Dividends in RIIO-GD/GT3

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Prepared for Future Energy Networks (FEN)

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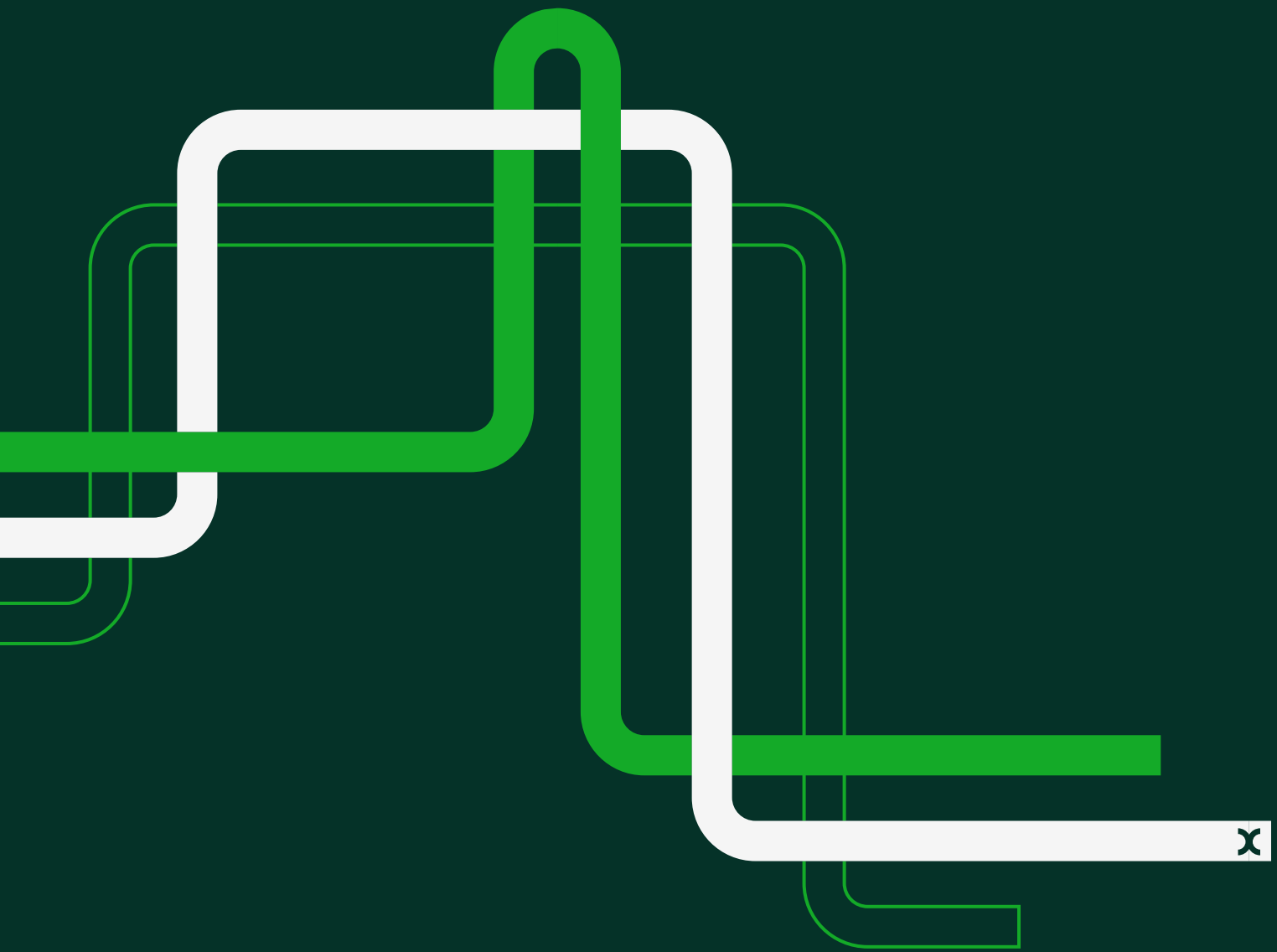

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Executive summary

In this report we critically assess, on behalf of members of Future Energy Networks (FEN), Ofgem's RIIO-3 draft determinations (DD) proposal to maintain a 3% dividend yield assumption for gas networks despite evolving economic and regulatory conditions.[1] We also assess Ofgem's proposal for a possible special dividend allowance.

We observe that, in the context of reduced investment opportunities as a result of the uncertain outlook for the future of gas, and therefore the expectation of lower or negative regulated asset value (RAV) growth in RIIO-3 and beyond, finance theory suggests that the dividend yield needs to be close to, or above, the allowed cost of equity. This would operationalise the return *on* equity capital to shareholders, as well as the return *of* equity capital, to the extent that the capital is not used for new business opportunities.[2]

For the RIIO-GD3 context, there is also new upward pressure on the level of dividend distributions due to the regulatory decision as regards accelerated depreciation, which is meant to speed up the process of returning the capital to shareholders, to reduce the asset stranding risk.[3] Such risk mitigation would tend to not be effective without operationalising the return *of* capital via dividend distributions.

