to equity financeability. [93]Rating agencies are independent and expert in credit assessment across all UK regulated energy sectors, therefore a weighting to their thresholds underpins the objectivity and independence of the process. Further, Ofgem has decided to strengthen the licence obligation to maintain an investment grade rating, making it an absolute requirement at all times and expanding this to a minimum of two rating agencies. Although a financial resilience measure, it would not be consistent to ignore the increased importance of rating agency influence in general and specifically on gearing levels.

1. At a BBB+ rating level, Moody's gearing range is 60% to 75%, subject to other key ratio thresholds (e.g. AICR) and qualitative factors being consistent. We infer a range of 60% to 70% from Fitch. [94]

2. In practice, we see rating agencies setting expectations from 60% to around mid-60% for some BBB+ rated utilities.[95]

ii. Second, we flex WACC by moving gearing within the target rating of BBB+.

- Therefore, we sensitise WACC from 60% to 70% gearing levels :

WACC sensitivity to gearing within a BBB+ rating level

		Gearing at 60%	Gearing at 65%	Gearing at 70%	
Gearing	**a**	**60.000%**	**65.000%**	**70.000%**	Flexed
RFR	b	1.270%	1.270%	1.270%	Per BPFM, updated by Ofgem
TMR	c	6.750%	6.750%	6.750%	Per SSMD, table 13, 3.227, mid point
Debt beta	d	0.075	0.075	0.075	Per SSMD, table 13, 3.227
Asset beta	e	0.35	0.35	0.35	Per SSMD, table 13, 3.227, mid point
Equity Beta	f	0.76	0.86	0.99	(e-(d*a)/(1-a)
Cost of equity	g	5.43%	5.99%	6.70%	b+f*(c-b)
Cost of debt	h	4.35%	4.35%	4.35%	per J93 of Finance Annex Support Workbook tab 4_Cost of Debt
Cost of additional debt	i	0.00%	0.41%	0.76%	Assuming 5.93% nominal cost for new debt
WACC	**j**	**4.78%**	**5.19%**	**5.59%**	g*(1-a)+(h+i)*a

Source: Finance Annex Support Workbook tab #1. *Small rounding differences ignored*

- A gearing increase from 60% to 65% increases WACC by 37 bps, equivalent to about £13m p.a. in revenue, and £26m p.a. in moving to 70% gearing. [96]This would lead to higher consumer bills and reduced headroom on key metrics within the rating level of BBB+.

- Therefore, a material increase to gearing above 60% would not be appropriate for RIIO-GD3. Nor would a reduction below 60% to be justified in the context of RAV depreciation acceleration, as this would lead to trapped equity capital and impede equity financeability for the GDN sector.

- As noted at the outset of this section 6.3, the gearing level set by Ofgem has been stable, in a narrow band from 60% to 65% over 18 years, supporting regulatory stability and predictability.

[93] SSC A39 of the license blocks dividend payments if the rating falls to BBB- negative outlook
[94] The inferred Fitch range is sourced from their publication "What Investors Want to Know – RIIO-3 Sector Specific methodology Decision, 14 November 2024, page 6, where IDR gearing sensitivities at BBB+ generally range between 60%-70%. We have not been able to determine gearing thresholds from S&P for RIIO-GD3.
[95] Moody's expects Cadent to target gearing at Opco to be "below the high 60's". (Moody's credit opinion on Cadent Gas Limited 17 September 2024). Fitch and S&P expects WWU gearing to be around 60% by March 2026.
[96] Document 58A - Finance Annex Support Workbook, WACC Gearing sensitivity, tab #1. Rows 24-35, col C-I.

- A 60% level is a prudent lower bound for a BBB+ rating. We think a prudent approach to gearing is needed when considered in the context of the need for extra caution in GD3 as outlined in section 2.2a(i)-(v) and the regulatory policy to deter gearing in excess of the 60%.

- Therefore, on balance, we consider a target gearing of 60% appropriate for WACC setting, and is consistent with a prudent level of gearing within a BBB+ rating target

6.4. Key credit ratios

a) With a target rating of BBB+, the key gearing and coverage ratio and thresholds are:

- **Moody's:** maximum net debt to RAV of 75% and minimum AICR of 1.4x [97]
- **Fitch:** maximum net debt to RAV of 70% and a minimum nominal PMICR at 1.6x.[98]
- **S&P:** FFO/net debt: 9%.[99]

b) For gearing, we apply Moody's threshold of 75%, and will bear in mind Fitch's threshold of 70%.

	Ofgem Notional Company					
	2026/27	**2027/28**	**2028/29**	**2029/30**	**2030/31**	**Average**
Gearing : Net debt/RAV	**60.0%**	**60.0%**	**60.0%**	**60.0%**	**60.0%**	**60.0%**
Maximum threshold	75.0%	75.0%	75.0%	75.0%	75.0%	75.0%
Headroom/(shortfall) in debt	475.7	483.7	489.1	492.9	493.9	487.1
Moody's AICR	**1.8**	**1.8**	**1.8**	**1.8**	**1.7**	1.8
Minimum threshold	1.4	1.4	1.4	1.4	1.4	1.4
Headroom/(shortfall) in cashflow	33.3	32.6	32.6	32.3	31.4	32.5
Fitch nominal PMICR	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	2.0
Minimum threshold	1.6	1.6	1.6	1.6	1.6	1.6
Headroom/(shortfall) in cashflow	36.4	37.5	38.1	37.7	36.6	37.3
S&P FFO/Net debt	**16.4%**	**16.9%**	**17.6%**	**18.3%**	**19.1%**	**17.6%**
Minimum threshold	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%
Headroom/(shortfall) in FFO	140.1	152.4	167.5	183.0	199.8	131.5
Source: Finance Annex Support workbook tab#6						

- Debt financeability

  i. Gearing is controlled to 60% at each year end.[100]

  ii. Coverage ratios :

  1. Moody's and Fitch coverage ratios appear adequate. The S&P ratio is significantly elevated, reflecting inclusion of RAV depreciation revenue in FFO whereas Moody's AICR and Fitch Nominal PMICR exclude this. [101]

  2. However, Ofgem's decision to change to a mixed nominal (70%) and real (30%) allowance for cost of debt is a significant speed of money adjustment and materially

[97] (redacted)
[98] (redacted)
[99] This level is observable from S&P's BBB+ rating of NGN.
[100] We assume the Notional Company would not, as a matter of principle, have gearing exceeding 60% given the regulatory policy to deter gearing in excess of 60% through tax clawback, and we also assume it would not allow gearing to fall below 60%, to avoid inefficient capital deployment.
[101] S&P may increase minimum thresholds significantly, therefore we do not think it is prudent to place material reliance on their FFO/net debt ratio at the levels in the table above.

flatters coverage for GD3, estimated at £28m p.a. [102] Excluding this weakens Moody's and Fitch ratios to just above their minimum thresholds at 1.4x and 1.7x, respectively.[103]

iii. However,given the prudent level of gearing ,we provisionally conclude that the Notional Company should be debt financeable at the BBB+ target. This conclusion assumes no material adverse outcomes from the concerns we have raised in section 2.2a(i)-(v) and that the Draft and Final Determinations by Ofgem in 2025 will be balanced on an overall risk and return basis.

- Equity financeability (including investability)

i. As noted in Section 2.4, Ofgem's Business Plan guidance requires that where financeability challenges are identified (including "servicing equity"), these must be addressed in accordance with the guidance, including "what regulatory measures should be taken".

ii. Based on Ofgem's Business Plan assumptions for cost of equity of 5.43% and the base dividend rate of 3%, both base dividends and also return of equity through special dividend are not impeded, whilst maintaining gearing at 60%.[104] To that extent (i.e. before wider investability matters are considered) the Notional Company should be equity financeable provided (i) our concerns in 2.2.a(i)-(v) do not result in material adverse outcomes and the Draft and Final Determinations in 2025 are balanced on an overall risk and return basis.

iii. However, applying equity financeability when it fully reflects investability, we must ask if Ofgem's assumed Ke and dividend rates are likely attract and retain equity if needed ? Based on strong evidence and argument provided in this annex, WWU disputes the sufficiency of Ofgem's assumed Ke and dividend rates. Those rates would not attract new equity in the event this is needed and are therefore not consistent with equity financeability.[105] Further, those rates could disincentivise maintenance of gearing at the prudent level of 60% and impel equity investors to withdraw more of the existing equity, subject to appropriate financial resilience measures.[106] We note Ofgem's view, in the context of investability, that UK and global infrastructure investment is likely to increase significantly in the coming years.[107] Therefore, it would not be prudent to assume equity investment in RIIO-GD3, should it be required, at the Ofgem assumed rates for Ke of 5.43% and dividend yield of 3%. Likewise, retention of existing equity is subject to the same investability considerations.

