Cadent
Your Gas Network

RIIO-3 Draft Determinations

Our response to Ofgem Finance Document

August 2025

Navigating our response

Cadent's response to Ofgem's RIIO-3 Draft Determinations is structured as follows.

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Further details on the annexes set out in this table can be found in the 'Supporting Reports' section.

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FA2	RIIO-GD&GT3 cost of equity and debt premium cross-check
FA3	Gas sector dividends in RIIO-GD/T3
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About this document

This document covers our responses to the questions in the Finance document of the Draft Determinations. To support our response, we have also provided annexes with key evidence and analysis such as expert consultant reports.

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Key Messages

Key Message	Related response	Evidence
Balance of Risk and reward		
The analysis presented in the Draft determination (DD) for the Return on regulated equity (RORE) range is incomplete and inaccurate. Remedying errors in Ofgem's approach analysis undertaken by Economic Insight shows that the return expectation is not, as presented in the DD, a 'fair bet' but that the proposed control would give a mean expectation of a return of 5.33% c.0.7% lower than the proposed base cost of equity of 6.04%. To deliver Ofgem's intent for an even risk/reward balance on cost performance as presented in the DD, Ofgem needs to re-assess the asymmetric skew between DD and Final Determinations (FD) and make changes to its decisions to ensure the price control represents a fair bet for equity investors. This will be critical to ensure an investable package. The DDs will result in a particularly difficult situation for our London network which, faces an almost certain inability to earn its base rate of return from the DD proposals (a range of expectation of a return between 3.19% to 5.18% with a mean expectation of 4.15% nearly 2% lower than the proposed base cost of equity). The imbalance in the range is predominantly driven by the cost assessment methodology proposed so addressing this with our proposals (for example on regional and company-specific factors and ongoing efficiency) is the key for the FD.	FQ17	FA9
Allowed return on equity		
Updating our Business Plan position for the latest market data results in an increased Cost of Equity range of 6.2% to 7.4%, with a revised mid-point of 6.8%, up from 6.3% as of December 2024. Our evidenced point estimate lies within the range that Ofgem has said can be justified by the available evidence it had assembled for its DD. As such, one possible alternative way of interpreting our estimate of the cost of equity is that there is a need to 'aim up' within Ofgem's range. If the imbalance in risk highlighted above is not adjusted, this would provide further rationale for 'aiming up' in the range Ofgem has provided. We set out our key points for each parameter below: **Risk free rate (RFR**) - We disagree with the DD to approach to solely rely on index linked guilt (ILG) yields when estimating the RFR and instead a basket of yields should be used. If Ofgem continue to rely solely on ILG yields, it must adjust for the convenience premium and difference between lending and borrowing rates. **Total Market Return (TMR)** – TMR should reflect the higher for longer interest environment in which this price control is being set and therefore the long run average is 6.97% plus an upward adjustment for current market conditions would be the minimum robust estimate based on the evidence. **Beta** - The bottom end of Ofgem's asset beta range is below the lower end of the asset beta range set in RIIO-2, implying a decrease in risk which is fundamentally inconsistent with statements made about risk and uncertainty for the gas sector. There is a systematic difference between the risk profile of gas and electricity sectors that should be reflected in the relative asset beta comparators selected by Ofgem. Credit rating agencies have recognised this increased risk profile and tightened credit metrics for equivalent ratings. **Cross Checks** - We believe there are fundamental inconsistencies in the standards applied to choosing relevant cross checks that results in a downward bias in the implied cost of equity. If this bias is removed, the evidence strongly indicates that a higher CoE is required to mitigate investability risks. The top end of Ofgem's CAPM range has greater overlap with the cross-check evidence and is more consistent with investor expectations of the sector.	FQ7 FQ8 FQ9 FQ10 FQ11 FQ12 FQ13 FQ16	FA2 FA4 FA5 FA6 FA7 FA8

Key Message	Related response	Evidence
Notional Dividend Policy		
We present additional evidence supporting a higher underlying dividend yield, closer if not equal to the cost of equity – this is more reflective of a price control package that provides no capital growth. This dividend yield should be distinctly separate from the return of capital afforded through Ofgem's proposed accelerated depreciation. Ofgem's proposal to only allow the notional company to return capital when it reaches 55% gearing does not result in an efficient use of capital, effectively trapping equity.	FQ14	FA3
Allowed return on debt		
The requirement for a large adjustment to the trailing average demonstrates that this trailing average tenor and index selection does not provide a good fit for sector debt costs. Evidence demonstrates that a 10yr trailing average of the iBoxx utilities 10+ index would provide a better match, with a lower calibration adjustment required mitigating the risk of divergence through the period given its fixed nature. Our assessment of Ofgem's estimate of the Gas Network Premium at 25bp is that this is insufficient. As this is a key assumption to assess the appropriate calibration adjustment, Ofgem's methodology will need to be re-considered for Final Determination. Ofgem have determined that the additional costs of borrowing should be funded at 25bps. This understates the cost of carry as uses historical market data, does not adjust for tenor in the transaction costs and does not consider the full RPI-CPIH risk mitigation costs. This will need to be reassessed to ensure these costs continue to be fully funded.	FQ1 FQ2 FQ3 FQ4	FA1
Regulatory Depreciation		
We continue to believe there is no need to act now on accelerating depreciation – the proposed policy is inconsistent with other statements in the DD and government updates which reiterated the importance of gas and its role beyond 2050. It will force a material impact on current customer bills (+£10 per annum) which can be avoided. Ofgem have fundamentally changed the regulatory model which investors relied upon – accelerated depreciation creates different risks; investors face the prospect of no capital growth and returns falling over time (despite retaining the risk of operating a network which will not reduce in size in proportion to the RAV, or reduction in customer numbers). If Ofgem retain their DD proposal they must ensure: • A robust long term financeability assessment (including affordability) is carried out to ensure there are no unintended consequences. • Consideration is given to the fact this policy fundamentally changes the investment proposition in which investors have invested. • Equity is not trapped through an inadequate notional dividend policy • A more detailed holistic review of the gas network is carried out with government prior to the next price control covering asset repurposing, disconnections and decommissioning to inform asset life policy.	FQ24	N/a
Debt Financeability		
We disagree with Ofgem's approach to assessing financeability for three reasons: 1. **Narrow Focus on Rating Agency Metrics** - the DD assessment only reflects one credit rating agency metrics, inconsistent with new financial resilience measures 2. **Outdated Reflection of Sector Risk** - Two credit rating agencies have updated their views on the gas distribution sector since the publication of the DD. 3. **Insufficient Long-Term Financeability Analysis** - We also expect a more thorough analysis of the long term financeability in light of the proposed introduction of the accelerated depreciation policy including impacts on long-term affordability. Ofgem should revisit its methodology in the FD to ensure that financeability assessments are both realistic and aligned with the evolving regulatory and financial landscape.	FQ18 FQ20	N/a
Financial Resilience		
We continue to believe the existing financial resilience protections have worked well in the past for the energy sector and ensure an efficient level of financial resilience, so we do not feel any strengthening is required. There is a high hurdle for introducing new regulation to avoid introducing distortions, additional costs and creating other unintended consequences.	FQ21	N/a

Figure 1: Key messages

Supporting Reports

Below are the reports, including high-level summaries, that we reference in our response to the Draft Determination ("DD"). Several of these reports have been jointly commissioned with Future Energy Network ("FEN") and the Energy Networks Association ("ENA").

Ref	Author	Title	Date	Commissioned by	Confidential
FA1	**Nera**	**Gas Network Premium (GBP) and Additional Cost of Borrowing (ACB) for GD/T3**	Aug 2025	FEN	Yes
	Nera's analysis considers the appropriate estimates for the Gas Network Premium (GNP) and Additional Cost of Borrowing (ACB). For GNP, Nera estimate a higher premium when replicating Ofgem's methodology at c.30bps and suggest 45bps would be more appropriate as the comparison of spreads in line with Ofgem's approach at RIIO-2. For ACB, Nera estimate this at 44bps (not including the infrequent issuer premium) compared to Ofgem's estimate of 25bps.				
FA2	**Oxera**	**RIIO-GD&GT3 cost of equity and debt premium cross-check**	Aug 2025	FEN	No
	Building on their previous reports submitted with our Business Plan, Oxera critically analyse Ofgem's approach to setting the allowed cost of equity (CoE). Specifically, to achieve an investable allowed CoE, we consider that Ofgem should: • account for the convenience premium embedded in government bonds when estimating the RFR; • inform its TMR predominantly based on the ex-post TMR; • reflect the change in the interest rate environment in its estimate of the TMR, consistent with the previous regulatory decisions, as it is likely to be required for investability; • set the asset beta range based on gas network comparators or in the upper half of the estimated range to account for forward-looking risks faced by gas networks. Ofgem's point estimate of 6.04% compares to Oxera CoE estimates of a range of 6.47–7.43% based on gas-specific asset beta range and a range of 6.17–7.57% based on a wider beta sample.				
FA3	**Oxera**	**Gas sector dividends in RIIO-GD/T3**	Aug 2025	FEN	No
	Given the reduced availability of investment opportunities in relation to the uncertain outlook for the future of gas (in the context of the introduction of accelerated depreciation and lower or negative regulated asset value (RAV) growth expected over RIIO-3 and beyond) the proposed notional dividend policy is inadequate and should be revised upward. This adjustment is important to ensure investability of the gas sector. Oxera consider the proposed special dividend mechanism triggered by gearing thresholds to be inappropriate. This is because it treats excess cash as non-recurring, whereas the cash surplus that RIIO-3 DD is expected to generate would be structural and recurring.				
FA4	**Frontier Economics**	**Updated cost of equity cross-check evidence**	Aug 2025	FEN	No
	Frontier Economics present evidence that suggests that significant investability risks remain in the allowed equity returns proposed in the DD. As a result, the Step 1 CAPM values should be revisited for the Final Determinations. If left unchanged, this level of allowed equity return would put at risk Ofgem's stated objective of ensuring that the RIIO-3 price control package is investable. Building on their previous report submitted with our Business Plan, Frontier Economics respond to Ofgem's critique on each cross check as well as critiquing Ofgem's chosen cross checks.				
FA5	**Frontier Economics**	**Standards of cost of equity cross-check**	Aug 2025	ENA and FEN	No
	Frontier Economics find that Ofgem and Ofwat have not to date appraised the merits of different types of cross-check (suggested by the regulators and the stakeholders) on a consistent and objective basis. Both have taken a selective approach to deciding which cross-check evidence to rely on, and which to essentially discard. If Ofgem and Ofwat were to apply a consistent standard of evidence to the available cross-checks, they should:				

- Place some reliance on DGM-based TMR cross-checks, if they continue to assign weight to their MAR inference cross-check; and
- Consider debt-based cross-checks such as hybrid bond cross-check when assessing the overall CoE, as the criticisms levied on the hybrid bond cross-check are present in regulators' own cross-checks.

By relying on a wider set of information, regulators can come to a more informed view of market conditions with respect to the allowed equity return; it is clearly superior to place weight on a suite of cross checks, albeit all with merits and limitations, than to place weight on a smaller number of cross-checks (given that Ofgem's own set of cross-checks are subject to limitations also).

FA6	**Kairos Economics**	**Cost of equity for RIIO-3: Gas vs. Electricity and MFM cross check**	Aug 2025	FEN	Yes

Kairos Economics find evidence that supports a material differential between market pricing of systematic risk of European gas and electricity networks under the CAPM, as evidenced by a differential in the betas for portfolios of gas and electricity companies that persists on a country-specific basis. The (value-weighted) effect is c.0.03 on the asset beta which translates to c.37bps on the CAPM cost of equity (CoE).

Multi-factor Models (MFM) provide one important cross check when moving from the CAPM-estimated CoE to the allowed return on equity. Using the q-factor MFM for UK comparators, the difference between a CAPM-CoE and MFM-CoE is 30bps on average.

FA7	**KPMG**	**Inference analysis as a cross-check on allowed returns at GD&T3**	Aug 2025	FEN	Yes

Inference analysis offers an empirical approach to calibrate a debt-equity cross-check, supporting a robust and investable CoE estimate. It is derived based on Merton's (1974) contingent claim framework and its empirical application by Campello, Chen and Zhang (2008). The approach is based on the premise that investors compare the expected return on equity with the expected return on debt of the same company, as both provide exposure to the same underlying asset.

Using 31 March 2025 as the cut-off date, KPMG estimate the inferred CoE to be between 6.94% and 7.45%, based on averaging windows of 1, 12, and 24 months, higher than the DDs point estimate of CoE at 6.04%.

FA8	**KPMG**	**Risk free rate**	Aug 2025	FEN	Yes

KPMG considers that the index linked guilt (ILG) yield should be adjusted for the convenience yield and the difference between risk-free borrowing and saving rates to arrive at the risk-free rate.

In arriving at their RFR they estimate ILG yield plus CY of 15.5bps and a risk-free borrowing rate of ILG yield plus AAA-ILG spread of 69bps. They take a point estimate of 42bps which is slightly below the midpoint of the two which is line with how the CMA estimated the risk-free rate at PR19. Adding 42bps to the 20Y ILG yield over March 2025 results in a risk-free rate of 2.33% in RPI terms. Inflating the RPI-real risk-free rate over March 2025 of 2.33% with the RPI-CPIH wedge of 10bps produces a CPIH-real risk-free rate of 2.43%, which compares to DD position of 2.01%.

FA9	**Economic Insight**	**Expected returns at RIIO-3 for Cadent**	Aug 2025	Cadent	Yes

Economic Insight estimates Cadent's expected return on regulated equity (RoRE) under RIIO-GD3 DD to be 5.33%, below Ofgem's allowed return of 6.04%, indicating the package is not a 'fair bet' for investors. Our North London network is particularly affected, with an expected RoRE of just 4.15%, driven by material errors in Ofgem's cost assessment (most notably related to regional and company-specific factors) and lack of recognition of other areas of the framework that penalise operating in the region. Three errors in Ofgem's risk modelling are identified and remedied in relation to (i) risk aggregation, (ii) coverage of risk areas and (iii) unrealistic scenarios.

Figure 2: Supporting reports

We have not resubmitted reports previously provided as part of our business plan but draw reference to some of these reports in our responses. After the submission of our draft determination response, we welcome continued engagement with Ofgem on these technical reports.

Allowed Return on Debt

FQ1 Do you agree with our approach to estimating efficient debt costs and calibrating the index?

We continue to support the full indexation approach to setting the allowed cost of debt and the calibration that ensures sector debt costs are fully funded. As noted in our business plan submission, the forward-looking assumptions that are made as part of the calibration are crucial to ensure the allowed cost of debt supports the funding costs and recognises the forward-looking risks in light of the energy transition into RIIO-3.

We support the split of the calibration cohorts between gas and electricity given divergence of sectoral risk due to the net zero transition, though note that continuing to include gas transmission in the gas calibration may not continue to be appropriate given divergence in regulatory depreciation policies so should be kept under review. We further support that the calibration continues to recognise the Cadent specific refinancing costs that resulted from the separation from National Grid.

However, evidence demonstrates that a 10-year trailing average of the iBoxx Utilities 10+ index provides a better match to sector debt costs, and results in a lower calibration adjustment which mitigates the risk of divergence through the RIIO-3 period.

Calibration adjustment

Ofgem's assessment of the allowed return on debt results in the recommendation of a 14-year trailing average index with a fixed calibration adjustment (currently estimated at 60bps). The requirement for a large adjustment to the trailing average demonstrates that this trailing average tenor or index selection (see FQ2 response) does not provide a good fit for sector debt costs.

There is also a likelihood that reality deviates from the forward-looking assumptions made to calibrate to a 14-year trailing average plus a fixed calibration adjustment (currently estimated at 60bps), which results in the adjustment amount no longer being appropriate. Selecting a trailing average that better fits sector average debt costs, and provides less volatility in scenario modelling would mitigate this risk. Ofgem's own calibration modelling demonstrates that the 10-year trailing average would result in a lower calibration adjustment and less volatility in scenario analysis. As stated in our business plan, we would support this trailing average tenor as it also better matches sector debt issuance tenors and therefore mitigates the risk of variability at each calibration through the future RIIO periods.