Overall, the dividend yield assumption for GDNs should be revised upwards. This adjustment is important to ensure the investability of the gas sector.

We further 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. Furthermore, if

[1] Throughout this report we refer to various concepts of dividend distribution. In general, dividend yield is assessed as the level of dividends relative to a measure of the value of equity (e.g. market capitalisation, or regulatory value of equity) while dividend payout is a measure of dividends relative to net income.
[2] In the general context of allowed revenue building blocks in a RAB–WACC price control regime, return *on* capital refers to the WACC return on the RAV, and return *of* capital refers to the building block that relates to depreciation (i.e. the value of the RAV returned over time, in line with the asset life assumption, capitalisation policy, depreciation profile policy, etc.). In this report, we use these terms to describe dividend distributions to shareholders, underpinned by the corresponding building blocks of allowed revenue.
[3] While accelerated depreciation relates specifically to the return of capital, we note that Ofgem's movement from a real WACC basis to a semi-nominal WACC basis would also tend to increase the cash available for distribution in RIIO-GD/GT3, relative to a real cost allowance in RIIO-GD/GT2, for the notional company.

the gearing threshold is below the notional gearing rate, this may result in trapped cash and hence inefficient cash management.[4] This could reduce shareholders' returns (i.e. the internal rate of return on equity would tend to decline below the allowed return on equity) and worsen business investability.

Our arguments for a higher dividend yield are also supported by an empirical analysis of European gas and electricity network data from 2018 to 2024. The average dividend yield of European gas networks has risen from 5.4% in 2018 to 8.5% in 2024, consistently exceeding the average dividend yield of European electricity networks, which has remained broadly stable over the same period (at between 4.1% and 4.8%). These are also consistently and significantly above Ofgem's notional 3% dividend yield assumption, which highlights that a 3% dividend yield assumption for gas networks is insufficient.

[4] We define 'trapped' cash as cash that is assumed to be unavailable for distribution and not used for funding company expenditure.

1 Introduction

1.1 In our previous report for the GB gas distribution networks (GDNs)—i.e. Cadent, Northern Gas Networks (NGN), Scotia Gas Networks (SGN) and Wales & West Utilities (WWU)—we examined how the dividends would be under upward pressure in RIIO-3 and beyond, as a result of scarcer investment opportunities for gas networks and the introduction of accelerated depreciation (as suggested in Ofgem's sector-specific methodology decision, SSMD).[5] We also reviewed empirical evidence suggesting that the trends in dividend yield and dividend payout ratios were diverging between European gas and electricity networks, with the dividend yields of European gas networks increasing in recent years.

1.2 These conceptual and empirical observations supported a recommendation that Ofgem ensures consistency between the different elements of the regulatory package, the economic context, and shareholders' expectations by allowing for increases in required dividend yields in its financeability and investability assessments for RIIO-GD3.

1.3 In its RIIO-3 draft determinations (DD), Ofgem indicates that, even though the gearing of the gas networks will likely be under downward pressure during RIIO-3, it intends to maintain a dividend yield assumption of 3%.[6] The regulator considers that, with options still under consideration, it would be premature to change the dividend yield assumption.[7] Instead, Ofgem proposes to allow for the payment of special dividends should gearing fall below a certain threshold.[8]

1.4 Following publication of the RIIO-3 DD, members of FEN have asked us to assess Ofgem's proposed special dividend mechanism, and in particular to discuss its adequacy in light of the evolutions affecting the operations of gas networks in RIIO-3 and beyond.

[5] Oxera (2024), 'Gas distribution networks' dividends in RIIO-GD3. Prepared for GB gas distribution networks', 3 December.
[6] Ofgem (2025), 'RIIO-3 Draft Determinations – Finance Annex', 1 July, para. 3.110.
[7] Ibid.
[8] Ibid.

1.5 They have also asked us to update the empirical evidence contained in our previous report.[9]

1.6 The remainder of this report is structured as follows.

- Section 2 discusses the rationale for increasing the dividend yield assumption in RIIO-3, and why the special dividend mechanism proposed by Ofgem is not adequate to efficiently manage the excess cash that GDNs are expected to generate over RIIO-3 and beyond.
- Section 3 provides an update of the empirical analysis of the evolution of dividend yields and payout ratios of publicly listed European gas and electricity networks presented in our previous report, in which we assessed whether a diverging trend exists between the sectors. We place this into context in relation to the changes in their fixed assets growth in recent years, to assess the existence of a relationship between dividend yields and payout ratios on the one hand, and fixed assets growth on the other.
- Section 4 concludes.

[9] Oxera (2024), 'Gas distribution networks' dividends in RIIO-GD3. Prepared for GB gas distribution networks', 3 December, section 4.