- Overall, we provisionally (i.e. before considering remediation and customer bill impacts) conclude that the Notional Company should be financeable, but with reservations on equity financeability and to a lesser extent on debt financeability.

6.5. Stress tests

[102] This is approximated as follows: Average time neutral RAV is £3.2 billion, therefore the debt RAV (60%) £1.9billion. The % delta between the real Kd (2.9%) and mixed nominal/real Kd (4.35%) is 1.45%. Applied to debt RAV increases the Kd revenue allowance by £28m p.a. Consistent with Ofgem's BPFM, we assume no phased implementation of this policy change by Ofgem.
[103] Gearing would also be higher. This is estimated by (5x £28m p.a) less the reduction to RAV indexation at £27m (estimated at (£3.2bn x 0.6 x 0.7 x 0.02x5) x 0.04x5)) giving £113m. As a % of average closing nominal RAV of £3.2 billion, this approximates to 3.5%. However, we cannot reliably judge if rating agencies would adjust gearing ratio thresholds for this impact in addition to any actions to be taken on coverage ratio thresholds.
[104] Document 58A - Finance Annex Support Workbook, RevenueEbitdaCashflow tab # 10, rows 36 -37, col's. B-I
[105] As noted in Section 2.3.
[106] And the rating agencies may tighten debt capacity (e.g. Ibid footnote 8 : Fitch report "What Investors Want to Know issued 14 November 2024), thus highlighting the negative consequences if the RIIO-GD3 package is not attractive to equity investors.
[107] SSMD para 3.23

a) Summary of results

NOTIONAL COMPANY - STRESS TESTS - RESULTS SUMMARY

Key : **red** highlights adverse movement to average base ratio

		Average AICR ratio			Average Gearing ratio			
Stressed variable	**Stress band**	**Base**	**High - impact**	**Low - impact**	**Base - see note 1**	**High - impact**	**Low - impact**	**Material ? (see note 3)**
Interest rates	+ / - : 2%	1.9	0.0	0.0	56.4%	-0.6%	0.6%	Not material
RPI/CPIH wedge (note2)	+ / - : 0.5%	1.9	0.0	0.0	56.4%	0.2%	-0.2%	Not material
CPIH inflation rate	+ / - : 2%	1.9	0.0	0.0	56.4%	-0.8%	0.8%	Not material
Totex	+ / - : 10%	1.9	-0.2	0.2	56.4%	2.9%	-3.0%	Material
RORE	+ / - : 2%	1.9	0.4	-0.4	56.4%	-2.5%	2.5%	Material
ILD - 30% of debt	+ / - : 10%	1.9	0.0	0.0	56.4%	0.1%	-0.1%	Not material

Note 1: Special dividends are used to control gearing to 60%. For the purposes of assessing the true impact on gearing, those special dividends are disapplied.

Note 2. This is the RPI/CPIH wedge. Only the CPIH variable is flexed for the Notional Company as it has no RPI exposure.

Note 3. We apply a materiality threshold for AICR of 0.2 and for gearing 1.5%

Source: Finance Annex Support Workbook tab #7

b) We note a material impact from the Totex stress test:[108]

- We noted in Section 2.2(a) Totex challenges for RIIO-GD3 and regulatory risk of allowance shortfall.
- In RIIO-GD2, there are Totex allowance shortfalls equivalent to 1% of RORE, placing upward pressure on gearing, therefore the risk of material Totex allowance shortfalls in RIIO-GD3 from inadequate allowances is non-trivial.[109] That risk, combined with a more challenging Totex programme for RIIO-GD3, puts adverse pressure on Notional Company credit metrics.
- The 10% adverse stress on Totex leads to an average increase to gearing of around 3% over the control period. By itself, that could be absorbed by the prudent gearing position. However, it should be considered in the round, including the concerns highlighted in section 2.2a(i)-(v) and thus add force to our qualifications of debt financeability at BBB+.

6.6. Remediation

a) We have provisionally concluded that the Notional Company should be financeable but must qualify this with our reservations for both equity financeability and debt financeability.

b) We have considered remediation measures outlined in section 2.4. for equity financeability.

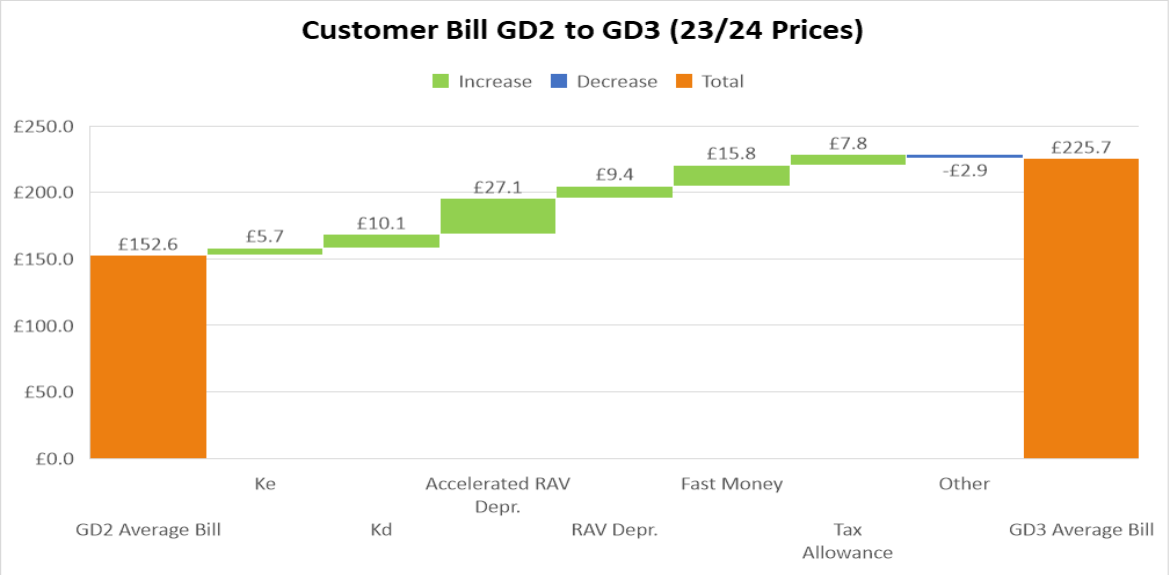
- We have identified the causes in section 6.4, i.e. a Ke and dividend rate that are both too low.
- We have considered management measures that could reasonably be made to address them. The only material company specific input is Totex. However, because Totex is largely (i.e. 96%) mandatory and efficiently set, there is no material likelihood of outperformance to improve equity financeability (including investability) through higher RORE from totex outperformance.
- We have considered regulatory measures that should be taken. Ofgem should :

[108] There is also a material impact from the RORE stress, but RORE is not an input risk. Therefore, we do not assess it further.
[109] WWU (2024), '2023/24 RFPR', 30 September, R1-RoRE

i. consider the evidence in this Annex for the WWU Company specific plan and adjust its assumed equity rate and dividend to the proposed rates in this plan.
ii. Ensure that our concerns raised in section 2.2a(i)-(v) do not lead to adverse outcomes.
iii. Ensure that the overall risk and return in the Draft and Final Determinations are balanced.

- We have considered all other applicable measures such as additional revenue acceleration measures. However, these are NPV neutral and cannot remediate inadequate equity returns taking investability considerations into account. Such measures would not attract equity into the Notional Company if equity would be needed, if the assumed Ke and dividend rates apply.[110]

6.7. Consumer bill impacts[111]



a) The increase to average bill level (relating to WWU's revenue) from RIIO-GD2 to RIIO-GD3 is 48% (£73). The increase is largely due to (i) Ofgem policy decisions on RAV depreciation and WACC and (ii) higher Totex to sustain the safety, reliability and customer service levels of the network.

b) Regarding Ofgem's SSMD policy decisions :

- Accelerated RAV depreciation causes a £27 bill increase, 18 percentage points of the 48% increase. This contributes to intergenerational fairness for consumers and some reduction to asset stranding risk.[112]

- Higher WACC causes a bill increase of £15.9, 10 percentage points of the 48% increase

c) Regarding the remaining increase to RAV depreciation of £9.4 and fast money of £15.8, totalling £25.2 or 17 percentage points of the 48% bill increase, these reflect essential efficient costs and investment to sustain the network for GD3 as noted above in 6.7(a).