Ofgem's calibration and proposed uplift to the trailing averages across the sectors results in a close fit for the gas sector, though we note electricity transmission are forecast to outperform the index by c.40bps. While we recognise sectoral differences exist, these are recognised through the assumptions made in the calibration exercise and a fair performance against the forecast allowed return on debt should be consistent across the sectors. Ofgem's calibration analysis demonstrates that a 10-year trailing average would provide a better fit to sector debt costs with an uplift applied which is fair and equal across the sectors.

Forward-looking assumptions

We note the change in methodology from RIIO-2 for the forward-looking assumptions for the forecast index and new debt costs and recognise that using the forward gilt curve to forecast new debt in the period may include some term risk premium. Given the same approach is applied for the forecast allowance and debt costs in the period, our assessment is that the impact of this is currently minimal

to the calibration exercise. However, this assessment is highly sensitive to market interest rates in the cut-off month as the new debt priced into the allowance and the sector actual new debt are unequal. We would encourage Ofgem to assess market interest rates and the impact of this methodology change at final determination.

We support the inclusion of a benchmark adjustment for new debt which implicitly reflects gas network premium including new issuance premium, however analysis by consultants Nera (FA1) shows the 25bps does not sufficiently represent the premium. Their report shows that replication of the Ofgem methodology for the same period estimates this at c.30bps however, tenor adjusting this by comparing spreads provides a better estimate at c.45bps (Ofgem understates this because of the shorter tenor of the gas network bond sample relative to the tenor of the iBoxx indices). Their methodology draws on the approach used by Ofgem in RIIO-2, and we would support the continued assessment of gas network premium using relative spreads to control for tenor and the relevant index selection (see FQ2 response). This historic-looking analysis also does not capture the likelihood that this diverges through the RIIO-3 period.

In Ofgem's draft determination, they state that they have not adjusted for tenor in the gas network premium analysis as companies have discretion over the tenor of their debt issuance. While we do have some discretion over financing tenor, we are increasingly seeing this squeezed due to perceived gas risk by the debt investor community and would expect a steep credit curve to achieve longer tenors. Further, Ofgem are incentivising network companies to issue shorter-dated tenor to ensure the cost of debt allowance appropriately funds actual debt costs.

We support the inclusion of scenario analysis in relation to the calibration modelling, though determine that the interest rate scenarios of +/- 1% does not capture a realistic profile of interest rates over the period. Given Ofgem's forecast of interest rates saw variability of over +2% in the RIIO-2 period, we'd suggest +/-2% to be more appropriate scenarios to reflect the potential interest rates over RIIO-3.

We support the introduction of a close out mechanism to consider whether RPI to CPIH transition costs are allowable as these costs are currently unknown. We would welcome the opportunity to contribute to a consultation in support of efficiently assessing the costs in RIIO-3 and future regulatory periods, and would expect this to include the compensatory adjustment as well as legal and other advisory costs in relation to the negotiation of an adjustment. We note that this assessment will not be straight-forward as we are not expecting a market-wide adjustment (akin to Libor reform) as the negotiation is financing document specific, and we expect Ofgem will need to use its judgement that network companies have acted reasonably.

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

While we recognise that the iBoxx Utilities 10+ index has been impacted by the volatility seen in the water sector, we have not seen the evidence that supports the change back to the iBoxx GBP A and iBoxx BBB non-financial 10+ corporate indices that were used to set the allowed cost of debt in RIIO-1.

As the iBoxx GBP A and iBoxx BBB non-financial 10+ corporate indices include a wider range of bonds, the impact of the water sector volatility is less pronounced compared to the Utilities 10yr+ index. However, this broader exposure also introduces sensitivity to shocks in much less relevant sectors such as telecommunications and airports, with the impact of Covid-19 on the latter being a reason for the change from RIIO-1

As mentioned in the response to FQ1, the requirement for a large calibration adjustment demonstrates that this trailing average tenor or index selection does not provide a good fit for sector debt costs. Our analysis shows that the iBoxx Utilities 10yr+ index continues to provide a better match to sector debt costs with a smaller calibration adjustment required should this index continue to be used.

Ofgem have proposed that a simple average of the iBoxx GBP A and iBoxx BBB non-financial 10+ corporate indices would be appropriate as this should broadly match the average credit rating observed in the RIIO sectors. However, given recognition of the divergence of sectoral risks, we would support the weighting of the indices to better reflect gas sector credit ratings if the change in indices were to be implemented. Only one gas network's bonds appear in the A rated index, which should be reflected by a weighting in favour of the BBB rated index and therefore result in a lower calibration adjustment. This is further supported by recent updates from Moody's and S&P[1] which stated that credit metrics would be tightened in RIIO-3, meaning it is even less likely that gas network bonds will qualify for the A rated index.

The composition of the indices, in relation to credit rating and corporate sectors, and the extent to which these do not reflect the gas sector credit profile and risks, increases the likelihood that the sector costs diverge from the indices through RIIO-3, which could result in the fixed calibration adjustment of 60bps no longer being sufficient.

We support the continued use of the iBoxx GBP Utilities 10+ index in RIIO-3 as evidence shows this provides a better match to sector debt costs and mitigates risk of volatility due to exposure to less relevant industries.

FQ3 Do you consider our proposed notional ILD assumption to be appropriate?

We support the index linked debt (ILD) assumption of 30% as this is consistent with prior RIIO periods and aligns with our actual debt book composition. We further support the inclusion of derivatives to make this assessment.

[1] Moody's Ratings update on UK Gas Networks – "Broader policy uncertainty on energy transition increases business risk" dated 29 July 2025 and S&P Global Ratings "Four U.K. Gas Distribution Networks Ratings Affirmed Following Regulatory Draft Determinations; Outlooks Stable" dated 29 July 2025

FQ4 Do you agree with our approach to setting the additional cost of borrowing allowances?

We support the continued assessment of the additional costs of borrowing and applying this to the allowed cost of debt however our assessment, supported by the Nera report on these costs (FA1), indicates that 25bps is insufficient. Our position is outlined below.

Liquidity

In its draft determination, Ofgem estimates liquidity costs (combined liquidity/Revolving credit facility (RCF) and cost of carry) at 15bps consisting of an estimate of 2bps for liquidity/RCF and 13bps for cost of carry. The analysis by Nera (FA1) finds this insufficient to fund the liquidity costs borne by networks over the RIIO-3 period.

The estimate for the cost of carry is understated as it considers historical data for the cost of carry (difference between the 3-month cash deposit rate and the iBoxx GBP A and BBB non-financial 10+ indices) as well as the historic average cash/ debt ratio. **Updating these using forecast rates for the cost of carry, updating for the gas network premium and a higher estimate of average cash balances to reflect shorter tenors of debt results in a more accurate estimate for cost of carry over RIIO-3, at 26bps.**

We also consider liquidity/RCF costs to be insufficient as this similarly uses company actual/ historic data to assess these costs, and does not account for the expected widening of RCF costs given perceived gas risk by the lending banks, in line with the broader debt investor community as noted in FQ1.

Transaction costs

In their assessment of transaction costs, Ofgem have estimated these at 7bps. Ofgem has not considered the impact of annualising these over shorter tenors, though recognises that gas sector debt tenor has shortened. Ofgem states they have conducted analysis which suggests that shorter-tenor bonds incur lower fees, and indicate this is common market practice. Our extensive experience in debt issuance does not support this conclusion as we do not incur lower fees for a shorter-tenor issuance.

Nera's analysis (FA1) suggests that Ofgem's consideration of transaction costs is wrong, and when costs are assessed on an annuitised basis and expressed as a percentage of the issuance size, there is a negative correlation between transaction cost and debt tenor. **On this basis, we would support these costs being annualised over a shorter tenor which results in the appropriate cost being 8bps.**

CPIH basis risk mitigation

We support the continued inclusion of an allowance to recognise RPI-CPIH basis risk following the change to a CPIH-linked price control in RIIO-2. We recognise that the allowance will need to be modified in RIIO-3 to reflect RPI reform in February 2030, though note 47 months may be more appropriate than 46 due to the currently unknown timing in February 2030 of implementation.

In RIIO-2, Ofgem considered the cost of CPIH risk mitigation as 30bps on new debt and 12.5bps on existing debt. In its draft determination, Ofgem propose to provide the allowance at the costs of an RPI-CPI basis swap.

While we consider the RPI-CPI basis swap cost to be appropriate, we do not support the disallowance of new CPI debt as this continues to be a credible route to issuance. Nera (FA1) estimate this to be 30-50bps based on bank quotes of nominal to synthetic CPI swaps. **Resulting in a CPIH basis risk mitigation total cost of up to 6bps.**

FQ5 Do you agree with our proposed treatment of inflation with respect to the allowed return of debt?

We agree with Ofgem's proposed treatment of inflation with respect to the allowed return of debt, though we note that Ofgem pointed to the OBR's October 2024 Economic and Fiscal Outlook, which assumes a long-run CPI-CPIH wedge of 0.4%. See response to FQ8 for our consideration on this.

FQ6 Do you agree with the removal of the infrequent issuer allowance?

We are unimpacted by this change therefore have not seen evidence in support or otherwise.

Allowed Return on Equity

FQ7 Do you agree with our methodology for calculating the RFR?

We disagree with the Draft Determination (DD) methodology for calculating the Risk free rate (RFR). The DD proposed that the RIIO-3 RFR should be set in line with the yield on a 20-year index-linked gilt (ILG), plus an adjustment for the RPI-CPIH inflation wedge. Consistent with our business plan, we propose to use a basket of yields in setting the RFR.

Basket off riskless assets

We recognise, in the appeal of RIIO-2, the CMA concluded that Ofgem's decision to rely solely on ILG yields when estimating the RFR was 'not wrong'. However, as discussed in the RIIO-3 SSMD Oxera report for ENA[2], we do not consider that the CMA's conclusion in the RIIO-2 appeals implies that using ILGs as the sole proxy for the RFR can be considered a better approach than a combination of ILGs and AAA non-government bonds, which was the approach used by the CMA itself in the case of the PR19 redeterminations.

As stated in our business plan, Ofgem's selection of a single proxy for the riskless asset, and hence a single reading of the RFR, also stands in contrast to the approach adopted by the CAA and the NI Utility Regulator in recent price control decisions[3]. These other regulators have been taking the view that there is a "specialness" to index-linked gilts that make yields a potentially unreliable indicator of the risk-free returns that are available to typical investor. As a consequence, the CAA and the NI Utility Regulator have each advocated estimating the RFR using a basket of instruments, rather than place sole weight on a reading from the index-linked gilt market. We note that such an approach is explicitly permitted under the UKRN's 2023 cost of capital guidance[4]. The final paragraph on p.14 of the guidance states that:

> … regulators agree that nearly any risk-free proxy stripped of accurately measured risk premia should give a value close to the 'true' risk-free rate. In principle this suggests that evidence from these proxies could provide a useful sense check in times of ILG market volatility or to help define the range within which the point estimate for the risk-free rate should be drawn.

In our business plan we set out given both the theoretical and the empirical evidence the RFR should be set in reference to a basket comprising the yields on:

- 20-year index-linked gilts, plus an adjustment for the RPI-CPIH wedge; and
- 20-year conventional gilts, converted to CPIH real.

This composition of the basket has the advantage of simplicity. It also acknowledges the concerns that Ofgem and other regulators have expressed about the special feature of some AAA non-government bonds, which are shown in the table below for reference.

	Nominal	RPI real	CPIH real equivalent
Index-linked gilts, 20Y	-	1.91%	2.01%
Nominal gilts, 20Y	5.21%	-	3.15%
AAA non-government bonds, 10+Y	5.18%	-	3.11%
AAA non-government bonds, 10-15Y	5.02%	-	2.96%

Figure 3: Yields

[2] FA3, Oxera RIIO-3 cost of equity – CAPM parameters report for the ENA submitted with our business plan
[3] NB: the CAA's 2023 decision for Heathrow Airport and the NI Utility Regulator's 2024 decision for Northern Ireland Electricity were issued after the publication of the UKRN guidance on the methodology for setting the cost of capital.
[4] UKRN (2023), UKRN guidance on the methodology for setting the cost of capital

We also proposed that the conversions from RPI real to CPIH real and from nominal to CPIH real, respectively, should be consistent with deflation assumptions used across the price control i.e. the Bank of England long term CPI target of 2%. Taking this approach, **we estimate the RFR consistent with the methodology set out in our business plan of 2.58%** (i.e. equal weighting of nominal and index linked gilts).

Convenience premium

Notwithstanding the above, if Ofgem continues to solely rely on index linked gilts, it should adjust to account for the convenience premium embedded in the gilts. As noted in our business plan there is extensive evidence supporting the inclusion of the convenience premium, including academic literature and recent regulatory precedents, such as those from the Competition and Markets Authority (CMA), the Civil Aviation Authority (CAA) and the Utility Regulator (UR). Ofgem states the evidence did not reflect a 20-year time horizon. Oxera's updated report (FA2) shows the existence of a large and positive convenience premium that can be observed across a variety of points of the gilts yield curve, including at the 20-year investment horizon. During the RIIO-2 CMA appeal, the CMA reiterated that there was evidence that supports the existence of a convenience premium

> *"we agree that ILGs are an imperfect proxy for the RFR (a view shared by GEMA [Gas and Electricity Markets Authority]). Specifically, we noted that there is evidence to support the notion of a convenience yield in government-issued securities, and we disagreed with the view that the appropriate investor when considering the RFR is a net lender"*[5]

Although the value of this premium varies over time, making no adjustment for it when setting the RFR introduces a downward bias to the estimate for a five-year price control period. We also note that despite the H7 and Northern Ireland Electricity decisions being published after the RIIO-2 appeals, the CAA and UR still included a convenience premium. Oxera provide extensive response to Ofgem's draft determination conclusion in their revised report for FEN (FA2) **estimating a convenience premium of 0.24%**.

Borrowing vs saving rate

As well as the convenience premium, Ofgem's approach to estimating the RFR is akin to using a saving rate to price a lending product i.e. it underestimates the true cost of capital by anchoring too heavily on gilt yields, which are more reflective of risk-free saving instruments rather than the cost of borrowing for infrastructure-heavy utilities. KPMG (FA8) provide evidence for a further adjustment to the RFR to account for the empirical reality that investors' risk-free borrowing rate exceeds their risk-free saving rate via Brennan (1971). Overall KPMG propose an **upward adjustment to ILG's of 0.42% which factors in both the convenience premium and the difference between saving and borrowing rates.**

The CMA at PR19 explicitly adjusted for differing risk-free saving and borrowing rates:

> *"We consider that our interpretation of the CAPM in a situation of different borrowing and lending rates…is in principle in line with Brennan's (1971) often quoted finding that the market equivalent RFR is a weighted average of the RFR of all individual investors"* [6]

The CMA used ILGs as a proxy for the risk-free saving rate and AAA corporate bonds as a proxy for the risk-free borrowing rate.

Both the convenience yield and lending vs borrowing rate differential arguments are subject to redetermination by the CMA as part of the PR24 appeals and Ofgem should consider conclusions

[5] Competition and Markets Authority (2021), 'Cadent Gas Limited, National Grid Electricity Transmission plc, National Grid Gas plc, Northern Gas Networks Limited, Scottish Hydro Electric Transmission plc, Southern Gas Networks plc and Scotland Gas Networks plc, SP Transmission plc, Wales & West Utilities Limited Vs the Gas and Electricity Markets Authority—Final determination Volume 2A: Joined Grounds: Cost of equity', 28 October, para. 5.68.
[6] CMA (2021), PR19 Final Determination, para. 9.263.

from the preliminary findings as part of their Final Determination. Both Oxera (FA2) and KPMG (FA8) provide extensive evidence supporting a positive adjustment to ILD in estimating the RfR.

We propose to use a basket of yields in setting the RFR. If Ofgem continue to rely solely on ILD gilts, it should adjust for the convenience premium and difference between lending and borrowing rates.

FQ8 Do you agree with our methodology for calculating the inflation wedge?

We agree with Ofgem's methodology for calculating the RPI-CPIH inflation wedge.