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[110] In addition to the revenue acceleration measures by Ofgem for RAV depreciation and the change of Kd from 100% real to 70% nominal and 30% real. Such measures could involve lower capitalisation rates and increasing the portion of Kd to be earned in nominal terms.
[111] Document 58A - Finance Annex Support Workbook, tabs 8 and 8a
[112] SSMD para 8.20. "Our principal objective is to protect current and future consumers, which includes considering their interest with respect to net zero. In the gas sector, following this objective suggests that we should start to address future gas demand reduction and its potential impact on consumer bills." And paragraph 8.25 : "Accelerating the depreciation rate, by increasing depreciation amounts during RIIO-3, will smooth the consumer bill payments over time for three of the four FES scenarios."

d) The increase of £73 in the context of the total end bill (excl VAT) to consumers is approximately 9%.[113]

6.8. Conclusions

a) We conclude that the Notional Company should be financeable but with reservations both on equity financeability taking investability considerations into account and on debt financeability.

b) We have considered remediation measures. Ofgem should (i) adjust its Ke and dividend rates to the well evidenced WWU Company specific equity and equity distribution rates, (ii) ensure that our concerns raised in 2.2(a)(i)-(v) do not lead to adverse outcomes and (iii) ensure that overall risk and return are balanced in its Draft and Final Determinations in 2025.

[113] Document 58A - Finance Annex Support Workbook, Customerbills tab # 8, cell D92.

7. Financeability assessment - Ofgem actual company structure basis

7.1. This section structured as follows :

a) Introduction
b) Core financial objectives
c) Track record
d) Target credit rating
e) Key credit ratios
f) Stress tests
g) Remediation
h) Consumer bill
i) Conclusions

7.2. Introduction

a) Ofgem requires a financeability assessment of its Actual Company structure basis. This requires, inter alia, WWU's actual capital structure to be included in that assessment. [114]

b) **Core financial objectives.** WWU's capital structure is anchored by:

- Consistent compliance with senior lender finance documents relating to the whole business securitisation ("WBS")[115] structure, prudent headroom with forward looking financial ratios.
- Consistent Class A debt credit ratings of A-.
- Consistently servicing the reasonable expectations of our capital providers.
- For equity investors, dividend and equity issuance expectations for RIIO-GD3 are as follows:[116]
  i. base dividend of 5% p.a. on equity RAV, as explained in section 3.3[117]
  ii. In terms of return of equity in the context of accelerated RAV depreciation, a fair return is expected assuming 60% gearing would be maintained.
  iii. Equity issuance strategy for RIIO-GD3 is primarily governed by the allowed cost of equity rate. As explained in Section 3, the proposed allowed rate for RIIO-GD3 is 6.89%.
  iv. The above expectations in (i)-(iii) are premised on the basis that all efficiently and prudently incurred Totex and debt (including derivatives) costs are allowed at 60% gearing.

c) **Track record**

- Consistent A- debt ratings with Fitch and S&P since 2010, unique in the sector.
- Shareholder support, followed by a £344m equity injection in 2023. This support is in a context for RIIO-GD2 where RORE is inadequate, projected at 1.9% (real CPIH) for GD2, despite efficient and

[114] RIIO-3 BP Guidance para 7.8
[115] Implemented in March 2010.
[116] Ibid footnote 114, para 7.9, requiring, inter alia, an explanation of licensee dividend and equity issuance policy and strategy. The expectations above are based on a WWU policy target gearing ratio of 60%.
[117] Appendix 11.1 contains WWU's current dividend policy.

prudent cost incurrence across the business and capital structure and 100% regulatory compliance with no workload backlogs.[118]

d) **Target issuer credit rating.** This is BBB+. Our rationale is as follows:

- The target credit rating required by Ofgem for WWU is an issuer credit rating, i.e. a credit rating of the entire company, not a rating confined to a particular debt class, i.e. a debt rating.
- The A- debt ratings from Fitch and S&P apply to Class A debt. After 2026/27, class A debt in WWU will represent all secured debt in WWU.[119]
- Fitch and S&P grant a one notch uplift for Class A debt due to the WBS credit protections.
- Therefore, it is reasonable to conclude that WWU's implied *issuer* rating, excluding the one notch uplift for the WBS, is BBB+.[120]
- In section 6.2, we considered the factors relating to a higher and lower target issuer rating for the Notional Company and concluded that BBB+ was appropriate. Those considerations and related conclusion also apply to the actual company structure.
- We have also considered the qualitative factors in Section 6.2d and reach the same conclusions.
- Therefore we apply a target issuer rating of BBB+ for the Ofgem Actual Company structure.

7.3. Key credit ratios

a) **Debt financeability**

[118] WWU (2024), '2023/24 RFPR', 30 September, R1-RoRE
[119] Contractually agreed with lenders to Midco. Further, the WBS in WWU prevents WWU from raising unsecured debt in excess of 0.8% of RAV. The UK corporate structure is in appendix 11.2
[120] The capital structure of WWU contains different rating levels relating to different parts of the capital structure. There is an issuer rating from Fitch of BBB flat/stable relating to the entire capital structure, and there are debt ratings from both Fitch and S&P of A- for Class A debt, per WWU rating update from S&P issued 19 September 2024. This capital structure – a "Whole Business Securitisation" ("WBS") in place since 2010 - is granted a one notch uplift for Class A debt by Fitch and S&P for its credit protective attributes. Fitch attribute a BBB+ level to WWU's Class B debt and S&P attribute a BBB+ for WWU's "standalone" credit profile in arriving at the A- rating for Class A debt.

- 121 122 123 124 **125** **126** 127 **128** 129 (paragraphs redacted)

[121] From 2024, WWU introduced a policy not to exceed the gearing threshold for regulatory tax clawback purposes.
[122] As noted in Section 3.3b, the WWU company "base" (i.e. before return of equity through special dividends) dividend rate is 5% p.a of equity RAV. We have applied a rate of 3% for 2 reasons : (i) equity issuance would be required to ensure gearing does not exceed 60%, even if special dividends were reduced to nil. It is not efficient to issue equity with attendant costs of issuance, when a lower dividend would preclude that cost. And (ii) to simplify analysis. Support in Document 58A Finance Annex Support Workbook, tab # 10, cols L-T rows 56-64.
[123] The assumed use of lower base dividends and special dividends to control gearing to 60% is in a context of Ofgem's assumed WACC allowances, which WWU dispute.
[124] The S&P coverage ratio reflects inclusion of RAV depreciation revenue in FFO. Prudently, we assume S&P will act to mitigate this through a higher threshold. It is also unclear whether S&P would act to mitigate the impact of revenue acceleration from the KD change. Given this uncertainty, we do not place reliance on it.
[125] "FFO" meaning "Funds from Operations", the numerator in the AICR ratio. See Document 58A, Finance Annex Supporting Workbook, tab 10, rows 63-64, column N, for the position shown in simplified extract form.
[126] Consistent with Ofgem's BPFM, we assume no phased implementation of this policy change.
[127] Negative outlook timeframes are generally for 12-18 months, signalling a rating decision action in the near term. Under the regulatory licence, SSC A39 blocks dividends where the rating is at BBB-/negative outlook.
[128] See Document 58A, Finance Supporting Workbook, TCB Impact tab 14, cell b25 and for supporting details.
[129] Oxera report on cost of debt summarised in Section 10.7.

7.4. Stress tests[130]

a) We note material impacts from the Totex stress test:

- We noted in Section 2.2(a) Totex challenges for GD3 and regulatory risk of allowance shortfall.
- In GD2, there are Totex allowance shortfalls equivalent to 1% of RORE projected and placing upward pressure on gearing, therefore the risk of material Totex allowance shortfalls in GD3 from inadequate allowances is non-trivial. That risk, combined with a more challenging Totex programme for GD3, puts further adverse pressure on credit metrics.
- The 10% adverse stress on Totex leads to an average increase to gearing of around 3%. By itself, that could be absorbed by the prudent gearing position. However, it should be considered in the round, including the concerns highlighted in section 2.2a(i)-(v) and the downgrade to BBB flat/negative outlook we consider likely as noted in 7.3(a).

[130] There is a material impact from the RORE stress but see our comments in footnote 108.In addition, to avoid undue complexity in stress test analysis, we disapply potential impacts from tax clawback where gearing would be exceeded. We note in 7.3(a) above (final bullet) the potential significant harm from tax clawback should gearing threshold be exceeded in any event.