However, we note that Ofgem said that it will consider whether an adjustment to the inflation assumption and inflation wedge is warranted to reflect the OBR's long-run CPI-CPIH wedge of 0.4% as referred to in the OBR's October 2024 Economic and Fiscal Outlook. We do not consider it appropriate to include the OBR's CPI–CPIH wedge in the estimation of the RFR for three key reasons which are discussed in more detail with supporting evidence in the Oxera report (FA2):

1. Historical evidence does not support the existence of a stable or predictable wedge – the observed differential between CPIH and CPI is highly variable over time, with no clear long-term trend. In fact, the analysis shows that, over the time horizons typically considered in regulatory decisions, the average wedge is both small and negative. Over the past ten years, the average difference between CPIH and CPI is -0.04%, while over the past 20 years it is -0.12%.

2. The OBR quantified a long-term wedge forecast between CPIH and CPI for the first time in its October 2024 report with the OBR explicitly noting that it will 'keep our estimates and forecast methodology under review'. In any case, in the latest forecast evidence published by the OBR, long-term wedge only fully applies for 2035-36. As a largely untested forecast, it lacks the track record and evidential basis needed to support regulatory application.

3. The underlying drivers of estimating the long-term CPIH are conceptually complex and extremely challenging to project reliably.

Therefore, introducing a CPI–CPIH wedge into the regulatory framework should not be done without robust and tested evidence of a predictable level of the wedge.

We agree with Ofgem's calculation of the RPI-CPIH wedge of 0.10% and disagree with any potential changes to this methodology for final determinations.

FQ9 Do you agree with our methodology change in calculating the ex ante TMR?

In our business plan we stated that historical ex-ante estimates of returns should not be included in Ofgem's RIIO-3 calculations. Instead, we believe that Ofgem should inform its Total Market Return (TMR) estimate predominantly on the basis of the ex-post estimation using the one-year arithmetic mean approach.

We note that, in line with the suggested approach in the RIIO-3 SSMD Oxera report for the ENA[7], Ofgem's decision to rely solely on the DMS decompositional approach for estimating the ex-ante TMR, and we welcome the exclusion of the COLI-CED and serial correlation adjustments from its calculation.

Whilst we agree with this methodology change in relation to the ex-ante TMR, the approach followed by Ofgem to set the overall TMR remains only partially consistent with the overall methodology outlined in the RIIO-3 SSMD Oxera report for ENA and our business plan submission. The main differences are that we believe little or no weight should be placed on the ex-ante approaches and that an upward adjustment is required to the TMR to reflect the higher interest rate environment.

While the UKRN guidance suggests that 'the TMR should be primarily based on historical ex-post and historical ex-ante evidence', it does not recommend assigning equal weight to ex-ante and ex-post estimates. We therefore consider that it is not correct to place 50% weight on the ex-ante TMR. Given the methodological concerns with the ex-ante approach we consider that Ofgem's decision to place equal weight on ex-ante and ex-post approaches remains unjustified. Furthermore, the DMS decompositional approach does not actually attempt to predict a forward-looking TMR. Instead, the DMS decompositional approach tries to assess whether the returns that investors were expecting in the past are well approximated by the historical mean.

As mentioned in our business plan, we also consider it wrong to not adjust the TMR to reflect prevailing interest rates and that not adjusting TMR is inconsistent with previous Ofgem decisions where the TMR was reduced in an environment of declining gilt yields. In particular, when gilt yields were at similar levels, the TMR exceeded 8.00%, significantly higher than the top of Ofgem's TMR range for RIIO-3.

It is therefore reasonable to expect an upward adjustment to TMR. Our equity investors, and investors of equity across the world more generally, can choose to put their money into a wide range of possible investments. It stands to reason that in a "higher for longer" interest rate environment investors will find it easier to make good returns and that regulated infrastructure will likewise have to increase the returns on offer to investors in order to retain and attract capital. If there is no recognition of an upward movement in the TMR, our returns will be unattractive relative to the returns that investors can earn elsewhere, impacting the overall investability of the price control.

Ofgem states that it plans to continue to use cross-checks to assess whether its bottom-up TMR is 'materially' out of line with what investors require. Ofgem uses limited TMR cross-checks and dismisses the evidence proposed in Frontier Economics' paper [8] which points to a higher TMR. We disagree with the reasons set out for dismissing these cross-checks and Frontier Economics sets this out in an updated paper for FEN (FA4). In particular, given the higher interest rate environment, the TMR glider developed by Frontier Economics acts as a useful cross check which points to a TMR closer to 8% consistent with when gilt yields were at a similar level. The Glider is calibrated using historical market implied TMR based on a Dividend Growth Model (DGM) and contemporaneous interest rates (gilt yields). The TMR Glider provides a framework for the TMR to move with gilt yields

[7] FA3, Oxera RIIO-3 cost of equity – CAPM parameters report for the ENA submitted with our business plan
[8] FA5 Frontier Economics, Updated cost of equity cross-check evidence report submitted with our business plan

but is much less than a one-to-one relationship. The TMR Glider therefore provides a framework for the TMR which is 'stable but not fixed' in line with UKRN Guidance.

Ofgem has continued to rely on its own TMR survey cross-check which has a sample of 9 investment managers but has rejected the Fernandez TMR survey that Frontier Economics proposed with 82 UK respondents. Survey evidence should only be used to assess relative trends and both Ofgem's own survey and the Fenandez TMR surveys show significant increases compared with RIIO-2 (2.4% and 3.0% respectively in nominal terms).

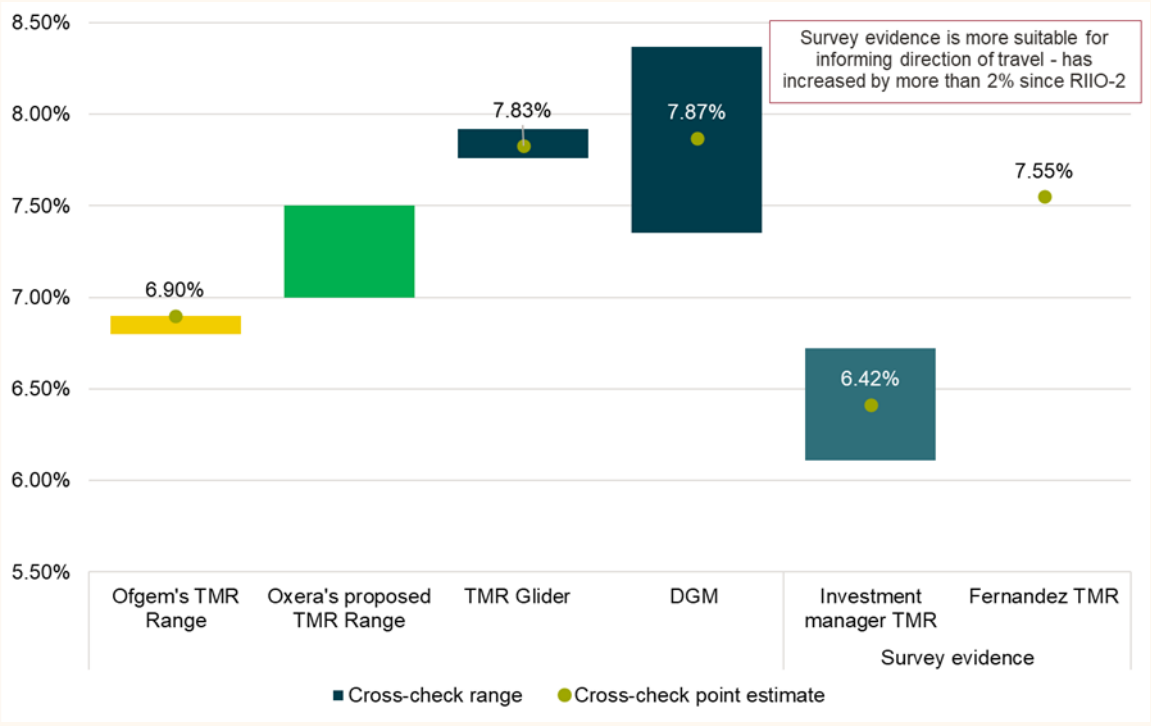

Figure 4: TMR cross checks

Consistent with our business plan the evidence would suggest a properly calibrated range for the TMR is therefore 7.0% to 7.5%.

FQ10 Do you agree with our methodology for estimating beta?

The incorporation of European utility stocks is a welcome addition to Ofgem's proposed comparator set for estimating beta. We also agree with Ofgem in placing reliance primarily on 10-year betas with reference to daily returns which are inherently more stable and less impacted by short term market shocks. However, we have some concerns over the beta calculations:

1. The low end of the asset beta range is lower than the allowed asset beta in RIIO-2 which contradicts Ofgem's own statement that there is more risk and uncertainty facing the gas sector.
2. Ofgem fail to recognise a systematic difference between the gas and electricity sectors, and instead continue to apply the same beta for both sectors

Lower end of Ofgem's asset beta range

Ofgem has itself recognised through the RIIO-3 price setting process that there is greater risk and uncertainty for gas networks in relation to net zero challenges.

However, the bottom end of Ofgem's asset beta range is below the lower end of the asset beta range set in RIIO-2, representing a decrease in risk. This is fundamentally inconsistent with previous statements made, and therefore we believe the lower end of the asset beta range should be increased accordingly.

Systematic difference between the gas and electricity sectors

The proposed set of comparators should reflect the risks facing that sector. Gas networks are entering a mature phase of their lifecycle with limited real RAV growth, unlike electricity networks and water companies which embark on significant growth investment. For gas networks, the future role of gas is less certain and there is a perceived asset stranding risk. To reduce the risk of asset stranding, Ofgem has proposed to accelerate depreciation. In doing so, Ofgem have fundamentally changed the regulatory model which investors relied upon – accelerated depreciation creates different risks; investors face the prospect of no capital growth and returns falling over time (despite retaining the risk of operating a network which will not reduce in size in proportion to the RAV, or reduction in customer numbers).

In FQ13 we provide further evidence which demonstrates that there is a systematic difference between the gas and electricity sectors. We believe this risk should be reflected in the relative weighting placed on the comparators, with more emphasis being placed on European gas companies facing similar risk profiles. In the Oxera report submitted with our Business Plan[9], they provided a robust analysis of different European regulatory regimes. We continue to promote the use of that analysis in informing relative weights to apply to different European comparators.

In their updated report for FEN (FA2), Oxera observe data points for a gas specific beta of between 0.360 – 0.500, and narrow this range to 0.400 – 0.440. Recognising Ofgem will also apply weight to non-gas beta's, Oxera do not solely rely on the use of gas betas, and provide another beta range which incorporates electricity and water betas of 0.375 – 0.450, given regional and regulatory consistency.

[9] FA1, Oxera Cost of equity for RIIO-GD3 for the GDNs submitted with our business plan

	Gas distribution	Gas transmission	Gas storage	Regasification
Unadjusted asset beta				
Range	0.39–0.50	0.38–0.47	0.38–0.51	0.38–0.52
Average	0.43	0.41	0.44	0.44
Asset beta adjustment I				
Range	0.37–0.47	0.36–0.45	0.36–0.48	0.36–0.5
Average	0.41	0.39	0.42	0.42
Asset beta adjustment II				
Range	0.42–0.53	0.41–0.50	0.41–0.54	0.41–0.56
Average	0.47	0.44	0.48	0.47

Figure 5: Asset beta precedents of different gas sectors

Consistent with our business plan approach, we consider the above evidence together with the supporting report from Oxera (FA2) in the round in estimating our **proposed beta range of 0.375 – 0.440.**

FQ11 Do you agree with our proposed set of comparators which also incorporates selected European utility stocks?

As stated in FQ10, we welcome the incorporation of European utility stocks which we believe provide a stronger reflection of gas specific risks.

Our beta range is entirely derived from comparators used by Ofgem and whilst we note there are differences in US regulatory regimes, we disagree that Ofgem should dismiss this data entirely. The differences in regulation and net zero risks between US gas networks and GB/European gas networks would generally be expected to indicate a lower risk (all else equal) for US gas networks compared to GB and European gas networks. This is primarily because of the perception that the current US government is promoting growth over net zero ambitions resulting in increased reliance on gas usage for longer. The increasing divergence between gas and electricity/water also warrants as a minimum further gas specific cross checks on the proposed range. **Oxera (FA2) demonstrate that the average ten-year asset beta of US gas networks is broadly consistent with the top end of their beta range, which provides a valuable cross check.**

FQ12 Do you agree with the conclusions we have drawn from our chosen cross checks?

We disagree with the conclusions drawn from Ofgem's cross checks. Just like the CAPM, all cross checks have merits and limitations which is why it is important to use a broad range of cross checks in validating the implied CAPM point estimate. The UKRN guidance states cross checks should be used to sense check the CAPM derived estimate and should deviate from the mid-point if there are strong reasons to do so. We believe there is strong evidence from a range of cross checks which indicate the cost of equity should be higher than the CAPM mid-point.

Below sets out a range of cross checks and compares against Ofgem and our CAPM derived point estimate. Overlaying the risk asymmetry in the price control (see FQ17), the evidence strongly indicates that a higher CoE is required to mitigate investability risks.

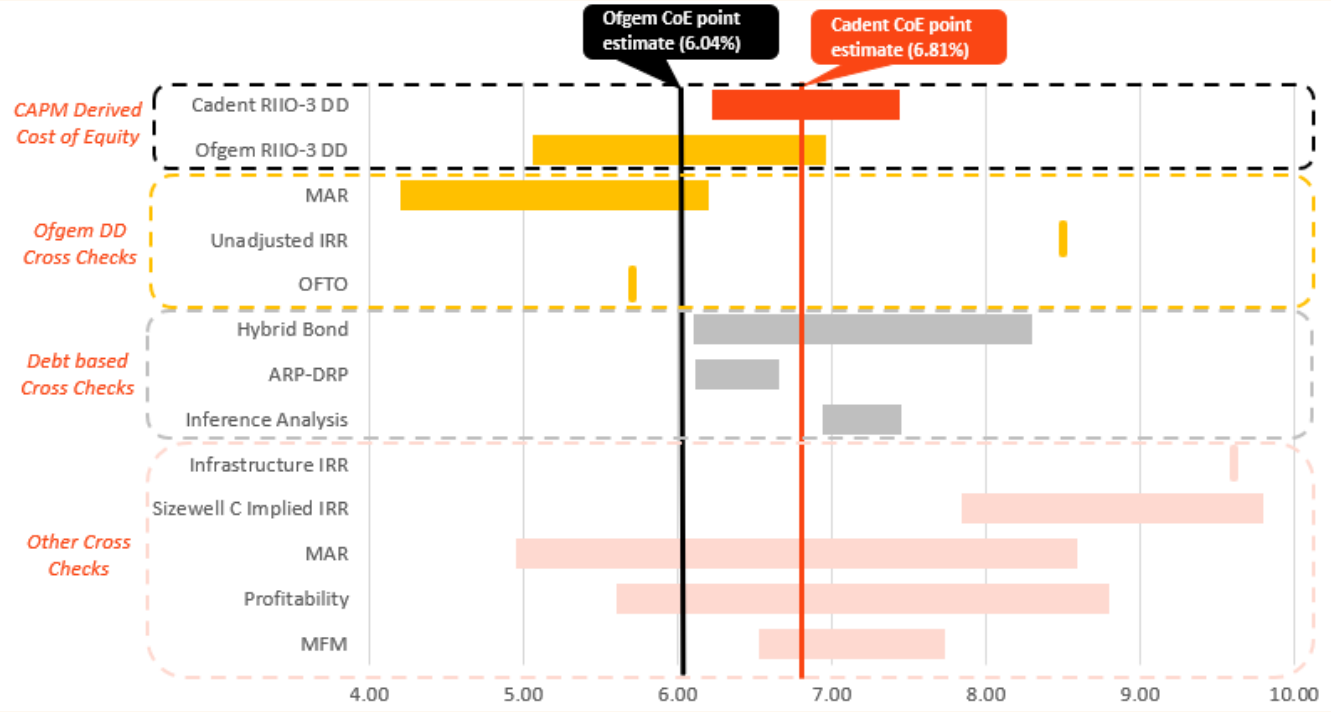

Figure 6: Cross checks

ARP-DRP cross check is based on Oxera's revised CAPM parameters as set out in FA2 figure 6.3. Using the DD CAPM parameters gives minimum implied cost of equity range of 5.89% - 6.43%.