7.5. Remediation measures[131]

a) We have noted in section 7.3(c) that this plan would not be financeable.

b) We refer to Ofgem guidance on remediation measures in this area – see 2.4 above.

- We have explained the key causes in 7.3(c) above.
- We have considered management efforts and measures that could reasonably be made to address them. However :
  i. Totex is largely (i.e. 96%) mandatory and efficiently set, there is no material likelihood of outperformance to improve equity financeability through higher RORE from totex outperformance.

  ii. There is no scope to reduce the cost of debt (incl derivatives).

  iii. Further reductions to base dividends and special dividends would reduce gearing but this is already at a prudent level of 60% and those reductions would not materially improve coverage ratios. Clearly, such reductions would impair equity financeability further. We agree with Oxera's view: "It would be inconsistent, however, to address financeability concerns by adjusting the dividend yield downwards; in particular, it would be inconsistent to introduce accelerated depreciation to return invested capital to investors faster and, at the same time, to restrict dividend payments for financeability purposes. This signals to investors that sufficiency of cash flows to service debt will be achieved at the expense of maintaining adequate incentives for equity investment. In particular, it sends a negative signal to investors that dividend payments might be reduced even when investors expect to realise their returns and recoup their investment through higher dividend payments."[132]

  iv. As noted in Section 3, Ofgem's assumed Ke of 5.43% and a dividend yield of 3% are too low to support investability and therefore equity financeability.These rates would not have enough incentive power to attract new equity.

- We have considered regulatory measures that should be taken. Ofgem should :

  i. consider the evidence in this Business Plan for the WWU Company specific plan and adjust its assumed WACC rates to the proposed rates in that plan. This should improve debt financeability to a BBB+ level subject to our concerns noted in 2.2(a)(i)-(vi).

  ii. Ensure that our concerns in section 2.2a(i)-(v) do not lead to adverse outcomes.

  iii. Ensure that the overall risk and return in the Draft and Final Determinations are balanced

- We have considered all other applicable measures that could aide financeability and do not consider these appropriate because they cannot remediate inadequate WACC returns.[133]

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[131] RIIO-3 BP Guidance para 7.11
[132] Document 58F - "Gas Distribution Network dividends in RIIO-3" (Oxera) page 2. Summarised in section 10.6.
[133] In addition to the revenue acceleration measures assumed by Ofgem for RAV depreciation and the change of Kd from 100% real to 70% nominal and 30% real. Such measures could be higher levels of accelerated RAV depreciation, reducing capitalisation rates and increasing the portion of Kd to be earned in nominal terms.

- Our financeability conclusion and statements are supported by evidence and justifications – primarily in Section 3.

7.6. Customer bill. Our comments in Section 6.7 apply here.

7.7. Conclusions

a) Ofgem's Actual Company plan would not be financeable. The primary cause is an assumed level of WACC that is too low and an equity distribution rate that is too low.

b) This is despite measures by WWU and its shareholders to support financeability in RIIO-GD1 and RIIO-GD2, including an equity injection of £344m in 2023, and efficient levels of expenditure in the business and capital structure.

c) Given equity investor expectations for RIIO-GD3 and noted in 7.2b, and investability considerations, remediation from equity investors in the form of new equity is unlikely due to a revenue allowance for WACC that is too low, a base distribution rate that is too low, and an inadequate return of equity in the context of £463.5m of RAV depreciation acceleration revenues.

d) Therefore Ofgem should consider the evidence base for the Ke and Kd rates in WWU's Company specific plan and :

- Adjust its assumed rates to those levels, and
- Adjust the equity distribution rate accordingly,and
- Ensure that our concerns in section 2.2a(i)-(v) do not lead to adverse outcomes, and
- Remove the flaw in the calculation of excess interest for tax clawback puposes to ensure that excess interest, as a matter of policy intent, fairly reflects excess gearing, and
- Ensure that overall risk and return are balanced in the Draft and Final Determinations in 2025.

8. WWU Company specific plan

8.1. This section is structured as follows :

a) Introduction
b) Target credit rating
c) WACC allowances
d) Key credit ratios
e) Stress tests
f) Consumer bill
g) Conclusions

8.2. **Introduction.** As noted in section 3, the key differences between this plan and Ofgem's actual company structure plan are revenue allowances for WACC and equity distribution levels.

8.3. **Target Credit Rating.** The target rating level for the Ofgem Actual Company structure basis equally applies here as we are using the same capital structure. Therefore we apply a target issuer rating level of BBB+

8.4. **WACC allowances and equity distribution rate.** These are covered in Section 3.

8.5. Key credit ratios

a) Debt financeability [134] [135] (paragraphs redacted)

b) Equity financeability [136] (paragraphs redacted)

c) We provisionally (i.e. before considering stress tets and customer bill impacts) conclude the plan should be financeable.

[134] Document 58A - Finance Annex Support Workbook, tab 10, columns V-AD, rows 63-64.
[135] Consistent with Ofgem's BPFM, we assume no phased implementation of this policy change by Ofgem.
[136] Ibid footnote 134, cell AD 37.

8.6. Stress tests

a) Stress test summary:[137]

b) We note material impacts from the Totex stress test:

- We noted in Section 2.2 a) Totex challenges for GD3 and regulatory risk of allowance shortfall.
- In RIIO-GD2, Totex allowance shortfall equivalent to 1% of RORE is projected, placing upward pressure on gearing. The risk of Totex allowance shortfalls in GD3 from inadequate allowances is non-trivial. That risk, combined with a more challenging Totex programme for GD3, adds pressure to gearing control and coverage metrics.
- The 10% adverse stress on Totex leads to an average increase to gearing of around 3%. By itself, that could be absorbed by the prudent gearing position. However, it should be considered in the round, including the concerns highlighted in section 2.2a(i)-(v) and thus add force to our qualifications of debt financeability at BBB+.

8.7. Consumer bill levels. Movement from RIIO-GD2 to RIIO-GD3 :

[137] For this plan, we apply a limited number of stress tests. Further, to avoid undue complexity, we disapply tax clawback impacts where gearing threshold would be exceeded.

a) Most of the bill increase (relating to WWU's revenue) stems from :

- Policy decisions by Ofgem on WACC, accounting for £15.9, and on RAV depreciation acceleration, accounting for £27 and which will lower bill levels after GD3
- Higher totex to sustain the network safety, reliability and customer service, accounting for £25.2
- These represent £68.1 (75%) of the bill increase
- WWU's higher WACC (£16.4) represents 18% of the bill increase. The scale of this increase is largely due to the low baseline created by inadequate revenues for GD2, mainly due to an inadequate cost of debt allowance and which caused a significant equity injection in 2023.

b) As noted in section 3.2(h), the 6.89% rate is approximate to average Ke rates from 2005 to 2026 of 7.0%. In that context and for the generation of consumers covering that timeframe, the 6.89% rate not a material factor to bill increases over that period.

c) WWU undertook customer research on RIIO-GD3, including bill level and direction.[138] This research shows support for WWU's RIIO-GD3 plan and bill level. Further details are provided in Section 10.8.

d) The total increase of £91 in the context of the consumer end bill (excl) VAT is estimated to be 11.5%.[139]

8.8. Conclusion: The WWU Company specific plan should be financeable. Within that there is some adverse pressure on debt financeability at BBB+. Our confirmation of financeability assumes our concerns raised in section 2.2a(i)-(v) do not result in adverse outcomes and the Draft and Final determinations in 2025 are balanced on overall risk and return.

[138] RIIO-3 BP Guidance para 7.9 requires a "well evidenced demonstration that it is in consumer interests and level of support"
[139] Document 58A - Finance Annex Support Workbook, Customerbills tab #8, cell D92.

9. OTHER POLICY MATTERS

9.1. Cost of debt

a) The respective approaches of WWU and Ofgem remain fundamentally unchanged from RIIO-2. These are the subject of ongoing legal proceedings so we do not repeat WWU's arguments. Our key points in response to the SSMD are:

- WWU's approach is not a "pass-through" approach. [140] Under WWU's approach, the allowance would not cover costs if transactions are executed above market rates. Efficiency assesment is subject to controlling factors. There would be scope for out and underperformance for every transaction undertaken. Prudence is governed by risk management consistent with investment grade status. Consequently, incentive properties are intrinsic to this approach.

- To properly discharge its statutory duties, Ofgem must determine an allowance based on the circumstances of each actual licensee, not by reference to a notional company allowance based on a cross sector averaging of debt costs that excludes most derivatives used for legitimate risk management purposes. Ofgem considers the notional company as the vehicle through which it gives effect to the principal objective and the duty to have regard to financeability. [141] For the reasons given in its submissions in the ongoing legal proceedings, WWU disagrees.

- The allowance must be grounded on efficiency and prudence. Ofgem does not clearly define those terms and their associated methodologies, not did it ask stakeholders to consider this matter in its consultations to date. At a minimum, this is not transparent policy making.[142]

- Further, we note Ofgem does not reference the four guiding principles used by it for RIIO-2. The status of those principles remains unclear to date for RIIO-3, but in any case, those principles contained language that was vague in terms of efficiency and prudence.

- Ofgem has stated that the role of the investment grade rating licence requirement to protect consumers from imprudent or risky choices from networks. [143] If the licence obligation to maintain a credit rating is expected to protect against imprudence, it follows logically that compliance with the condition must be expected to ensure prudence.

- Ofgem can, and should, include derivatives used for legitimate interest rate and inflation risk management purposes as it does for cross currency derivatives. We note :

  i. Ofgem holds significant detail on derivatives on a licensee by licensee basis and includes cross currency interest rate swaps in its calibration of the allowance, so should be able to carry out full term evaluations for those derivatives. The volume of those cross currency swaps could be significant and exceed the amount of RPI swaps.[144] [145]

  ii. In their SSMC response, six licensees challenged Ofgem's exclusion of derivatives.[146]

[140] SSMD para 2.49
[141] (Redacted)
[142] In accordance with Ofgem's statutory duty under section 4AA(5A) GA 1986, Ofgem must, in carrying out its functions, have regard to the principles of best regulatory practice which include "transparency".
[143] SSMD para 2.58
[144] SSMD para 2.18
[145] SSMD para 2.17
[146] SSMD para 2.9

iii. In 2006 and 2011, Ofgem suggested that RPI derivatives could be used as overlays on nominal rate debt to achieve inflation linked cost of debt positions.[147]

9.2. Tax clawback ("TCB")

a) Excess interest should reflect excess gearing.

- In our SSMC response, we raised a serious flaw in the methodology for calculating tax clawback and suggested a solution to remedy it. Calculation of excess interest is not driven by excess gearing in all circumstances, including those for WWU. As TCB is intended to deter excess gearing, the estimation of excess interest should be consistent with that objective for all licensees.

- We do not agree with Ofgem's response. [148] The cost of debt allowance is largely driven by embedded debt where credit spreads are fixed. Higher credit spread differentials would not arise from small increases to gearing above the notional level. Ofgem is aware that the problem impacts WWU in a disproportionate adverse way where gearing is marginally above the notional level.

- If Ofgem includes derivatives in actual interest, there can be circumstances where interest costs are elevated from market rate changes, which have no relation to excess gearing.

- The TCB methodology is not proportionate as WWU could incur significant revenue loss where negligible, even where temporary, increases over the TCB gearing threshold would arise. [149]

b) Inclusion of RPI swap accretion in net debt. We continue to disagree with Ofgem on this matter on grounds of inconsistency of treatment of derivatives between the allowance for cost of debt and tax clawback.[150] This is one of the grounds of claim submitted to the High Court for RIIO-GD2, wherein further details are contained. Therefore, we will not comment further at this stage.

9.3. Financial resilience:

a) Two "issuer" credit ratings instead of one: We have discussed this matter with Ofgem, and continue to seek flexibility for our position which provides the additional financial resilience protection Ofgem seeks.

b) Replacement of "reasonable endeavours" with "require": We note Ofgem's concern.[151] Our arguments in our SSMC response remain.[152]

9.4. Capitalisation rates and RAV depreciation rates

a) Capitalisation rates :

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[147] 2006: Ofgem and Ofwat – Financing Networks- A discussion paper, para 146. 2011: Ofgem – Decision on strategy for the next transmission and gas distribution price controls – RIIO-T1 and GD1 financing issues; para 3.26.
[148] SSMD para 7.27
[149] For example, gearing could exceed threshold whilst awaiting determination from Ofgem of reopener claims.
[150] WWU SSMC response, page 102 in response to FQ20.
[151] SSMD para 6.47
[152] WWU SSMC response pages 96 -97

- We have applied the capitalisation rates in the BPFM Guidance for the Notional and Actual Company structure plans.[153] We have also applied those rates to our Company Specific Plan. We agree with Ofgem on using natural capitalisation rates.

- With regard to Capitalisation Rate 2, in our SSMC response, we recommended that this capitalisation rate should reflect natural capitalisation of the expenditure that is the subject of the reopener claim. Consistent with our SSMC response "reopeners should have a bespoke capitalisation rate reflecting the approved spend mix under each reopener."[154] This position reflects the principle of natural capitalisation applied by Ofgem through Capitalisation Rate 1.

- Capitalisation rate 2 for reopeners is an ex ante fixed 70%. We ask Ofgem to consider our recommendation for the Draft Determinations.

b) RAV depreciation rates:

- We do not propose alternate (to Ofgem's) RAV depreciation rates. With regard to RAV depreciation acceleration, we agree with Ofgem's policy decision on accelerating RAV: "We have decided that action is needed during RIIO-3 to accelerate depreciation for gas distribution and transmission companies during RIIO-3……..."[155]Ofgem's analysis …"indicates that there is the potential for significant increases in bills to cover depreciation under the existing depreciation policy, with the potential for an increased perception of asset stranding risk due to the unaffordability of bills and outstanding RAV by the government's net zero target date (2050)." [156]

- We have not suggested alternate accelerated RAV depreciation profiles. This would add complexity without commensurate value to financeability analysis and consumer impact. We have assessed Ofgem's four options and think these are reasonably framed prior to Business Plan submissions. Ofgem should be better placed to develop its position with the evidence (e.g. RAV profiling over RIIO-GD3) that those submissions should provide. Further, as 2025 develops, further information may emerge on the transition pathways to Net Zero Carbon (e.g. Heat policy decision due 2026).

- (Redacted)

- We recognise that this is a complex area, particularly with prevailing uncertainties on Net Zero Carbon pathways, customer bill affordability and investor considerations to weigh.

[153] RIIO-3 BP Guidance para 7.12. Also para 7.9. "A clear explanation of the company's proposed capitalisation rates and regulatory depreciation rates and the basis for these proposals (for example, whether proposed capitalisation rates match accounting treatment of opex and capex). "
[154] WWU SSMC response to FQ 31 page 109
[155] SSMD para 8.19
[156] SSMD para 8.24

10. SUMMARY OF CONSULTANT REPORTS

10.1. The consultant reports are summarised below:

	RIIO-GD3 : EXTERNAL CONSULTING REPORTS ON COST OF CAPITAL AND CUSTOMER FEEDBACK				
	Subject	Type	Status	Scope	Sender
1	RIIO-3 cost of equity - CAPM parameters	Expert report	Public	Cross sector	ENA
2	Regulatory regimes and business mixes for relevant European comparators	Expert report	Public	Cross sector	ENA
3	Cost of Equity : Cross-Check Evidence	Expert report	Public	Cross sector	ENA
4	Cost of equity : Prepared for GB Gas Distribution networks	Expert report	Public	GDN sector	WWU
5	Gas distribution Networks' dividend yields for RIIO-GD3	Expert report	Public	GDN sector	WWU
6	WWU cost of debt and derivatives for RIIO-GD3 - efficiency assessment	Expert report	Private	WWU	WWU
7	Customer engagement for WWU	Research study	Private	WWU	WWU

10.2. Oxera: RIIO-3 Cost of equity - CAPM parameters[157]

a) This report establishes an estimated "baseline" cost of equity range and mid-point for the aggregated ET, GT and GD sectors, i.e. before consideration of sector specific risks. Gas distribution sector specific risks and their impact on this cost of equity range are covered in section 10.5 below.

b) Oxera's estimated baseline Ke range is 5.7% to 6.83%, with a mid-point of 6.25%.