Inference analysis (FA7) uses Nera's (FA1) estimated GNP of 45bps. Using the DD estimated GNP of 25bps provides a range of 6.17% to 6.63%, still higher than the DD point estimate of 6.04%.

MAR's range within other cross checks is based on Frontier Economics (FA4) updated assumptions, compared to the DD quoted position of 4.20% to 6.20%.

MFM cost of equity range has been derived by taking Cadent's updated CAPM range and adding 30bps based on Kairos Economics (FA6) assessment of inherent under funding in CAPM. Applying the same uplift to the DD CAPM range gives a range of 5.36% to 7.26%.

Cross Check Eligibility

We believe there are fundamental inconsistencies in the standards applied to choosing relevant cross checks that results in a downward bias in the implied cost of equity. Frontier Economics (FA5) discuss this in their Cross Checks – Standards of Evidence report prepared jointly for the ENA and FEN. For example, in respect of Dividend Growth Model (DGM) based cross-checks on TMR, we note again that Ofgem has rejected these over concerns around DGM based methods generally. But at the same time, Ofgem continue to rely heavily on MAR cross-checks that are based on entirely the same DGM logic, without any justification.

Equally, Ofgem's concerns around the hybrid bond cross check apply similarly to their own cross-checks, and therefore should not render the Hybrid bond cross check uninformative. Indeed, Frontier Economics provide further evidence showing the Hybrid bond check is supported by a much wider set

of bonds which undermines Ofgem's concern around the narrow sample used. In regards to making assumptions, Frontier Economics (FA4) provides sensitivities and further justification for the assumptions used.

We believe Ofgem should take a more balanced approach for Final Determination that engages with a full range of cross checks weighting them appropriately based on merits and limitations.

Cross Check Evidence

We discuss each cross check in the table below:

Cross Check	Consultant	Discussion
Debt Based Cross Checks - *Equity inherently faces higher risks in relation to loss of capital and return compared to debt. Given this higher risk, the expected return on equity must be substantially higher than the expected return on debt from the same company to adequately incentivise investment in equity.*		
Hybrid Bond	Frontier Economics (FA4)	Ofgem has not incorporated the Hybrid bond cross-check, citing concerns over how equity-like hybrid bonds are, and the variability of hybrid bond spreads over time as the main criticisms. Frontier Economics set out responses to all Ofgem's critique in detail in their full report, with key arguments summarised below. a) Equity likeness – which follows from the option to skip coupon payments, the subordinated nature of hybrids relative to senior debt; it is also observed that equity likeness is recognised in the way they are treated by rating agencies, and in their relative tenor. b) Variability of spreads - 80 percent of the observed spreads in the sample were within a relatively narrow range of 100bps to 213bps. Frontier Economics find this narrow range a compelling feature of the data and one that shows the cross-check can be applied robustly. As a result, the updated Hybrid bond cross check implied CoE range of 6.1% to 8.3% CPIH-real
ARP-DRP	Oxera (FA2)	Oxera have updated their ARP-DRP cross-check which involves comparing the difference between the ARP (the expected excess return from holding risky assets compared to riskless assets) and the debt risk premium (DRP, the expected excess return to holding risky debt relative to riskless assets). Ofgem's proposed point estimate of the CoE allowance fails to meet most of the specifications of the debt premia cross-check on the implied CoE. Therefore, Oxera conclude that Ofgem's CoE allowance range from the lower bound of 5.06% to mid-point estimate of 6.04% is set lower than required by investors to compensate them for the addition risk of investing into equity compared to debt.
Inference Analysis (IA)	KPMG (FA7)	The key rationale for exploring IA as a cross-check is as follows: a) IA provides an independent framework in estimating the CoE, and therefore, it is not subject to the same estimation issues that affect the CAPM. b) IA uses debt yields that are directly observable and automatically forward-looking, in contrast to the historical Total Market Return estimates used in the CAPM. c) IA provides an analytical method to infer the CoE based on elasticity – that is, the sensitivity of changes in equity value to changes in debt value – combined with current debt pricing. The inferred CoE range is between 6.94% and 7.45%, based on averaging windows of 1, 12, and 24 months. These averaging windows capture the most up-to-date data (1 month) as well as longer-term, more stable trends (24 months) in the inferred CoE.

Cross Check	Consultant	Discussion
OFTO bid implied IRR		
OFTO	Ofgem DD	In the DD, Ofgem proposed to continue to use an OFTO-based cross-check in RIIO-3 for the following reasons: a) the benefit in using evidence from competitive processes. b) OFTO projects have a comparable level of risk to networks. c) OFTO projects, like network investments, have long-term time horizons. Ofgem estimates latest OFTO bids (2022-2024) implies a cost of equity of 5.7% real. Ofgem does not provide any justification for choosing bids from this time period nor does Ofgem provide any further context to the data. Key limitations with looking at OFTOs are: a) There are no construction activities associated with OFTO bids; b) OFTOs do not operate under a RAB model For these reasons comparisons to network is challenging and there are more relevant data points such as bid-implied IRR of Sizewell C below)
Sizewell C IRR	Frontier Economics (FA4)	New evidence from the Sizewell C nuclear project, a RAB financed nuclear project with substantial risk mitigation, provides a further real-world benchmark for what is required for a sizeable new equity investment on a relatively safe infrastructure project in the UK. Centrica reports a 10%-12% nominal IRR for its 15% equity stake. Given the scale and risk profile, this is a relevant cross check for required equity returns on large network investments.
Other Cross check evidence		
Infrastructure IRR	Frontier Economics (FA4) / Ofgem DD	The infrastructure fund implied equity IRR cross-check is intended to provide market-based evidence of the return expectations of equity investors in infrastructure assets with similar risk-return profiles to regulated networks. Since RIIO 2, Ofgem's CoE has increased by 1.5 percentage points, while implied infrastructure equity IRRs have risen by 5.4 percentage points (to 9.6% CPIH real in March 2025). The widening gap points to a growing disconnect between regulatory allowances and capital market pricing which indicates that a more significant increase in the allowed CoE is likely to be required for RIIO-3 than Ofgem has so far been minded to provide. Ofgem reports an average implied equity IRR of 10.7% nominal (8.5% CPIH-real). Frontier Economics evidence suggests the average implied equity IRR stands at 11.8% in nominal or 9.6% in CPIH-real terms. Both are well above the top end of the CAPM range.

Cross Check	Consultant	Discussion
Market Asset Ratio (MARs)	Frontier Economics (FA4) / Ofgem DD	Ofgem continue to rely on MAR analysis which uses assumptions for RCV growth and Return on Regulated Equity (RoRE) outperformance projected to perpetuity for three of the higher performing water companies, to infer a plausible cost of equity given the allowed return on equity. Ofgem provides a range of 4.2%-6.2%. The use of MARs as a cross check for the allowed return for the gas sector has several limitations: a) Ofgem has used data from Ofwat that is out of date b) Ofgem does not attempt to infer a cost of equity for National Grid c) Water companies do not act as good comparator for the gas sector given different stages of maturity and inherently different challenges d) assumptions used by Ofwat were poorly calibrated and do not stand for the gas sector especially in light of accelerated depreciation. Notwithstanding the above, a more realistic range of assumptions for asset base growth and regulatory performance shows that the Step 1 output in the DD sits at the lower-end of a very wide range. Specifically, Frontier Economics estimate an implied CoE range of 4.95% to 8.59%.
Profitability	Frontier Economics (FA4)	The long-term profitability cross check looks at accounting information on companies' profitability to benchmark equity returns. Frontier Economics consider profitability metrics are a helpful reference point to ensure the CAPM-CoE point estimate falls within a reasonable location of the range of long-term average profitability metrics. They assess a reasonable range for this cross check is 5.6% - 8.8%. We recognise limitations for this cross check with not being able to control for gearing and imperfect comparability, but these limitations are also present in Ofgem's cross checks, so this shouldn't be dismissed.
Multi-factor model (MFMs)	Kairos Economics (FA6)	Given the known flaws with the CAPM, multi-factor models (MFMs) provide one important cross check when moving from the CAPM estimated cost of equity (CAPM-CoE) to the allowed return on equity (Allowed-RoE). Kairos Economics assessed the evidence provided by a MFM cross check and find that: a) The q-factor MFM should be applied when deriving a UK CoE estimate, given its superior performance compared to alternatives such as the Fama-French Five Factor (FF5F) model. Factor returns for the q-factor model are not readily available for the European comparators, hence the MFM cross check is applied to Ofgem's UK comparators only. b) For the UK comparators, the difference between a CAPM-CoE and MFM-CoE is 30bp on average (using Ofgem's approach of a 10-year historical estimation period of data with no adjustments for exceptional events). The finding that the MFM-CoE for the UK comparator set is above the CAPM-CoE is as expected, given the omitted variables in the CAPM, and particularly poor performance of the CAPM for low beta stocks (like utilities).

Figure 7: Cross check review

Ofgem's cost of equity point estimate fails almost all of the cross checks – there is a risk that Draft Determination proposals undermine the investability of the sector. It is clearly better to rely on a wide set of information, rather than planning weight on a small number of cross-checks. By considering a

wider range of evidence, Ofgem would be better equipped to set the cost of equity at an appropriate level which mitigates investability risks and protects customers accordingly.

The evidence strongly indicates that a higher CoE is required to mitigate investability risks. By contrast, the top end of Ofgem's CAPM range has greater overlap with the cross-check evidence and is more consistent with investor expectations of the sector.

FQ13 Do you agree with our treatment of risks to the ET and Gas sectors as non systematic?

We disagree with the draft determination's (DD) treatment of risks to the ET and Gas sectors as non-systematic. In particular, the regulator contends that asset stranding risk, a gas-specific risk in RIIO-3 and beyond, is diversifiable and that it is inadequate to use an adjustment of the asset beta to address this risk.

This stands in contrast however to the proposed treatment in the allowed return on debt calibration, where Ofgem apply an uplift for new gas issuances, acknowledging a divergence from the index due to increased risks facing the gas sector in comparison to electricity. Since the publication of the DD credit rating agencies have also updated their views on the gas distribution sector, highlighting an increased risk profile and tightened credit metrics for equivalent ratings (see FQ18).

Evidence from Kairos Economics set out in their report commissioned by FEN (FA6), shows that there is a material differential between market pricing of systematic risk of European gas and electricity networks under the CAPM, as evidenced by a differential in the betas for portfolios of gas and electricity companies that persists on a country-specific basis. The effect is c.0.03 on the asset beta. This uses data from Ofgem's own European comparator set, which were included given similar regulatory regimes and net zero challenges.

As stated in FQ11 we believe the proposed set of beta comparators should reflect the risks facing that sector. We believe the risk of asset stranding is systematic and market evidence points to this requiring an uplift to asset beta. This risk itself is not fully mitigated through accelerated depreciation which returns capital, which the regulator contends allows investors to diversify the risk. The retained equity still faces a higher risk given Ofgem's own analysis shows bills increasing significantly in future periods which raises concerns about the feasibility of such bill levels especially given the remaining customers are likely to be vulnerable customers. There are the potential for other longer term unintended consequences which have not been robustly assessed (see FQ20). This is also further exacerbated given the notional dividend policy doesn't allow the notional company to return capital efficiently for investors to diversify the risk as stated by Ofgem (see FQ14).

FQ14 Do you agree with our proposed dividend allowance policies for the notional gas and electricity companies?

We fundamentally disagree with Ofgem's proposed dividend allowance policy, which we believe fails to reflect the realities of investor expectations and sector-specific dynamics. We have two inter-related concerns:

1. Return on capital - a 3% dividend yield is inadequate and does not align with gas sector investor expectations
2. Return of capital - The introduction of a special dividend mechanism for when gearing falls below the notional level by an arbitrary 5%, is inconsistent with Ofgem's policy to accelerate depreciation for GDNs.

Return on Capital

Ofgem's assumption of a 3% dividend yield for the notional company is inadequate, particularly in the current "higher-for-longer" interest rate environment. This assumption does not align with investor expectations and fails to account for the differing growth profiles of gas and electricity networks.

Gas networks are entering a mature phase of their lifecycle with limited real RAV growth, unlike electricity networks which will see significant growth. This divergence should be reflected in the notional dividend yield. As RAV growth slows, the dividend yield should naturally converge toward the cost of equity. In scenarios where RAV growth turns negative, capital should be returned to shareholders, implying that dividend distributions may exceed the cost of equity allowance.

This dynamic is supported by investor benchmarking. Historical RFPR data for UK regulated utilities shows dividend yields ranging from 3.5% to 7.0%, with a midpoint of 5.0%, further underscoring the inadequacy of the proposed 3% assumption. Oxera's analysis (FA3) of European energy networks supports this view, showing consistently higher dividend yields for gas networks (5.3–8.5%) compared to electricity networks (4.1–4.8%) between 2018–2024. This trend reflects the relationship between slowing asset growth and increasing dividend yields, and is mirrored in payout ratios as demonstrated in Oxera's updated report (FA3). These findings reinforce the need for a dividend yield assumption that reflects sector maturity and investor expectations.

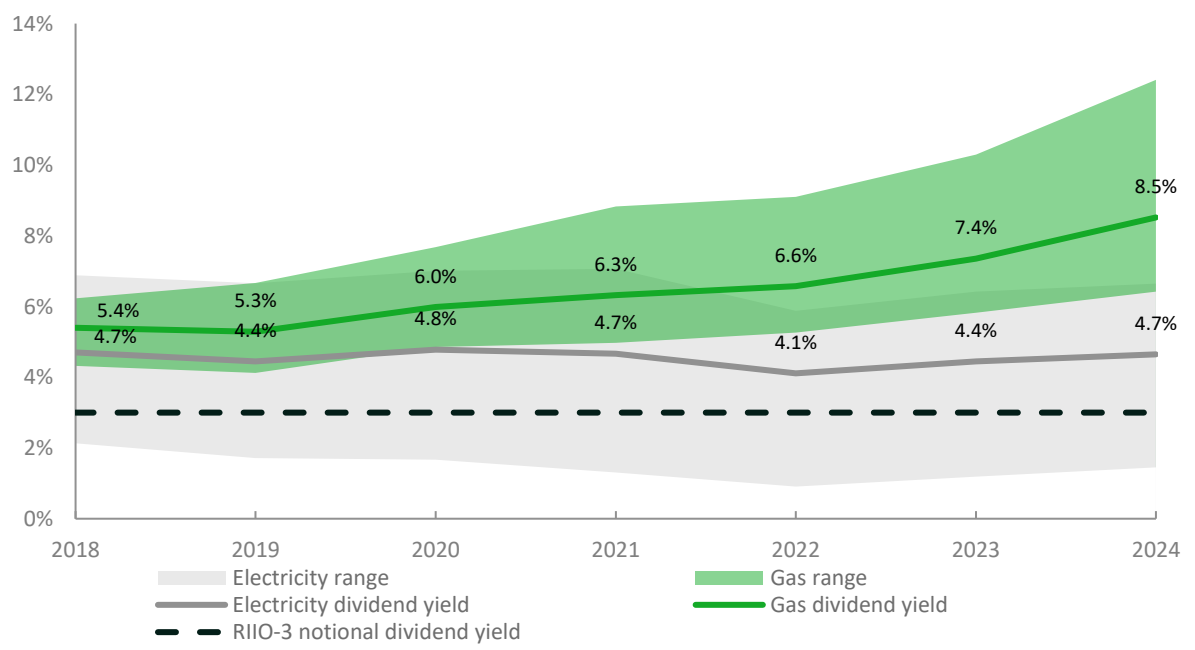

Figure 8: Gas vs electricity dividend yields

In mature or declining sectors, companies typically distribute a higher proportion of earnings as dividends rather than reinvesting in growth. Conversely, growth sectors retain more earnings to fund expansion. Regulators must therefore adopt flexible dividend assumptions that reflect these sector-specific investment dynamics and minimum investor expectations.

Consistent with our business plan we continue to believe a base dividend yield of 6% is reflective of gas specific investor sentiment as evidenced above.

Return of Capital

Whilst we continue to disagree with the need to accelerate RAV depreciation (see FQ24) it would nonetheless inevitably increase cash flows. To maintain the notional gearing level, it is essential that the return of RAV be used to repay both debt and equity, necessitating higher dividend distributions. The purpose of accelerated depreciation is to reduce RAV stranding risk which includes returning capital to shareholders, which should be reflected in dividend policy.

Ofgem's introduction of a special dividend mechanism triggered when gearing falls 5% below the notional level is problematic. It leads to gradual de-gearing over RIIO-3 due to trapped equity, followed by large dividends toward the end of the period, an outcome inconsistent with the behaviour of an efficient company. Should Ofgem continue with the proposal, we propose removing the arbitrary 5% threshold to allow for a more consistent return of capital and to maintain the notional gearing level of 60% annually.

Indeed, the failure to do so fundamentally contradicts Ofgem's hypothesis that accelerated depreciation reduces exposure to asset-stranding risk, as equity is trapped in the notional company in future periods where, as Ofgem stated, the future of the gas network is less certain.

Importantly, any increase in dividend yield resulting from return of capital should be clearly distinguished from return on capital. Reporting these figures separately is essential to avoid misleading interpretations by external stakeholders.

Ensuring that the dividend yield assumption reflects the sector's growth prospects is critical to maintaining investability, indeed the ability to attract and retain equity capital. A regulatory settlement that aligns with investor expectations grounded in sector lifecycle and capital return dynamics is essential for long-term sector stability and therefore consistent with our business plan, **we think Ofgem should:**

1. **Increase notional dividend yield to 6%**
2. **Remove the arbitrary 5% threshold for paying a special dividend**

FQ15 Do you agree with our proposal not to apply the flat WACC approach?

As stated in our previous responses above, we believe there is evidence showing divergence between the gas and electricity sectors. The cost of capital should reflect the risks faced by the sectors.

FQ16 Do you agree that our proposed package for gas and electricity companies is investable?

We welcome the positive movements from the SSMD in the draft determination (DD) on the cost of capital, however we continue to have concerns about the overall investability of the package. It is paramount the cost of capital properly reflects the overall risks facing investors in this sector for the package to be investable. While Ofgem has stressed it is taking a "data driven" approach, the DD proposals do not match our view of what a fair return would be against the overall risks of the control. Indeed, our own risk analysis shows that the package is asymmetrically skewed such that it is highly unlikely that investors are able to earn the allowed return, which is particularly pronounced in our London Network.

In our business plan, we set out Oxera's expert views on what Investability in the gas distribution sector requires and below we compare this with the outcomes from the DD and identify areas of inadequacy:

Our views on what investability requires (as set out in our business plan)	Observations on the Draft Determination position
An appropriate return to equity including an equity beta based on a sample of companies that reflect gas specific forward-looking risks, given the evolving risk landscape. We provide details of listed European gas sector beta data that should be included.	We welcome the upward movement in beta from Sector specific methodology decision (SSMD) to DD and recognition of a broader European comparator set. However, we believe that the lower end of the range being lower than levels allowed in RIIO-2 is inconsistent with Ofgem's own statements that risk and uncertainty have increased. We also disagree with Ofgem's statement that they "did not think any additional risks identified were systematic, non-diversifiable, and therefore something that consumers should compensate investors in energy networks for. We also did not see that the European comparator evidence gave an unambiguous signal that the market awards gas companies higher betas than electric companies." Evidence from Kairos Economics (FA6) shows that European betas show a systematic risk between the gas and electricity sectors and Ofgem should recognise this through appropriate weighting of its comparator set. We provide further details in FQ10.
Ofgem should ensure that the available returns reflect the macro-economic environment prevalent at the time of the price control, showing flexibility to amend assumptions on Risk Free Rate and Market Returns so the overall returns cross check appropriately to industry analysis.	We recognise that Ofgem has shown some flexibility on individual parameters, particular on Total Market Return (TMR) where it has removed the Cost of Living Index (COLI)-Consumption Expenditure Deflator (CED) and serial correlation adjustments from the calculation of the ex-ante. On the Risk Free Rate, we provide further evidence of the existence of convenience premium even at longer investment horizons which was Ofgem's primary concern and continue to disagree with sole reliance on ILG yields rather than using a relevant basket of yields as set out in FQ7. On TMR, we consider Ofgem to be incorrect in not adjusting to reflect prevailing interest rates and inconsistent with previous Ofgem decisions where the TMR allowance was reduced in an environment of declining gilt yields. When gilt yields were at similar levels, the TMR allowance exceeded 8.00%, and our TMR cross checks also support a higher value. This is a key parameter where placing reliance on historical data could lead to a miscalibration of the cost of equity (see FQ9). We believe Ofgem have been selective in their selection of relevant cross-checks and have failed to apply the same criteria to the cross checks they use compared with the cross-checks Frontier provided. Applying the same criteria would point to a higher cost of equity, more consistent with what we have proposed (see FQ12).

Our views on what investability requires (as set out in our business plan)	Observations on the Draft Determination position
We welcomed Ofgem noting that it is not in consumers' interests for investors to face the risk of stranded assets. We believe more time and policy development is needed across government and Ofgem to ensure a fair and equitable transition to net zero.	We continue to disagree with the requirement for any urgent change in depreciation policy (see FQ24). Notwithstanding this, Ofgem have failed to robustly assess the long-term implications of implementing the policy. In addition, the application of a 3% notional dividend yield, and a special dividend when gearing reduces 5% below the notional level, contradicts Ofgem's hypothesis that accelerated depreciation reduces exposure to asset-stranding risk, as equity is trapped in the notional company in future periods where, as Ofgem stated, the future of the gas network is less certain (see FQ14). In addition, accelerated depreciation (AD) alone does not remove the risk of asset stranding, as Ofgem's own analysis shows customer bills increasingly rapidly up to 2050. Indeed, AD changes the regulatory model in which investors have invested and therefore creates new risks for which they expect reasonable remuneration.
The funding for debt costs must index accurately to the quantum, tenor and interest rates that are achievable. The funding for new debt should consider the diverging costs between sectors and the benchmark indices used.	We welcome the recognition of diverging costs between the gas and electricity sector however the requirement for a large adjustment to the trailing average demonstrates that this trailing average tenor and index selection does not provide a good fit for sector debt costs. Evidence demonstrates that a 10yr trailing average of the iBoxx utilities 10+ index would provide a better match, with a lower calibration adjustment required mitigating the material risk of further divergence through the period as discussed in FQ2.
Ofgem should consider not just a fair return on capital but also how the return of capital is reflected in the allowed dividend yield.	As in FQ14, the 3% notional dividend yield is inadequate and does not reflect a fair return on capital based on investor sentiment in the gas sector. The special dividends mechanism is not appropriate and results in trapped equity restricting the efficient flow of funds to shareholders. Ensuring that the dividend yield assumption reflects the sector's growth prospects is critical to maintaining investability.
An overall price control financial package that is a fair bet to investors – consistent tightening of price controls has led to investor caution over the ability to generate the allowed return and reduces the pool of potential investors into the sector. As expected for RIIO-2, the allowed totex was below required levels set out in business plans and this has led to a Return on Regulated Equity ("RoRE") below the baseline allowed. Over time this will prevent new capital becoming attracted to the sector.	We do not agree that there is risk symmetry within the aggregate balance of the whole price control. Ofgem have made errors in it's assessment of risks: 1. Not covering the full list of risk areas embedded within the RIIO-3 framework in their assessment of overall control price control risk 2. Not considering a realistic performance distribution in calibrating its risk assessment 3. Ofgem's risk analysis makes the crude assumption that all upward and downward risks are perfectly correlated The downward skew indicated by Economic Insight's risk analysis is most pronounced in our London network due to the punitive nature of several decisions Ofgem's Draft Determination contains on outputs and costs (see FQ17). Together this means that there is a significant risk that investors will not earn the allowed return as has been experienced in RIIO-2. It is vital that these underlying issues in the price control are resolved at source and even after resolution we would consider the current position the be inadequate.

Figure 9: Investability considerations

It is in all stakeholders' interests that the RIIO-GD3 review produces an 'investable' package of obligations, revenues and returns. This is of particular importance to consumers who rely on us to be able to attract and retain the capital required to deliver the investment required for a safe and resilient network. We welcome opportunity to work with Ofgem prior to the Final determination to ensure the final package is aligned with investor expectations.

FQ17 Do you agree with our working assumption that there is risk symmetry within the aggregate balance of the whole price control?

We do not agree with the statement that there is risk symmetry within the aggregate balance of the whole price control and believe Ofgem has erred in its analysis of Return on Regulated Equity (RORE). We have commissioned EI to conduct an independent assessment of the expected RORE for an efficient notional operator of our networks in RIIO-GD3 ('EI RORE Report', appended as FA9), which shows that:

- there is an asymmetric downward skew to potential equity returns for Cadent networks, relative to Ofgem's stated RORE range (4.27% - 7.78%)[10] meaning that the price control does not represent a 'fair bet' to equity investors; and
- this is particularly pronounced in the case of our North London network and reflects the greater challenges of operating this network within the RIIO-3 framework proposed at the Draft Determinations with key decisions on cost allowances (most notably regional and company-specific factors) unduly discriminating against Cadent, and output targets not recognising what is achievable within the London geography.[11]

At Draft Determination in setting the proposed allowed cost of equity, Ofgem selected a mid-point estimate of 6.04% on the basis that the control was a fair bet to equity investors. EI's analysis shows this is not true and there is a significant material downward skew in the aggregate price control, largely driven by errors in Ofgem's approach and execution of its cost assessment. For Final Determination, therefore, Ofgem should accept our proposed remedies to errors made in respect of cost assessment (detailed across our responses to **OVQ19 and GDQs 32 and 36-46**) to address this skew and justify continuing to utilise a midpoint estimate for the cost of equity. Otherwise, the remaining negative skew would necessitate Ofgem in needing to 'aim up' on the cost of equity.

As noted in our Key Messages section at the front of this document, however, it is clear that even if it was legitimate to utilise a midpoint estimate for the cost of equity, this midpoint has materially increased from when business plans were submitted.

In this response we:

- explain why Ofgem has erred in its approach to the assessment of RORE;
    - as a key part of this, we explain how various errors, in particular as regards cost assessment, in Ofgem's Draft Determination mean that Ofgem's assumption that there is risk symmetry with the aggregate balance of the whole price control is wrong;
- highlight the particularly stark impact of Ofgem's errors on our London network's RORE; and
- explain what actions Ofgem should take to address the lack of risk symmetry.

Ofgem has erred in its approach to the assessment of RORE to reach a view on risk symmetry in the control

EI consider that our networks (and the underlying data related to them) provides a valid basis for estimating RORE risk for the efficient notional company because, as a company, we are:

- cost efficient, with two out of four of networks either at, or ahead, of the cost efficiency benchmark for the industry; and
- deliver high service quality for our customers, for example, achieving outperformance (on average) against ODI and NARM targets in RIIO-GD2, indicating the cost efficiency has not been achieved through lower service quality.

[10] Ofgem (2025), "RIIO-GD3 Draft Determination Finance Annex", para. 3.143

[11] For more details on our views on Regional and Company-Specific factors please see our responses GDQ36 and GDQ37, for the impact of Ofgem's output decisions regarding repair standards and unplanned interruptions please see our responses GDQ3 and GDQ17

In the EI RORE Report, EI set out that Ofgem have made three errors in its approach to assessing whether the price control in aggregate is symmetric as regards risk:

Error	Remedy
Error 1 – Ofgem uses risk scenarios that presuppose equal upside and downside risk relative to the allowed return on equity without sufficient justification.	EI use historical data from RIIO-GD2 (and forecasts where needed), alongside expert judgement, to inform plausible performance distributions for our networks (rather than overly simplistic and unrealistic assumptions – such as the potential for +/-10% totex under or outperformance, which are unjustified in Ofgem's analysis).
Error 2 – Ofgem aggregates risk by simply summing across all risk areas, implicitly assuming all are perfectly correlated.	EI use a Monte Carlo risk aggregation approach allowing for non-perfect correlation of risks, which is more reflective of reality, than Ofgem's approach of summing risks together (we note this results in a more conservative estimate of RORE risk than put forward by Ofgem as under EI's approach outperformance in one area may occur when underperformance occurs in another)[12].
Error 3 – Ofgem does not have a full coverage of the risks areas facing an efficient company.	EI consider a greater scope of risk areas relative to the narrow range of factors considered by Ofgem

Figure 10: Errors and remedies

Figure 11 sets out the range of risk areas EI have considered in their analysis relative to those Ofgem have considered in Draft Determinations:

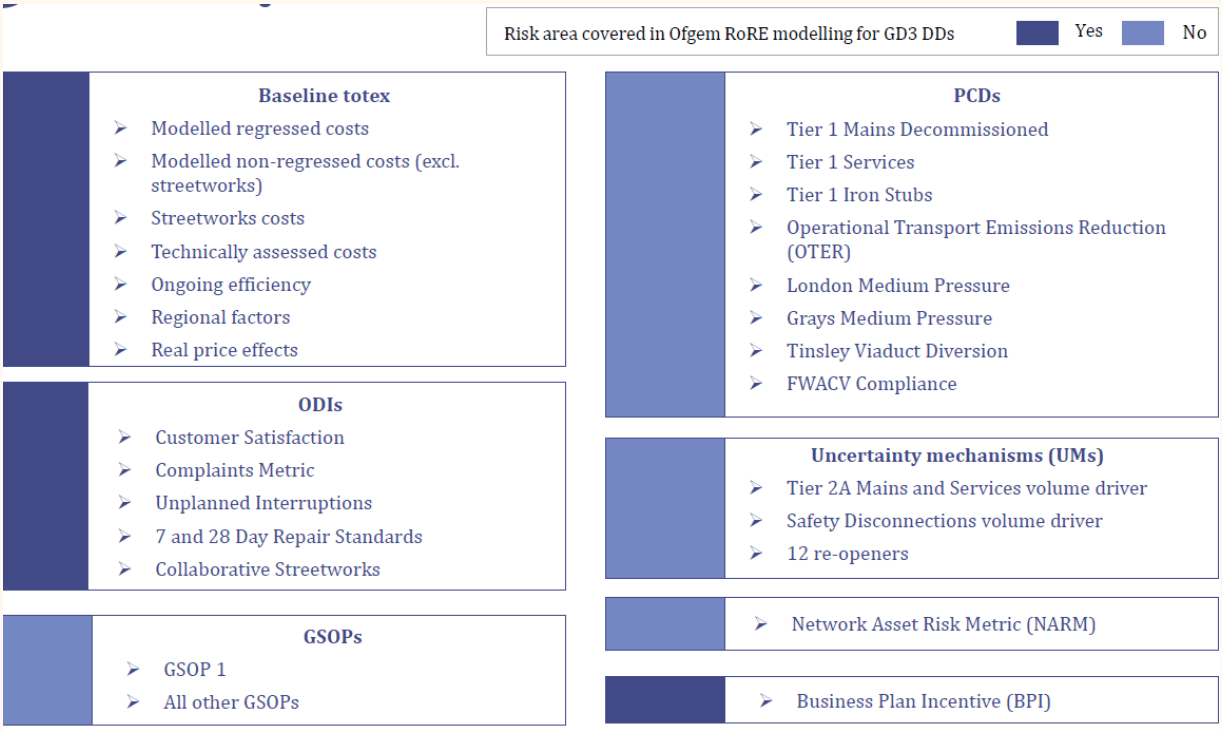

Figure 11: Risk areas considered by EI

Further information on the range of risks we face across each of these areas is set out in more detail in the EI RORE Report.

As Figure 11 shows, EI's analysis includes additional risk areas such as PCDs, GSOP payments, UMs, and NARM, extending beyond Ofgem's scope. EI also accounts for the impact of Ofgem's decisions not to fund certain activities, like Streetworks charges and penalties, which are excluded

[12] Monte Carlo modelling uses repeated random sampling across financial distributions to simulate aggregated RoRE outcomes. For RoRE risk analysis, samples are drawn from distributions of financial impacts across price control components and summed. This process, repeated thousands of times (e.g. 10,000 in EI's analysis), produces a distribution of possible RoRE results.

from Ofgem's RORE analysis but must still be covered by equity holders.