	Formula	Ofgem (RIIO-3 SSMD)			Oxera		
		Low	High	Midpoint	Low	High	Midpoint
RFR[1]	[A]	1.27%	1.27%	1.27%	1.54%	1.54%	1.54%
TMR	[B]	6.50%	7.00%	6.75%	7.00%	7.50%	7.25%
Asset beta	[C]	0.30	0.40	0.35	0.35	0.40	0.38
Re-levered equity beta at 60% gearing[2]	[D] = {[C] – (gearing*beta debt)} / (1-gearing)	0.64	0.89	0.76	0.76	0.89	0.83
CAPM CoE	[E] = [A] + [D] × ([B] – [A])	4.60%	6.36%	5.45%	5.70%	6.83%	6.25%

c) Ofgem implemented a series of changes consistent with the methodology set out in the RIIO-3 SSMC Oxera report, which include:

- using the arithmetic mean as the only approach for calculating the ex post total market return (TMR);
- using the Consumption Expenditure Deflator (CED) series, new backcast CPIH series, and CPIH estimates from ONS for deflating nominal historical returns;
- including European comparators in the calculation of the beta;
- signalling potential for aiming up within the beta range to reflect the circumstances around RIIO-3.

d) There are still areas where Oxera disagree with Ofgem's approach. In particular, Ofgem should

- account for the convenience premium embedded in government bonds when estimating RFR;
- exclude the downward COLI-CED adjustment in the calculation of the ex ante TMR because this is no longer required

[157] Document 58B - RIIO-3 Cost of equity - CAPM parameters (Oxera report to ENA).

- exclude the serial correlation adjustment in the calculation of the ex ante TMR because Ofgem's rationale is not robust, including a lack of statistical significance.
- inform its TMR allowance predominantly on the basis of the ex post TMR, instead of placing 50% weight on historical ex ante approaches;
- recognise the relationship between the TMR and gilt yields, as has been done in previous regulatory decisions, as it is likely to be required for investability;
- include Pennon in the sample of water companies considered in the estimation of the beta.

10.3. Oxera: Review of European comparators to strengthen the use of European Beta data.[158]

a) As part of the process to set allowed returns for the next round of network price controls (RIIO-3), Ofgem is minded to include a set of listed European energy networks, to act as additional comparators when it evaluates systematic risk. Ofgem notes that while the listed European comparators operate in different countries and under different regulatory regimes, they are likely to face similar challenges to GB energy networks.[159] Ahead of the Draft Determinations, Ofgem will consider further whether the regulatory regimes and business mixes of these European comparators are suitably similar to GB networks.[160]

b) Oxera presents information on the regulatory regimes/business mixes of the European comparators identified by Ofgem (Enagás, Redeia, Italgas, Snam, Terna) and assess whether there is evidence that these comparators are exposed to similar, higher or lower risk than networks under RIIO-2.[161]

c) Oxera find that risk factors relating to the regulatory process are similar across the British, Italian and Spanish regimes. Either the competition authority or a court hears an appeal rather than makes a redetermination. The regulators in these countries have powers to operate independently. Regulatory frameworks in all three countries have been broadly consistent over time, with methodologies and parameters being updated at each price control review.

d) Oxera also find that the design of the regulatory regime for energy networks is broadly similar across these jurisdictions. Companies are largely insulated from demand risk but face exposure to the risk that actual costs differ from the regulatory allowances. Although in Italy and Spain operating expenditure and capital expenditure are regulated separately rather than being regulated as total expenditure (Totex), overall, Oxera considers the level of cost risk to be broadly comparable to Totex under RIIO-2.

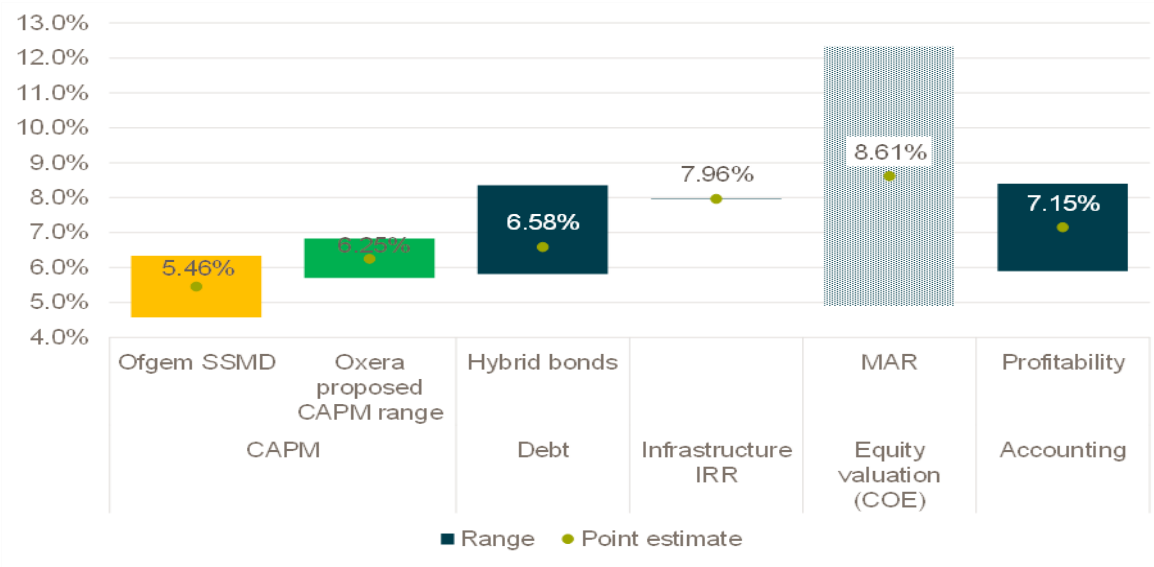
e) Oxera consider it appropriate for Ofgem to include the five European networks in its comparator sample.

10.4. Frontier Economics: Updated cost of equity cross check evidence[162]

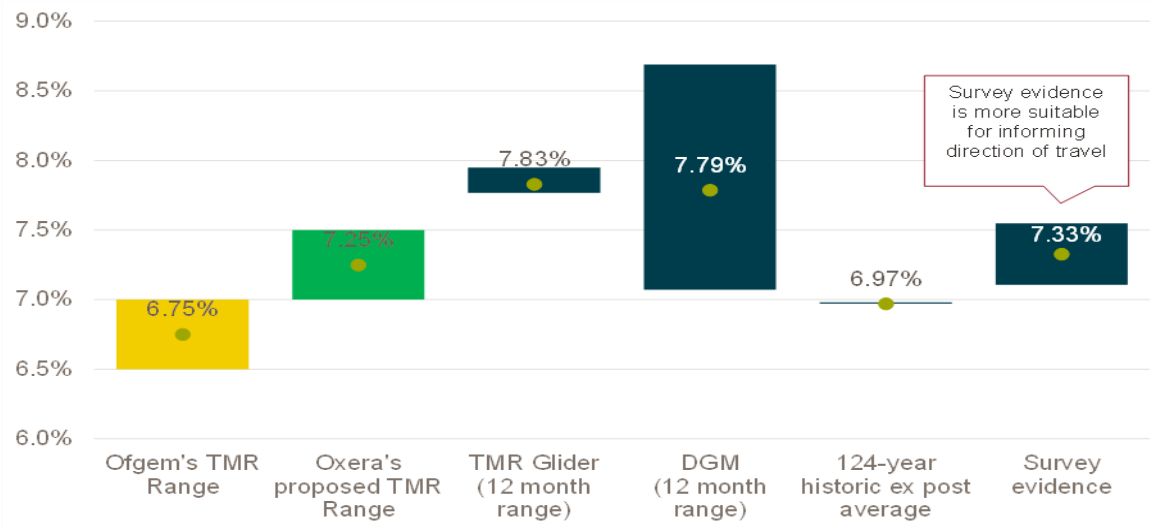
a) Cost of equity cross checks

[158] Document 58G - Review of the regulatory regimes and business mixes for relevant European Comparators to strengthen the use of European beta data (Oxera report for the ENA)

[159] SSMD para 3.197.
[160] SSMD para 3.199.
[161] As the details of RIIO-3 and the risks companies will be exposed to are still emerging, Oxera's assessment of comparability focuses on RIIO-2.
[162] Document 58D - Updated cost of equity cross check evidence (Frontier economics report for the ENA)



b) TMR cross checks



c) The overall finding of the updated CoE cross-checks is that the CoE range proposed in Ofgem's SSMD Step 1 CAPM estimation is too low. Furthermore, the midpoint of Ofgem's range will not satisfy its equity investability objective.

d) Frontier find that a key contributor to the SSMD CoE range being too low is the TMR range (6.50%-7.0%) proposed by Ofgem. The SSMD TMR range is inconsistent with the TMR cross-checks presented in this report, and the proposed uplift by Ofgem of just 25 bps from RIIO-2 (6.5%) to 6.75% is at odds with the scale of change seen in wider market evidence since that decision.

e) Frontier recommend that the TMR point estimate should be towards the top end of Oxera's range.

f) Frontier conclude that a TMR range of 7.0% - 7.5% CPIH-real proposed by Oxera is in line with the TMR cross-check evidence. Along with other changes proposed by Oxera, it also leads to an overall CoE range that mitigates investability risks and Oxera's recommendations provide a good indication of the changes that Ofgem should make to its position on CoE over the coming year.