Remedying Ofgem's errors in approach shows the aggregate price control to be significantly negatively skewed, with the expected return on equity significantly below the base return

Having remedied all errors set out above, EI assessed potential equity returns and the level of symmetry in the price control. Figure 11 presents EI's analysis and compares this to Ofgem's Draft Determination RORE analysis, which they have applied Monte Carlo methods so a clear read across can be made (with the base allowed return of equity shown as the red dotted line). EI's analysis shows[13]:

- When only remedying Error 2 (assumption of perfect correlation) and applying a more sophisticated, realistic and conservative approach to risk aggregation, but maintaining the other elements of Ofgem's analysis, EI show the aggregate price control to have a slight negative skew (with upside potential of+129bps and downside of -141bps) with the actual level of expected returns[14] slightly below the base return on equity (5.99% relative to a base return of 6.04%). A difference of 5bps.
- When correcting for Errors 1 (presupposition of equal upside and downside) and 3 (insufficient coverage) as well, our potential return is significantly more negatively skewed – with the profile appearing more analogous to an 'iceberg' than symmetrical: with a smaller +34bps positive upside and a larger downside of -171bps compared to Ofgem's range of (129bps to -141bps), resulting in the expected level of returns (5.33%) being materially below the base level return on equity by 71bps
- When correcting for all of the errors in Ofgem's RORE analysis for our London network specifically, the entire range of potential returns sits underneath the level of base returns, with an expected return of 4.15%. This is 189 bps below the base return on equity. There is only downside potential with even a P90 outcome estimated to be a return of 5.18% (i.e. a -86bps downside) below the base return and a P10 downside scenario yielding a return of 3.19% (i.e. almost half the level of the base return). Hence, we are 'under water', in one of our networks before the price control even starts, with very small chance this can be recovered to deliver base returns to equity holders.

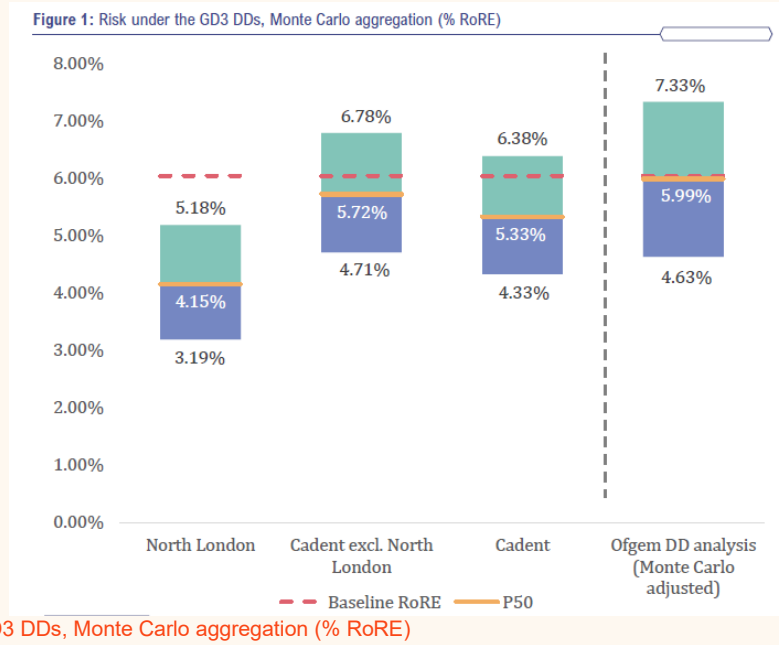

Figure 12: Risk under the GD3 DDs, Monte Carlo aggregation (% RoRE)

[13] It is important to note in reviewing this analysis that for the assessment of totex risk, the work has used our 'error corrected' version of Ofgem's Draft Determinations analysis so that calculation errors present in the Draft Determination do not impact results.

[14] Referred to as 'Most Likely' in EI's work

This analysis shows the price control lacks symmetry, undermining Ofgem's assumption that it's DD represents a 'fair bet' for equity holders. This calls for substantial revisions to Ofgem's positions taken at Draft Determinations.[15] We detail below the drivers of these outcomes and their disproportionate impact on London.

The negative asymmetry is driven predominantly by expected totex performance, as well as factors Ofgem does not account for in its risk analysis

The EI RORE Report, breaks down the key drivers of the results using a simple risk aggregation method (i.e. not remedying Error 2 as above) since under this approach, risk ranges of individual risk areas are summedto highlight the relative impact of each factor. Figure13 below restates EI's analysis above under a simple aggregation approach.[16]

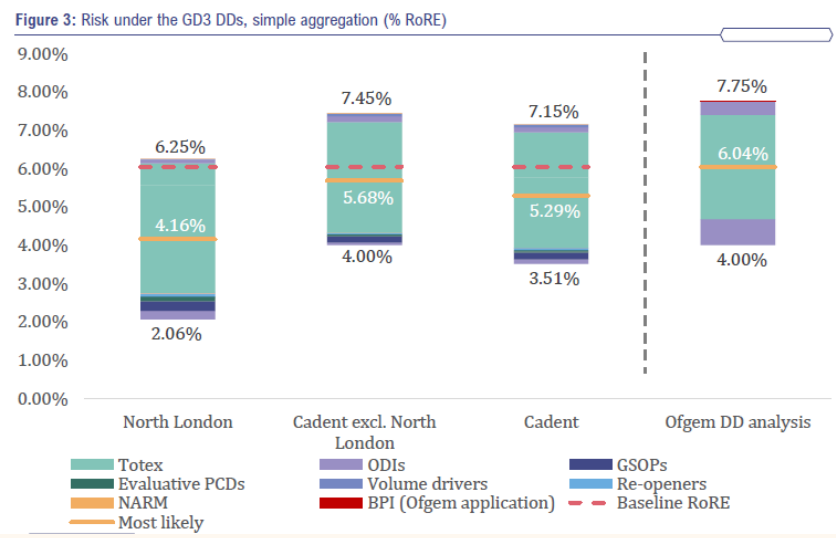

Figure 13: Risk under the GD3 DDs, simple aggregation (% RoRE)

As shown above, while risk ranges vary to when Error 2 is remedied, the main profiles of the risks remain the same. Furthermore, in respect of the factors that have driven EI's results:

- Totex performance against Ofgem's allowances is a much larger driving factor of our expected returns than Ofgem's analysis suggests – emphasising the need for Ofgem to undertake a robust cost assessment and remedy key errors in its approach set out elsewhere in our response to the Draft Determinations so that allowances provide efficient levels of funding.

- Output Delivery Incentives offer more relatively muted upside and downside risk than suggested in Ofgem's analysis. This is driven by both the potential to actually achieve all potential upside rewards or face all downside penalties not being realistic (i.e. meaning we get reduced upside and reduced downside) and our impressive performance against ODIs in RIIO-2, notably as regards Customer Satisfaction (i.e. meaning we get reduced downside), which informs EI's analysis of potential performance distributions for our networks.

- A significant portion of the downward skew in potential performance has not been recognised in error in Ofgem's analysis with GSOPs expected to reduce equity returns significantly over the period. This is a significant error in Ofgem's analysis.

[15] It is important to note these results do not include the impact of increases Employers National Insurance Contributions (NICs) that will increase costs for reasons outside of our control (i.e. Uk Government Policy Decisions, embodied in the Autumn 2024 Budget). We estimated in our Business Plan submission that this would increase our costs by c. £96m over the RIIO-3 period. Were this not taken account of in Ofgem's Final Determination, this would materially increase the downward RORE skew set out above and reduce the expected return to 5.13%, 20bps below the expected return stated above.
[16] The results of this analysis, where simple risk aggregation is applied, is not intended to represent EI's view on expected RORE ranges as it does not remedy Error 2 described above. However, it is used in their report, and here, to allow for the factors driving the results to be discussed. EI's views on potential RORE ranges are set out when Error 2 is remedied as presented in Figure 13

We expand on each of these points further below.

Negative totex risk highlights three key areas where Ofgem needs to address errors in its cost assessment approach: regressed costs, ongoing efficiency and Streetworks

Figure 13 above demonstrates that totex performance is the principal driver of network outcomes under the Draft Determination, underscoring the need for robust and accurate cost assessment. Our broader response highlights critical errors in Ofgem's current approach that must be addressed in the Final Determinations. The figure below breaks down totex risk, showing that regressed costs, ongoing efficiency, and Streetworks are the main sources of risk.

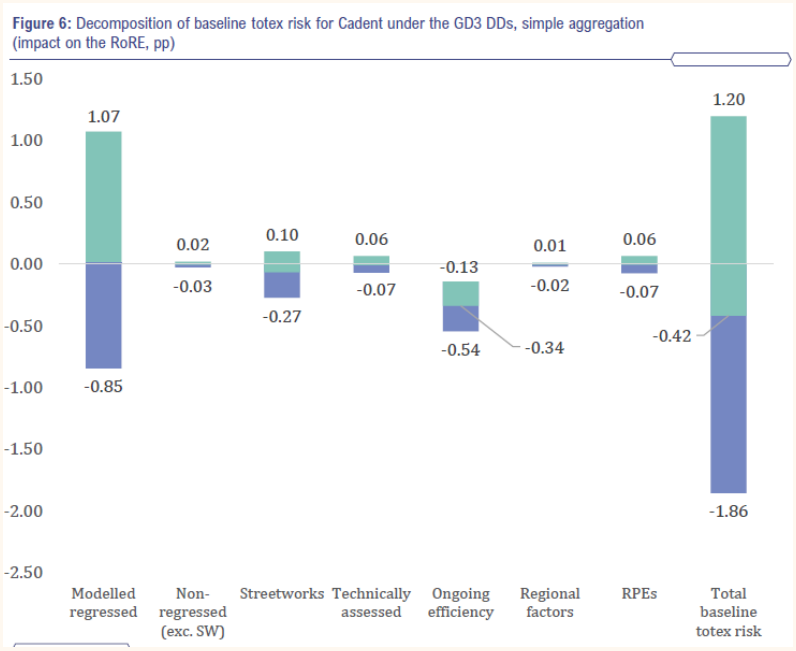

Figure 14: Decomposition of baseline totex risk for Cadent under the GD3 DDs, simple aggregation

Regressed costs drive most of the totex risk, largely due to Ofgem's single totex regression model. As noted in our response to GDQ32, under the Draft Determination approach to regressed costs (when corrected for calculation errors in Ofgem's cost model suite), Cadent's West Midlands network sets the efficiency frontier, with Cadent now being the most efficient ownership group. Therefore, given how well our networks benchmark, there is potential upside in the framework. Still, this is not consistent across all networks—London, for example, faces a more pronounced negative risk profile.

Because Ofgem's Ongoing Efficiency assumption applies to all costs, it creates a negative upside—meaning even in a best-case scenario, networks cannot meet the unjustified ongoing efficiency 1% annual challenge set by Ofgem. This highlights the need for Ofgem to correct this error in the Final Determinations, as detailed in our response to OVQ19.

Ofgem's treatment of Streetworks costs also heavily skews risk, driven by how allowances are set and specific policy decisions on funding.

1. Ofgem currently uses a 10-year average to set allowances for Streetworks costs (5 years historical, 5 years forecast) – as a result, given rising costs over time, networks are systematically underfunded for efficient costs, this is a significant error, as set out in our response to GD41. As these costs are unavoidable and largely outside of our control the expectation is that networks will be less likely to outperform their allowance on these costs than they will underperform; and
2. Ofgem has taken a policy position that it will not fund any Streetworks charges or penalties. This is an error and highly punitive element of the RIIO-3 framework as also explained in our response to GDQ41, and means that, as a level of zero charges and penalties is neither

efficient nor achievable, that equity holders are guaranteed to need to use some of their returns to fund these costs. This impact will only become more material moving forward as in December 2024,[17] the Government decided to double the charge for Fixed Penalty Notices, and expand the time periods covered by s74 overrun charges by 40%. The costs of neither of which were factored into Business Plans, nor EI's RORE analysis. This means this further increase in costs will further exacerbate potential underperformance embodied in the RORE range.

In light of the above, as set out further in our response to GDQ41, it is important Ofgem remedies these errors in the Draft Determination for its Final Determination through changes in its approach to set ex ante streetworks allowances and by ensuring the Specified Streetworks re-opener is appropriately scoped to allow recovery of efficient costs by networks.

When accounting for potential performance, ODIs present both reduced upside and downside risk to equity holders

In Ofgem's analysis of RORE risk, ODIs are estimated to present a potential upside on the base return of +34bps with a potential downside of -68bps. Whilst this shows a contributing factor to the downside skew of potential returns in Ofgem's analysis, based on EI's analysis of potential performance for Cadent both the potential upside and downside are materially smaller on a like-for-like basis than in the Draft Determinations, with an expected positive outcome for Cadent.

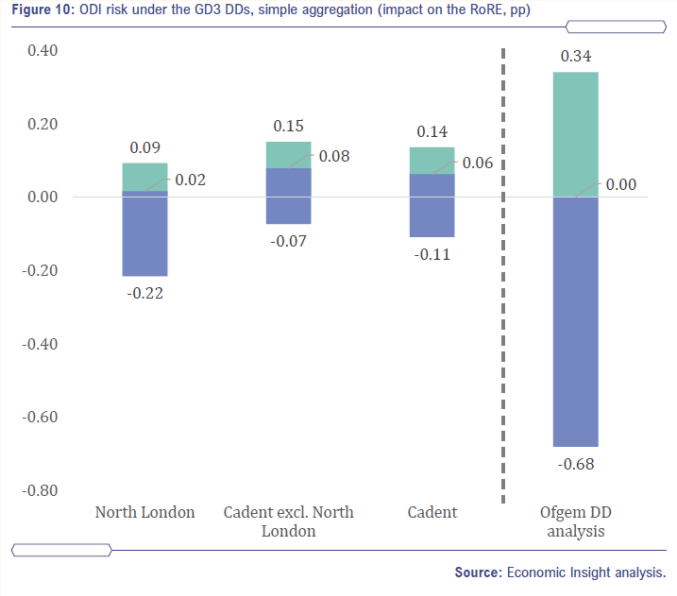

Figure 15: ODI risk under the GD3 DDs, simple aggregation

Ofgem's assumption that networks can achieve maximum ODI rewards or penalties is unsupported by past performance, leading to an overstated risk range. RIIO-2 performance show a much tighter range, making Ofgem's analysis erroneous. Notable contributors within this range are set out in the chart below, which shows:

- We have upside potential on the Customer Satisfaction ODI – we have led the sector in our performance across key areas of customer satisfaction in RIIO-GD2, leading EI to estimate that we would be expected to achieve a positive reward from this incentive across RIIO-GD3.
- Whilst there is upside potential from the Collaborative Streetworks ODI, this is relatively minor – there is no downward skew accounted for by this incentive as it is reward only, but the upside potential is significantly limited as meeting the minimum annual threshold for reward – 5 projects – will be stretching in certain networks.

[17] Dept for Transport, December 2024: Streetworks: fines and lane rental surplus funds – consultation outcome

- The most material contributor to the downward portion of the range is Ofgem's newly proposed 7 and 28 repair standards ODI. As a penalty only ODI this only adds to the negative skew evident in the price control, and even when taking conservative assumptions shows the introduction of significant downside potential to what was an already downwardly skewed price control at RIIO-GD2. Both this and Ofgem's proposed common non-Multioccupancy Buildings (non-MOBs) targets also significantly impact potential returns for our London network relative to others. Further comments on Ofgem's new repair ODI can be found in our response to GDQ3.

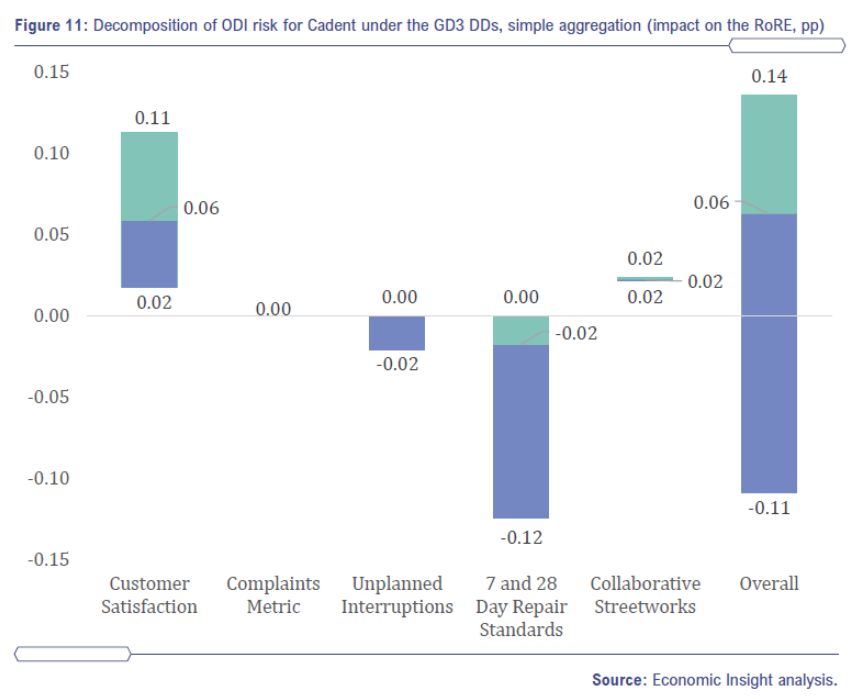

Figure 16: Decomposition of ODI risk for Cadent under the GD3 DDs, simple aggregation

When included in risk analysis, GSOP payments contribute significantly to reducing networks' expected returns

GSOPs are licence obligations requiring networks to compensate customers if standards are not met. Ofgem's policy is not to fund even efficient levels of GSOP payments, making equity holders responsible. In practice, some GSOP payments are unavoidable, and not recognising efficient costs can lead to higher overall customer costs, as networks might act inefficiently to avoid penalties. Ofgem's Draft Determinations fail to account for this GSOP-related risk, meaning the current regime consistently reduces expected equity returns, as shown in Figure 17 below.

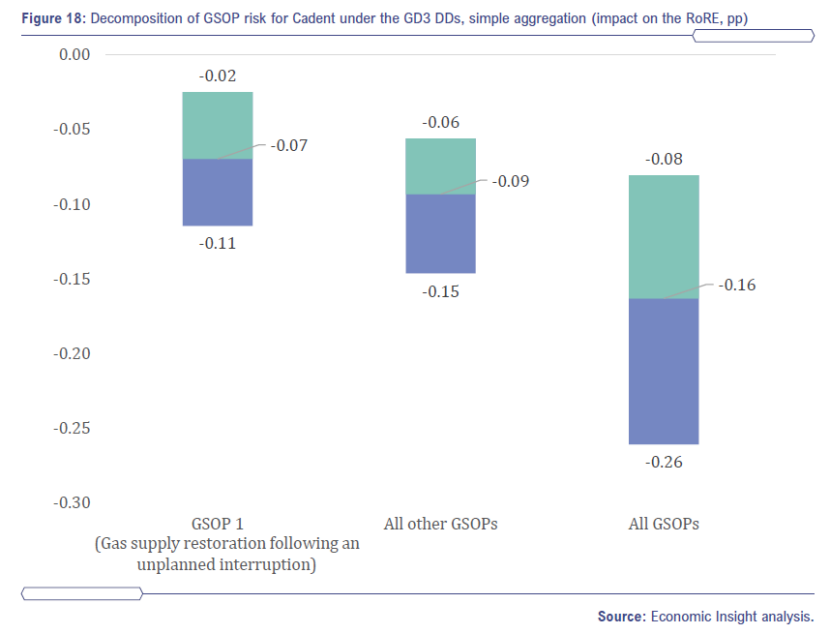

Figure 17: Decomposition of GSOP risk for Cadent under the GD3 DDs, simple aggregation

It is important to note that the majority of the impact on the risk range comes from "GSOP 1" payments (related to unplanned interruptions). The need to compensate customers for violation of this particular GSOP is significantly more difficult to avoid in our London network as explained below.

Analysis shows the base return is unachievable in our London network, with the expected return 189 basis points below Ofgem's Draft Determination base return on equity.

As shown above in Figure 18, the downward skew indicated by EI's analysis is most pronounced in our London network due to the unduly discriminatory nature of several decisions Ofgem made in its Draft Determination on outputs and costs. As a result, we are left in a position that before the price control begins, we most likely will not achieve our base level of returns with an expected return of 4.15%. This is 189 bps below the base return of 6.04%.

As explained above, the largest contributor to this expected performance is the potential risk from totex underperformance. As shown below, London is expected to perform materially worse compared to our other networks in respect of totex:

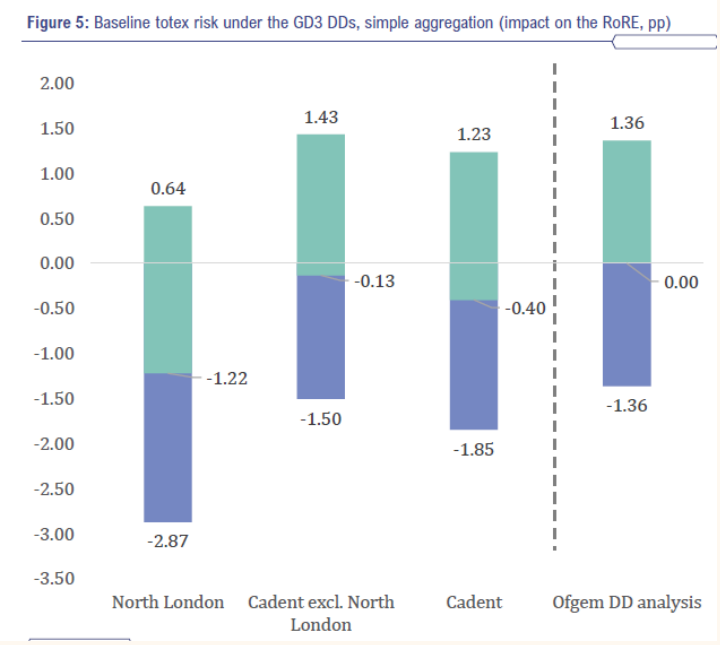

Figure 18: Baseline totex risk under the GD3 DDs, simple aggregation

This is directly driven by the errors made in Ofgem's cost assessment in Draft Determinations, which uniquely and disproportionately impacts our London network:

- Ofgem has materially erred in its Draft Determination decisions to reject our proposal to set GDNs allowances using a density model and, without prejudice to that primary position, to reject our proposed improvements to its framework for Regional and Company-Specific Factors. If accepted in full, our proposals would increase our allowances by £53-127m (with the lower bound from only using only pre-modelling adjustments and the latter from using our density model, which we view as the superior approach) at Final Determinations. This correction in Ofgem's approach would materially reduce the risk of totex underperformance by providing further allowances for factors which cause us to incur increased costs, but which are out of our control. For further information on this see our response to GDQ36.

- Our London network, faces disproportionately higher streetworks costs as a result of significantly more costly and restrictive permits and permitting conditions. Higher cost permits drive incremental unit cost increases while more restrictive permitting conditions decrease productivity leading to further upward cost pressure to deliver identical work in London compared to elsewhere in Great Britain. Due to the dense working environment in London, we are also required to comply with many more parking bay suspensions and we also need to comply with more costly and onerous traffic management requirements. Therefore, Ofgem's errors made in its Draft Determination in respect of setting Streetworks cost allowances have disproportionately larger impacts on operating in London than other geographies. For further information on our views on Streetworks cost allowances see our response to GDQ41.

Additionally, London faces disproportionate downside risk due to the approach taken to calibrate ODIs and the specific conditions under which GSOP must be paid – both of which particularly penalise operation of the London network:

- In respect of Ofgem's new 7 and 28 day repair standards – these are significantly more challenging to achieve for our London network, relative to other networks due to factors outside of control. For example, it is accepted in Ofgem's cost assessment via it's urbanity adjustments (and our Nature of Streets proposal) that underground working is less productive and takes

more time to complete in London than elsewhere. As a result it is more likely that equivalent repair jobs will take longer to complete in London meaning there is a much higher likelihood that standards will not be achieved leading to a disproportionately large negative skew on potential returns than for other non-London networks.

- There is also a similar issue in respect of Ofgem's Draft Determination proposal to set a common target for non-MOB unplanned interruptions, as explained in more detail in our response to GDQ17. Specifically, in our London network, we have a large number of complex non-MOB buildings which skew our annual average restoration times. The characteristics of these buildings, and complexity of supply restoration activities, have far more in common with MOBs than standard non-MOBs (for example single occupancy terraced, semi-detached, detached properties), which themselves have longer restoration times. As a result this means setting a common target amongst networks will mean London is more likely to not meet this than other networks for reasons outside of our control – further increasing the disproportionate downward skew we face in potential returns.

- GSOP 1 payments must be paid to customers as compensation for unplanned interruptions, with the payments required increasing depending on duration of the interruption. In London we face increased exposure to longer duration interruptions for reasons outside of our control compared to other networks. In particular, the high proportion of Multi Occupancy Buildings (MOBs) present. The average duration of unplanned interruptions for MOBs is substantially longer than that of non-MOBs meaning greater levels of compensation are payable to customers living in MOBs than compared to other property types. As a result, with London containing more MOBs, we are always expected to incur significantly greater GSOP 1 payments than other networks. Therefore, given all GSOP payments are shareholder funded, we are also expected to see larger downside RORE risk compared to other networks – which is not recognised in any way in the RIIO-GD3 framework.

EI's analysis shows that the control is not a fair bet to equity investors and there is a significant material downward skew in the aggregate price control, largely driven by errors in Ofgem's approach and execution of its cost assessment. For Final Determination, Ofgem should accept our proposed remedies to errors made in respect of cost assessment (detailed across our responses to OVQ19 and GDQs 32 and 36-46) to address this skew and justify continuing to utilise a midpoint estimate for the cost of equity. Otherwise the remaining negative skew would necessitate Ofgem in needing to 'aim up' on the cost of equity.

As noted in our Key Messages section at the front of this document, however, it is clear that even if it was legitimate to utilise a midpoint estimate for the cost of equity, this midpoint has materially increased from when business plans were submitted.

Debt Financeability

FQ18 Do you agree with our approach to assessing financeability?

We disagree with Ofgem's approach to assessing financeability for three key reasons:

1. **Narrow Focus on Rating Agency Metrics**
   Ofgem's financeability assessment relies predominantly on one credit rating agency metric, which is inconsistent with the newly introduced financial resilience measures requiring companies to maintain **at least two investment-grade credit ratings**. Whilst we disagree with the requirement to mandate that licencees should maintain more than one investment grade rating, a broader and more balanced assessment framework is needed to reflect the full spectrum of financial resilience expectations.
2. **Outdated Reflection of Sector Risk**
   Since the publication of the draft determinations, credit rating agencies have updated their views on the gas distribution sector[18], highlighting an **increased risk profile and recognising that gas networks no longer sit at the lower end of the utility risk spectrum, and differentiating the gas and electricity sectors.** As a result, both Moody's and S&P plan to tighten credit metrics for equivalent ratings. While the higher revenues from the change to a semi-nominal WACC from RIIO-GD3 supports credit ratings to a point, this reduces over time so Ofgem's assessment needs to firstly include the developments from the ratings agencies and secondly factor in the reducing benefit in the longer term because, as it stands, Ofgem's assessment presents an **overly optimistic and incomplete view** of sector financeability.
3. **Insufficient Long-Term Financeability Analysis**
   The longer-term financeability implications of policies such as accelerated depreciation require **deeper and more robust analysis**. These changes fundamentally alter the regulatory model, which has historically been based on the assumption that assets are held in perpetuity. A comprehensive and forward-looking financeability assessment should be a **prerequisite** to implementing such structural changes. The long-term analysis presented in the draft determinations is overly simplistic and does not adequately address these concerns. We expand on this point further in our response to FQ20.

In the DD, the financeability assessment indicated an A2 rating under both current thresholds and a modelled scenario reflecting estimated rating agency thresholds, but we do not believe an A2 rating would be achieved under the revised thresholds published by the credit rating agencies.

In summary, Ofgem's current approach lacks the necessary depth and breadth and does not adequately respond to sector developments. **We urge Ofgem to revisit its methodology in the final determinations to ensure that financeability assessments are both realistic and aligned with the evolving regulatory and financial landscape.**

FQ19 Do you agree with our proposal to adjust bucket 2 capitalisation rates from natural rates to 85% for all ET licensees to support financeability? Are there alternative measures that stakeholders consider more appropriate?

We do not have a view on capitalisation rates for the electricity transmission sector.

[18] Moody's Ratings update on UK Gas Networks – "Broader policy uncertainty on energy transition increases business risk" dated 29 July 2025 and S&P Global Ratings "Four U.K. Gas Distribution Networks Ratings Affirmed Following Regulatory Draft Determinations; Outlooks Stable" dated 29 July 2025

FQ20 Do stakeholders have views or evidence on long-term financeability considerations, including the appropriateness of the proposed asset lives?

We welcome Ofgem's inclusion of long-run modelling in its financeability assessment. In our business plan, we conducted a comprehensive financeability analysis with support from KPMG, which incorporated long-term considerations aligned with the evolving regulatory landscape.

Ofgem's own modelling[19] indicates that the Fitch PMICR metric approaches the threshold required to maintain the minimum credit rating in 2031 - even before any adjustments to rating agency thresholds. Moody's and S&P[20] have already published revised sector outlooks following the publication of the DD which included tighter thresholds for the same credit ratings from RIIO-3 so it would be reasonable to assume Fitch will do something similar. It is essential that any long-term financeability modelling takes this relevant information into account and is updated to reflect these tighter thresholds when reperformed at Final Determination (FD) and any adjustments made to ensure networks' long-term financeability.

However, we note that Ofgem's long-term modelling does not fully account for the future affordability of customer bills - a risk that accelerated depreciation alone does not resolve. The combined impact of the Totex profile, accelerated depreciation, and an accelerating rate of customer loss in later periods results in materially higher bills compared to the end of RIIO-GD2. This raises concerns about the feasibility of such bill levels, particularly for vulnerable customers. This is an issue that Ofgem must properly consider in line with its principle objective of protecting existing and future customers.

If future bill levels cannot be assumed to be economically feasible, then financeability and investability in later periods remain uncertain. Investors may perceive heightened risk around full RAV recovery in such scenarios, absent alternative mechanisms to underwrite recovery. This uncertainty already affects debt investor appetite which Ofgem have already recognised in the DD and but the uncertainty could hinder our ability to retain and attract equity capital - both of which are critical to maintaining a safe and reliable network.

Under the current RAV-based framework, equity risk is implicitly proportional to RAV, as returns are directly linked to it. However, as Totex/RAV increases - driven by the relatively fixed nature of Totex and accelerated depreciation - the operational risk borne by equity increases relative to the quantum of equity invested. Simultaneously, the declining RAV reduces the allowed equity return through revenue.

While accelerated depreciation in RIIO-GD3 aims to mitigate asset stranding and reduce future bill risks, Ofgem's own modelling shows that bills still reach unsustainable levels in several scenarios. Accelerated depreciation alone does not enable sustainable recovery of RAV and ongoing costs over the long term, especially as network charges are spread across a shrinking customer base. Moreover, the declining RAV balance exacerbates the issues outlined above.

We urge Ofgem to undertake a more thorough long-term financeability assessment, that takes into account concerns over the affordability of future customer bills.

[19] Ofgem RIIO-3 DD Finance Annex figure 97

[20] Moody's Ratings update on UK Gas Networks – "Broader policy uncertainty on energy transition increases business risk" dated 29 July 2025 and S&P Global Ratings "Four U.K. Gas Distribution Networks Ratings Affirmed Following Regulatory Draft Determinations; Outlooks Stable" dated 29 July 2025

Financial resilience

FQ21. Do you agree with our proposal to implement the Financial Resilience measures as laid out in our SSMD and the proposed methodologies set out above?

We continue to believe the existing financial resilience protections have worked well in the past for the energy sector and ensure an efficient level of financial resilience, so we do not feel any strengthening is required. There is a high hurdle for introducing new regulation to avoid introducing distortions, additional costs and creating other unintended consequences. We are strongly of the view that imposing lock-up provisions or dividend controls would not benefit consumers.

We are very aware of the perception that financing policy has contributed to some of the resilience issues in the water sector in the UK. We acknowledge this, however, the problems seen in the water sector are not evident in energy and so there is no reason to believe that the model applied in the water sector is appropriate. Ofgem already has the tools to deploy should the currently strong financial resilience of networks not continue. There is no evidence to support or justify the need for increased financial resilience measures. Any such measures would not be proportionate or appropriately targeted.