10.5. Oxera: Cost of Equity for RIIO-GD3 prepared for GB Gas Distribution Networks[163]

a) **Background.** This report analyses evidence on an appropriate level of the allowed asset beta for gas distribution networks (GDNs) in the RIIO-GD3 price control by complementing the existing evidence base with gas-specific sector data. Oxera specifies the implications for the cost of equity (CoE) range, as well as assess the implications of the debt market evidence for gas networks on the CoE. Oxera also discuss how non-systematic asymmetric risks may need to be accounted for.

b) **Asset beta range of 0.40-0.44 for the UK GDN sector**

- Oxera focus their assessment on:

  i. Three listed European gas networks (Enalgas, Italgas and SNAM) who face largely similar risks, under the regulatory frameworks in which they operate, as the GDNs.
  ii. Asset beta allowances by European regulators for gas transmission (GT), gas distribution (GD), gas storage and regasification assets.
  iii. Asset betas of nine listed US gas networks [164]

- Oxera observe that while the level of asset betas varies among companies, most asset betas in its analysis follow a similar pattern over time. The co-movement of gas network companies' betas in the international sample assessed, supports Oxera's hypothesis that the risks of these companies are reasonably similar and representative of the UK gas network sector.

- Oxera narrowed down a gas-sector asset beta range of 0.29 to 0.50 to 0.40–0.44 based on the following considerations.

  i. **Lower bound of 0.40**: In light of European evidence, whether empirical (the evidence on the long-term European gas networks' asset betas suggesting a figure towards the top of Ofgem's SSMD range of 0.30–0.40), or regulatory (precedents on the asset beta allowance for gas networks being in a range of 0.38–0.50). Furthermore, the empirical analysis of the asset betas of Oxera's sample across the two considered geographies (i.e. the USA and Europe) shows that most of the estimated asset beta averages are above 0.40, with only the very short-term (i.e. the spot and two-year average of the two-year asset betas) below this mark. Given Ofgem's view that more weight should be placed on long-term betas, Oxera consider that the balance of the evidence supports a lower bound of 0.40.

  ii. **Upper bound of 0.44**: It is the midpoint of the range of European regulatory precedents on asset beta allowances for gas networks (0.38–0.50). It is consistent with the average of the long-term betas in the two considered geographies within the sample (i.e. the USA and Europe), with less weight placed on the US listed companies through the averaging process.

c) **Gas specific risks.** The Oxera report also addresses Ofgem comments in this area.

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[163] Document 58C - Cost of equity for RIIO-GD3 (Oxera)

[164] In order to further inform Oxera's analysis of a gas-specific asset beta range, it widened the sample of comparators to include network companies from other countries. As a starting point, it looked at the international sample used by the New Zealand Commerce Commission (NZCC) for its beta allowance for energy networks—the NZCC screens for pure-play gas networks across Australia, New Zealand, the UK and the USA. Combined with the European gas network comparators, this results in a comparator sample of nine publicly listed US gas networks and three European gas networks.

- Ofgem considers that changes to the beta comparator sample (i.e. the inclusion of European energy networks) and to the depreciation profile of the GDNs' regulated asset value (RAV) (i.e. accelerated depreciation) are sufficient to reflect changes in the GDNs' risk profile between RIIO-3 and RIIO-2.[165] Oxera considers that these changes do not adequately eliminate or compensate the GDNs for gas-specific risks. [166]

    i. Systematic risks: Oxera considers that Ofgem's beta comparator sample in the SSMD does not properly reflect gas-specific, forward-looking risks. Gas sector-specific data supports a range of 0.40–0.44, starting from the top end of the range assessed by Ofgem in the SSMD (i.e. 0.30–0.40).

    ii. Non-systematic risks: Oxera consider that proposed changes to the depreciation of network assets are.."not sufficient to fully eliminate the asymmetric stranding asset risks, as uncertainty remains around networks' future ability to recover their costs. Besides, Ofgem's proposed changes to the depreciation schedule of the GDNs' RAV might create other risks that would need to be compensated." [167] While Ofgem indicated in the SSMD that it was considering aiming up within the asset beta range, Oxera note the regulator's intention in doing so is to improve the accuracy of its asset beta estimate, and not to compensate for asymmetric risks. In light of the fact that asymmetric risks (i.e. the inability for GDNs to (fully) recover their investments into the networks, or even the ongoing costs of operating the networks, in the future) are not fully mitigated by the proposed regulatory package, Oxera view aiming up within the proposed cost of equity range as an appropriate mechanism that Ofgem may use towards providing a compensation to GDNs for these risks.

d) ARP-DRP cross check

- In section 4 of the report, Oxera considers two scenarios for the ARP–DRP cross-check in line with the CoE estimation in section 3 of the report:

    i. the 'Oxera low' scenario with an asset beta of 0.38 and TMR of 7.00%;
    ii. the 'Oxera high' scenario with an asset beta of 0.44 and TMR of 7.50%.

- The results demonstrate that Oxera's CoE range, calibrated with the wider beta range of 0.38–0.44, is supported by the ARP–DRP cross-check when anchored on gas sector-specific debt data, suggesting that the allowed CoE should be set within the range that it proposes.

- The ARP-DRP cross-check anchored on gas-specific debt data also shows that the SSMD minded-to position is too low as regards the allowed cost of equity for GDNs, thereby supporting the use of gas-specific evidence (i.e. asset beta range of 0.4-0.44) to extend the SSMD analysis and inform the RIIO-GD3 decision.

10.6. Oxera : Gas Distribution networks' dividends in RIIO-GD3.[168].In this report, Oxera assess the role of dividends in the RIIO-GD3 price control and the evolving context around it.

a) Dividends are a way to remunerate shareholders (the other being share price appreciation). As a result, dividend expectations are a crucial component of a shareholder's assessment of the value of the company. Based on this premise, dividend yields, i.e. the ratio between the dividends paid by the

[165] SSMD para 3.305.
[166] Document 58C - Cost of equity for RIIO-GD3 (Oxera) paragraphs 5.5-5.33
[167] Ibid, pages 6-7
[168] Document 58F - Gas Distribution networks' dividends in RIIO-GD3 (Oxera)

company and the (market) value of its equity, can be linked to the expected growth rate of the dividends paid by the company and to its cost of equity.

b) Dividend expectations depend on the ability of the business to reinvest the cash it generates into profitable investment opportunities: a business that is mature and less likely to expand will likely pay more dividends than a business that is growing its asset base.

c) This has implications for a regulator carrying out an investability assessment that aims to ensure that the sectors it regulates can attract and retain equity capital: from the perspective of the investors investing into assets that are currently early in their lifecycle, the future treatment of their assets may be informed by the regulatory treatment of mature assets in other sectors. In that regard, the investability assessment should assess the ability of the regulatory framework to not only attract and retain capital, but also to return it to shareholders.

d) When considering the economic context of the gas sector over RIIO-3 and subsequent price controls, the application of these principles should lead Ofgem to account for an increase in the dividend yield of gas networks in its financial modelling. This would be reflective of the fact that the expected regulatory asset value (RAV) growth of gas networks from RIIO-3 may be lower than before—or even negative at some point in RIIO-3 or subsequent price controls. This will mechanically put the dividend yield of gas networks under upward pressure, to the point that it may be higher than the cost of equity allowance itself (when capital needs to be returned to investors).

e) In particular, a higher dividend yield is necessary to maintain the gearing at or around the notional assumption, as higher distributions to shareholders would counterbalance the downward pressure that the introduction of accelerated depreciation (and lower RAV growth more generally) would put on the GDNs' gearing. Oxera note that Ofgem seems to acknowledge this necessity, as its latest Business Plan Guidance to gas networks for RIIO-3 includes an assumption of dividend distribution explicitly aimed at maintaining notional gearing.

f) If RAV growth is expected to flatten over multiple price controls, then the dividend policy needs to be sufficiently flexible to adjust accordingly, as would be expected from shareholders. As per the dividend growth model, the dividend yield will tend towards the cost of equity as the (expected) growth rate in dividends tends to zero.

g) For this reason, it would be appropriate for Ofgem to have its dividend yield assumption and cost of equity allowance converge over the next price controls, starting with RIIO-3, and therefore to increase its dividend yield assumption compared to RIIO-2. This would reflect expectations of a slower RAV growth in RIIO-3 and subsequent price controls. In other words, as the RAV GDNs' remuneration on capital would be paid out to shareholders in dividends (instead of being reinvested into the networks).

h) It would be inconsistent, however, to address financeability concerns by adjusting the dividend yield downwards; in particular, it would be inconsistent to introduce accelerated depreciation to return invested capital to investors faster and, at the same time, to restrict dividend payments for financeability purposes. This signals to investors that sufficiency of cash flows to service debt will be achieved at the expense of maintaining adequate incentives for equity investment. In particular, it sends a negative signal to investors that dividend payments might be reduced even when investors expect to realise their returns and recoup their investment through higher dividend payments.

i) The average dividend yield of European gas networks has increased from 5.4% in 2018 to 7.4% in 2023, which exceeds the average dividend yield of European electricity networks, the latter remaining relatively constant over the same period (between 4.1–4.8%). Importantly, empirical evidence also confirms that

a 3% dividend yield assumption for gas networks is insufficient, even without upward pressure on the (future) dividend yield from the return of capital, in the context of accelerated depreciation.

j) While it is understandable for the regulator to look to ensure that dividend increases are not carried out at the expense of financial resilience, we consider that as long as financial resilience requirements are met by network companies, their dividend policies should not be constrained in a way that would make them fail to meet investors' expectations.

k) If financeability concerns are indeed identified, Ofgem has signalled that one of the levers under consideration to address them could be a reduction in dividend payments. However, it would be inconsistent for Ofgem to, on the one hand, introduce accelerated depreciation (which precisely aims to return the RAV to investors faster than under the status quo), thereby putting upward pressure on the GDNs' dividend yields, while, on the other hand, using (restriction of) dividends as a financeability lever.

l) The suggestion that financeability concerns can be addressed at the expense of dividend payments creates a tension between financeability and investability. This is because financeability analysis in regulated settings has tended to be relatively narrow—i.e. with a focus on achieving sufficient cash flows to service debt, while ensuring investability necessitates looking beyond debt financing to also ensuring that equity capital can be attracted and retained in the sector. If reducing dividend payments is a remedy for financeability concerns, then this suggests that sufficiency of cash flows to service debt will be achieved at the expense of maintaining adequate incentives for equity investment.

10.7. Oxera report: Efficiency assessment of WWU's debt and derivatives and comparison against Ofgem's revenue allowance for cost of debt – November 2024 update[169] [170] [171] [172] (paragraphs redacted)

10.8. Mindset report: Customer Engagement[173] (redacted).

[169] Document 58E - Efficiency assessment of WWU's debt and derivatives and comparison against Ofgem's revenue allowance for cost of debt (Oxera)– November 2024 update
[170] Oxera (2020), 'RIIO-GD2 preparation: cost of debt (2020)', prepared for West & Wales Utilities Limited, 4 June (hereafter 'the 2020 Oxera report').
[171] Oxera (2021), 'RIIO-2 cost of debt allowance', 2 March.
[172] SSMD paras 2.13–2.14
[173] Document 58H - Customer consultation: GD3 proposals and positions. (Mindset Research)

APPENDIX 11.1 – DIVIDEND POLICY - Extract from published financial statements for the year ended 31 March 2024

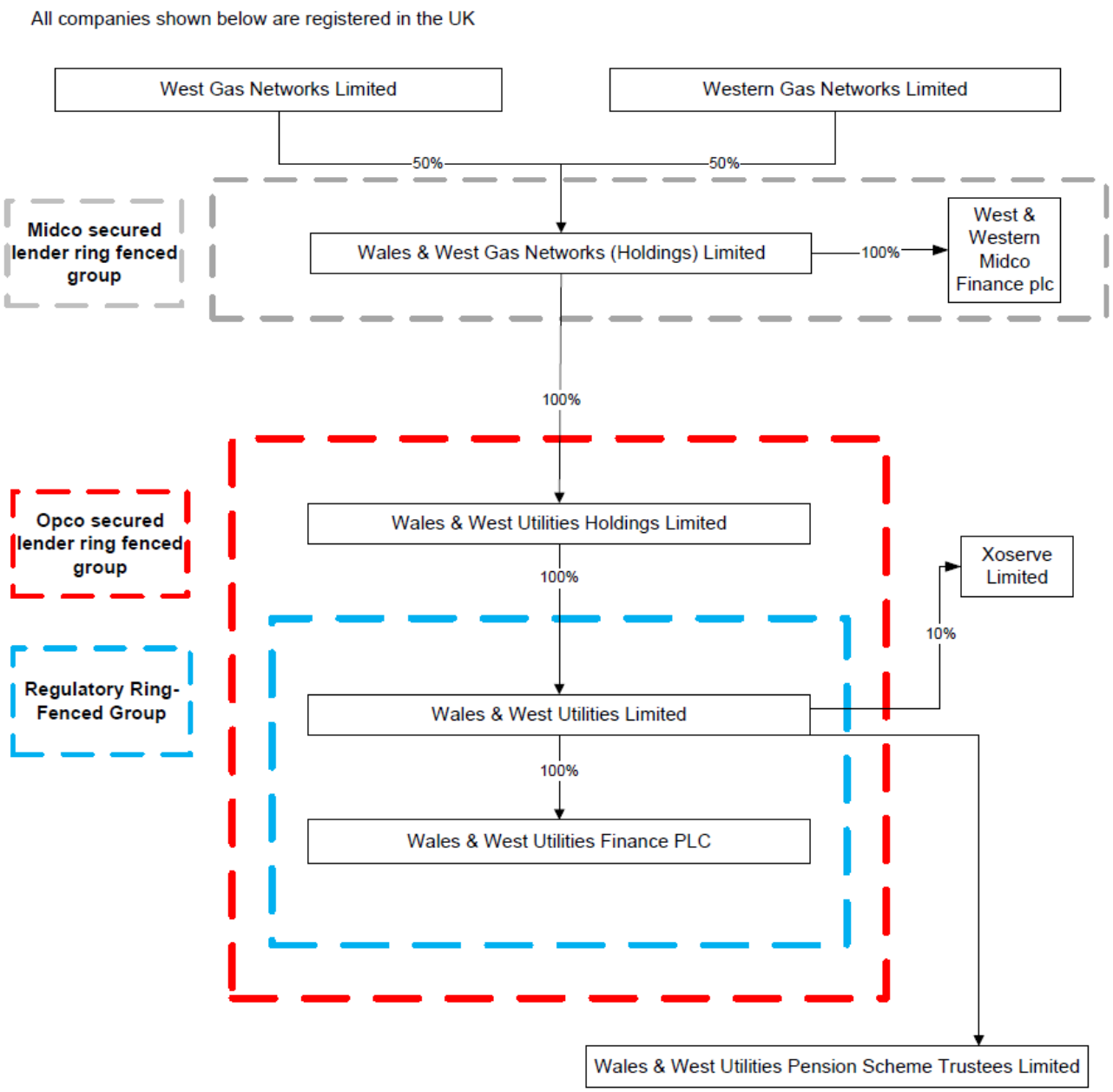
The Company instituted a dividend policy following approval by the Board on 17 July 2024. This policy reflects the following principles :

1. The need for a reasonable and fair cash return to our equity investors, to maintain their ongoing support for this investment intensive business and investment grade capital structure
2. Regulatory compliance across all licence requirements, including requirements for safety, reliability and customer service
3. Compliance with lender terms and conditions and maintaining their support to provide debt capital at efficient cost to support financing of future investment
4. The need for ongoing investment grade status with our rating agencies, to support access to cost efficient debt finance
5. Recent, current and projected financial and other corporate performance to the end of the current regulatory control period
6. Adequacy of distributable reserves
7. Compliance with 2006 UK Companies Act, 1986 Insolvency Act and common law duty to act prudently

Before any dividend payment is made, these principles are considered when taking account of company, sector and macro-economic circumstances in which any recommendation of management is made to the Board for payment. Overall, WWU's dividend policy aims to sustain support from its investors whilst maintaining financial resilience and access to cost efficient capital. This policy aim is in the consumer interest and helps to promote the success of the Company, in accordance with Section 172 of the 2006 Companies Act.

Note: The first dividend payment by WWU was made in July 2024. No dividend payments were made before then. Returns on equity were previously made via interest payments on shareholder debt. That debt was repaid in 2023 by equity issuance. Audited financial statements for years ended 31 March 2025 and thereafter will have narrative for dividend payments and in the context of the dividend policy.

Appendix 11.2: UK Corporate structure.



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