As set out in our response to the sector specific methodology consultation (SSMC), Ofgem already has in place a very comprehensive suite of obligations and mechanisms to manage financing, financial resilience and dividend distributions. These include board level obligations, responsibilities for companies' auditors and financial resilience reporting requirements that impose additional requirements on any companies that fail to meet certain resilience criteria.

Ofgem's requirements for reporting of dividend policy and dividends distributed are extensive. In particular, the Regulatory Financial Performance Reporting (RFPR) requirements were introduced to collect accurate and consistent information to help customers and stakeholders to understand networks' performance on a comparable basis.

Our Annual report and Accounts are fully compliant with the Wates principles for large private companies Corporate Governance and we provide enhanced disclosures in our RFPR.

We do not believe mandating licensees to maintain more than one investment grade rating is required or appropriate. It is not reasonable to place an obligation on networks where many aspects to the obligation that are out of management control, e.g. a changing regulatory environment and the views of the rating agencies on those changes and any uncertainty this creates. This is particularly relevant for the gas sector as we move towards Net Zero.

We do not believe amending the dividend lock-up trigger to be the earlier of reaching BBB- with a negative watch/outlook and 80% regulatory gearing is required as linking licence provisions credit ratings could have unintended consequences as management and Ofgem are not able to control for the opinions of rating agencies which will vary over time.

It is important that any measures that Ofgem introduces do not result in additional costs to licensees and customers.

Corporation Tax

FQ22. Do you agree with the proposed position that by including robust protections within the Price Control Financial Handbook, a tax forecasting penalty is not required?

We agree with the view that it is not necessary to introduce a tax forecasting penalty within the Revenue Restriction provisions of the licenses. We consider that the proposed amendments to the Price Control Financial Handbook alongside existing protection in the licence offer sufficient and appropriate mechanisms to mitigate the risk of material unexplained variances.

FQ23. Do you agree definitions for ANDt and TDNIt should be updated to reflect the principles outlined in paragraph 7.41?

We agree that the definitions of ANDt and TDNIt should be updated. The proposed changes more accurately reflect the actual tax position of Cadent Gas Limited as submitted to HMRC, while retaining a sensible and balanced approach in areas such as the application of the Corporate Interest Restriction (CIR).

Regulatory Depreciation

FQ24 What are your views on our proposal to accelerate depreciation for new assets only in GD and is there any further evidence you would like us to consider before we reach a final decision?

We think any **decision to accelerate regulatory depreciation is premature**.

Given the uncertainty over future pathways for decarbonisation, with the government yet to conclude on their position on heat policy (including the extent to which gas network assets will be repurposed) and the significant time that the UK will continue to be reliant on the gas networks, Ofgem do not need to make any change to the RAV depreciation policy at this time.

While option 4 (the DD proposal) represents the most cautious of the four approaches considered by Ofgem, it nonetheless carries financeability implications by depreciating assets to a fixed 2050 date and increases bills in RIIO-3 by c.£10 per annum. This bill impact increases significantly into RIIO-4 and RIIO-5 due to the compounding impacts of accelerated depreciation. The impact of this should be considered in light of customer affordability and RAV stranding.

While accelerated depreciation in RIIO-GD3 aims to mitigate asset stranding and reduce future bill risks, Ofgem's own modelling shows that bills still reach unsustainable levels in several scenarios. Accelerated depreciation alone does not enable sustainable recovery of RAV and ongoing costs over the long term, especially as network charges are spread across a shrinking customer base.

Depreciating new additions to nil by 2050, i.e. leaving a projected real RAV balance of less than 10% of the current balance by 2050, is inconsistent with statements elsewhere in the DD that there is an expectation that gas network assets will be required well beyond 2050. There is a manifest inconsistency if Ofgem were to increase bills to support accelerated depreciation whilst simultaneously disallowing some proposed investment due to affordability concerns.

The DD proposals are also inconsistent with the government's "Midstream gas system: update to the market" published in June 2025, which reiterated the importance of gas and its role beyond 2050.

> *"gas will have a crucial part to play in supporting our energy transition. Gas will continue to heat many of our homes and fuel hard-to-decarbonise industry for years ahead, and gas will retain a role post-2050, using carbon-neutral gas from green or offset sources. It will remain important for electricity security, and Great Britain will continue to maintain an expected 35 GW of unabated gas-fired reserve generation capacity as a key part of our Clean Power 2030 Action Plan, as gas moves into a reserve role. Our natural gas infrastructure will also continue to be a valuable asset in the future, with biomethane, carbon capture, usage and storage (CCUS) and hydrogen all emerging as potential components of a more sustainable, longer-term future for the gas network."*[21]

Ofgem itself says in its DD that *"any decisions we take for the RIIO-3 period and beyond must be able to adapt to the outcomes of this future of gas policy review, in line with our statutory duties".*[22]

The DD does not seek to assess the long-term implications of this change in policy. In particular, as RAV declines more sharply than network retention, a policy to accelerate depreciation will create unnecessary risk exposure to equity investors. This risk requires compensation through higher equity return. Accelerated depreciation alone does not mitigate the risk of asset stranding, as evidenced by Ofgem's own customer bill analysis showing significantly higher bills beyond 2040.

By introducing this policy, Ofgem have fundamentally changed the regulatory model which investors relied upon – accelerated depreciation creates different risks; investors face the prospect of no capital

[21] Midstream gas system: update to the market published in June 2025
[22] Ofgem RIIO-3 DD Finance Annex paragraph 8.32

growth and returns falling over time (despite retaining the risk of operating a network which will not reduce in size in proportion to the RAV, or reduction in customer numbers).

The policy decision is also inconsistent with other decisions within the price control, for example the notional dividend policy, and funding decisions around disconnections. Based on draft determination totex projections real RAV decreases over RIIO-3, and a 3% notional dividend policy is insufficient to return equity capital and maintain gearing at the notional 60% as calibrated and set by Ofgem. A special dividend is only allowed when gearing reduces below 55%. Insufficient return on and return of capital for equity investors will ultimately result in trapped equity which again results in increasing costs to consumers as discussed further in FQ14.

This further increases the risk, as the duration that equity is held in the notional company is lengthened, which creates a risk that this equity is stranded in future price controls.

FQ25 Do you agree with our proposal to maintain the existing depreciation policy for gas transmission assets?

Consistent with our response to FQ24, we do not support Ofgem's proposal to change the asset lives within the gas sector at this time. Any decision to accelerate depreciation should be deferred until the conclusion of the government's wider review into the future of gas infrastructure and its role in the UK's energy transition.

We do not see a compelling rationale for why gas transmission assets are considered more likely to be repurposed than gas distribution assets, given that Local Transmission System (LTS) infrastructure serves a similar function to the National Transmission System (NTS). Moreover, regional development of hydrogen production and industrial demand is expected to be just as significant as national-level initiatives.

FQ26 Do you agree with our proposal to maintain the existing depreciation policy for electricity transmission assets?

We do not have a view on the depreciation policy for electricity transmission.

Return Adjustment Mechanism

FQ27 Do you agree with our proposals for the RAM thresholds and adjustment rates?

We support the use of a Return Adjustment Mechanism (RAM) and the use of primary and secondary thresholds, and believe they have a role to play in enhancing customer confidence in returns earned by utilities whilst ensuring an appropriate backstop to downside risk (as we have seen the consequences of not having these in the water sector).

As stated in our Sector Specific Methodology Consultation (SSMC) response the RAM should be set as part of the holistic risk/reward incentive framework for RIIO-3 including the cost of capital, Business Plan Incentive (BPI), Totex Incentive Mechanism (TIM) and Financial Output Delivery Incentives (ODI-F). As such, the RAM thresholds and rates should be kept under review and set based on what is needed from network companies as well as the overall risks and opportunities they face within the control period.

The RORE range presented by Ofgem in the Draft Determinations shows a plausible range of 4.00% to 7.75% against the base cost of equity of 6.04% (a range of +1.75% and -2.04%). The analysis assumes that all the outperformance opportunities can be maximised at the same time and all the underperformance risks can occur together at the same time. This is an unlikely assumption (as we show in our response to FQ17). Even with this assumption however, the proposed RAMS primary and secondary thresholds are a considerable distance from the extremes of this presented RORE range (being proposed to be set at +/- 3% for the primary threshold and +/-4% for the secondary threshold). We think Ofgem could consider moving the thresholds to a lower level (as we discussed in our SSMC response) whilst still meeting the intent of the thresholds being breached only in exceptional circumstances.

FQ28 Do you agree with our proposal to include programmes such as ASTI within RAMs?

As set out in our SSMC response, large strategic programmes of work, such as those delivered under the Accelerated Strategic Transmission Investment (ASTI) regime, should be excluded from a 'Business As Usual' Return Adjustment Mechanism (RAM). These large value strategic programmes of work could have a disproportionate impact on the RAM and should include their own mechanisms to protect customers and companies from material deviations from expected spend.

Indexation of Regulatory Asset Value

FQ29 Do you agree with our proposals for RAV Indexation?

On the basis that Ofgem appropriately addresses the current RIIO-2 closing balance issues as set out in their draft determination, our view is that the change to semi-nominal WACC is acceptable on the basis that the notional company maintains some 30% linked debt within its portfolio to manage inflation risks and financeability.

However, the change from full to partial RAV indexation does change the investment proposition in which investors have invested. In a similar way to the introduction of the accelerated depreciation, this creates the risk of potential unintended consequences in future periods which has not been fully assessed.

Other Finance Issues

FQ30 Is there any additional evidence we should consider to improve our setting of regulatory capitalisation rates?

We agree with Ofgem's decision in applying natural capitalisation rates i.e. 100% capitalisation rate on repex and capex, consistent with our business plan proposal.

FQ31 Do you agree with the approach to maintain the RIIO-2 treatment for disposal of assets?

We agree with the proposal to retain the RIIO-2 approach to asset disposals for RIIO-3, as we do not anticipate any significant disposals during the period. However, we believe that the treatment of disposals should be considered within a broader review by Ofgem. This review should encompass related areas such as asset repurposing, disconnections, and decommissioning, to ensure a more holistic and future-proof regulatory framework. We have also recently separately responded to *Ofgem's proposed asset valuation methodology for repurposing of natural gas assets consultation* and Ofgem's call for input on *Exercising consumer choice: a review of the gas disconnections framework.* We welcome further engagement on these complex topics.

FQ32 Do you agree with the proposal for the ex ante base revenue definition we will use to calculate the re-opener materiality thresholds?

We support the Draft Determination proposal for setting re-opener materiality thresholds. We agree that the influence of uncertainty mechanisms should be excluded when setting the materiality thresholds. We support the greater certainty that this approach provides networks in managing the uncertain activities and costs that are captured within the scope of re-opener mechanisms.

FQ33 Do you agree with the proposal for how we will set ODI caps and collars at final determinations that are fixed for the duration of RIIO-3?

We support the Draft Determination proposal for setting ODI Caps and collars. Importantly, in contrast to FQ32, UM's should be included in the definition of Totex, as this provides a more reflective incentive package in relation to the whole price control settlement. Therefore, we agree with the assessment within the Draft Determinations that the use of the full Totex allowance to set incentives is correct, as these incentives are intended to reward (or penalise) companies' actions across the whole of the price control period.

FQ34 Do you agree with the proposal to move to using nominal WACC as the single uniform TVOM?

Our views have not changed since RIIO-2 or since our response to this in the sector specific methodology consultation (SSMC), where we submitted paper provided by First Economics[23] on this.

First Economics took an independent look at the reasons why regulators use either (a) bank rate plus a margin; or (b) cost of capital as an interest/discount rate in price control calculations; and; the criteria that Ofgem should use to decide which of these metrics to apply. The key point from Ofgem that we disagree with is that the underlying risk of all prior year adjustments is similar and therefore there is no reason to apply different rates.

FQ35 Do you agree with the proposed base revenue forecasting penalty mechanism?

We do not support the introduction of a revenue forecasting penalty mechanism as no robust evidence has been presented of how this will help consumers. The proposed mechanism would create additional risk for networks beyond our control. This raises the potential cost of capital for no benefit to consumers.

The DDs do not present any evidence that Gas Distribution Networks (GDNs) are systematically incorrectly forecasting revenues. Ofgem's own analysis of RIIO-2 performance indicates that there are only a few instances where GDNs approached penalty thresholds and in those instances these outcomes were primarily driven by external and uncontrollable factors, rather than shortcomings in company-specific forecasting. For example, natural gas prices have exhibited extreme volatility throughout the RIIO-2 period, largely influenced by geopolitical events such as the conflicts in Ukraine and the Middle East. Additionally, fluctuations in Exit Capacity unit rates, stemming from the charging year misalignment dictated by Ofgem, further distorted revenue forecasts. As mentioned, these are variables over which network companies have no influence, and it is therefore unreasonable to penalise them for outcomes beyond their control.

In addition, given that there is currently no proposed cap on the forecasting penalty, and considering the potential for significant, uncontrollable revenue fluctuations due to geopolitical events, we believe the proposal is unreasonable in its current form.

Likewise, there are specific uncertainties within RIIO-GD3 that could materially affect forecasting accuracy, making a penalty mechanism inappropriate at this stage:

- **Uncertainty around the implementation of the NTS Exit Capacity Charges modification:** The timing of this change remains unclear, and the Draft Determination does not currently account for the potential increase in costs. This introduces a forecasting risk that is outside the control of GDNs.

- **Introduction of the Debt Relief Scheme into pass-through costs**: From April 2027, GDNs will be required to begin collecting revenue for this scheme. Depending on the timing and implementation details, there may be a mismatch between forecasted and actual revenues. This type of uncertainty highlights the need for flexibility, which we understand the waiver process is intended to address.

- **Update to Business rates**: Rateable values will be updated and could lead to significant increases in business rate costs. Again, this introduces a forecasting risk that is outside the control of GDNs.

[23] FA10, First Economics RIIO-2 prior year adjustments as submitted in our response to the SSMC

We note that Ofgem has referenced a waiver process, however the details provided on this process are insufficient. Network companies require greater clarity on the criteria, governance, and practical application of this process to assess its viability and implications. We also note that this process would add further regulatory burden to both networks and Ofgem and we do not believe that this is best practice for this mechanism to allow for discretion. There is also a concerning lack of consistency in the proposed implementation timeline for the penalty mechanism. The Business Plan Financial Model (BPFM) documentation indicates that the penalty would take effect from Year 3, yet this is not reflected in the draft licence, creating ambiguity around the intended start date.

If Ofgem proceed with the revenue forecasting penalty this would further add to the downward skew on RORE as explained in FQ 17.

In summary, we urge Ofgem to reconsider the introduction of this penalty mechanism. It risks unfairly penalising network companies for factors outside their control, offers limited benefit to consumers, and introduces unnecessary regulatory uncertainty.

FQ36 Do you agree that the thresholds have been set appropriately?

Whilst we acknowledge and support the increase in the revenue forecasting penalty threshold from 6% to 8%, we continue to disagree with the introduction of the penalty mechanism and a threshold in principle, as outlined in our response to FQ35. The inclusion of a threshold implicitly acknowledges the presence of external drivers of forecasting error and we believe that a more effective approach would be to address the issue at source by excluding specific line items that are subject to exogenous impacts. Setting an appropriate threshold is inherently challenging and is difficult to capture external volatility in advance. Furthermore, this deadband approach may lead to unintended outcomes, for example, situations where external factors offset controllable forecasting errors, resulting in no penalty applied. This undermines the intent of the mechanism, which is to incentivise accurate forecasting, and raises questions about its overall effectiveness.

Consequently, we disagree with the mechanism as the fundamental issue remains: the mechanism does not adequately distinguish between forecasting variances caused by external, uncontrollable factors and those within the remit of company management.

Notwithstanding our opposition to the penalty mechanism, if Ofgem intends to proceed, it is imperative that the design of the mechanism includes explicit exclusions for forecasting differences that are outside the control of network companies. This would ensure that the mechanism targets genuine forecasting inefficiencies rather than punishing companies for systemic or market-wide disruptions.

We urge Ofgem to provide greater clarity on how such exclusions will be identified, assessed, and applied, and to ensure that the mechanism is both fair and proportionate in its implementation.