2 Theoretical discussion of the dividend yield assumption for RIIO-GD3

2.1 In our previous report, we explained that, considering the economic context of the gas sector over RIIO-3 and subsequent price controls, as well as the regulatory evolutions considered by Ofgem (including the acceleration of the depreciation of gas distribution assets to enable the faster return of invested capital), Ofgem should consider increasing the gas network dividend yield assumption used in its financial modelling. This is because lower growth in the RAV of gas networks, as well as the use of accelerated depreciation, will put the dividend yield of gas networks under upward pressure in the future—as dividend payments will increasingly need to cover not only the return *on* capital, but also the return *of* capital to shareholders.[10]

2.2 Note that we refer to various concepts of dividend payments or distribution, throughout this report. In general, dividend yield is assessed as the level of dividends relative to a measure of the value of equity (e.g. market capitalisation, or regulatory value of equity) while dividend payout is a measure of dividends relative to net income.

2.3 In its DD, Ofgem acknowledged that '[d]uring RIIO-3 there may be downward pressure on gearing in the GD sector', but that 'with options still under consideration it would be premature to change the allowed notional company dividend yield at this stage'.[11] As a result, Ofgem's DD assumption is to maintain the 3% dividend yield assumption used in RIIO-2,[12] as proposed in the SSMD.[13]

2.4 Instead of increasing the notional dividend yield assumption, Ofgem raised a proposal to allow the payment of special dividends if gearing were 'to reach a certain level' (i.e. a gearing

[10] In the general context of allowed revenue building blocks in a RAB–WACC price control regime, return *on* capital refers to the WACC return on the RAV, and return *of* capital refers to the building block that relates to depreciation (i.e. the value of the RAV returned over time, in line with the asset life assumption, capitalisation policy, depreciation profile policy, etc.). In this report, we use these terms to describe dividend distributions to shareholders, underpinned by the corresponding building blocks of allowed revenue.
[11] Ofgem (2025), 'RIIO-3 Draft Determinations – Finance Annex', 1 July, para. 3.110.
[12] Ibid.
[13] Ofgem (2024), 'RIIO-3 Sector Specific Methodology Decision – Finance Annex', 18 July, para. 3.282.

trigger mechanism).[14] However, that proposal is not articulated further in the DD and, specifically, Ofgem does not provide any detailed explanation as to how this proposal would be implemented in practice.

2.5 Having said that, we understand from Ofgem's modelling that Ofgem has in mind a gearing threshold set below the notional gearing—it is modelled such that the special dividend distributions would be triggered when gearing falls below 55%, against a notional gearing of 60%—i.e. with a 5% spread.[15]

2.6 Based on our assessment of the financial pressures facing gas networks over RIIO-3 and beyond, we consider that Ofgem's proposal to combine a 3% base dividend yield with a special dividend mechanism involving a gearing trigger mechanism is inadequate, as it fails to properly account for the structural changes affecting the gas sector and does not reflect efficient cash management.

2.7 Instead, we maintain the view that it would be appropriate for Ofgem to increase the notional dividend yield assumption from 3% to a level that is close to or above the allowed return on equity. This level of dividend yield would allow for the payment of dividends to cover both the return *on* capital (corresponding to the return on equity allowance) and the return *of* capital (corresponding to the depreciation). The payment could be operationalised through higher base dividend yields, or through the use of a specific recurring dividend assumption expressed as a return of capital, as proposed by Ofgem in the business plan financial model (BPFM) guidance,[16] rather than through a special dividend payment.

2.8 This would reflect the structural changes in the sector, in particular the expectation of lower—potentially negative—RAV growth, as well as regulatory evolution such as the acceleration of depreciation for certain assets, which places upward pressure on dividend distributions. Adjusting the notional dividend yield would ensure that the financial framework

[14] Ofgem (2025), 'RIIO-3 Draft Determinations – Finance Annex', 1 July, para. 3.110.
[15] Ofgem (2025), RIIO GD3 BPFM_Draft Determinations_Jun25, 'Finance&Tax' tab, rows 99, 126 and 127, columns AU to AY.
[16] Ofgem (2024), 'RIIO-GD/T3 BPFM Guidance v7', 30 September, para. 1.14.

remains consistent with the evolving risk profile of gas networks and supports continued investor confidence.

2.9 In this section, we start by summarising the findings of our previous report, and reestablish the rationale for increasing the dividend yield assumption (section 2.1). Then, we discuss Ofgem's proposal for a special dividend allowance (section 2.2).

2.1 Rationale for increasing the dividend yield assumption

2.10 In our previous report, we discussed the rationale for increasing the dividend yield assumption used in Ofgem's financial modelling, considering that it would reflect the upward pressure on the dividend yield of gas networks over RIIO-3 and beyond. We explained that this upward pressure on gas networks' dividend yields results from:

- lower (or even negative) expected RAV growth as a result of limited growth opportunities that gas networks may face in future periods;
- further accelerated depreciation of the gas networks' RAV, which, once operationalised through higher dividend payments, allows for the return *of* equity capital (i.e. the repayment of invested capital) to shareholders.

2.11 We consider that Ofgem has not sufficiently engaged with these concerns. While Ofgem suggests that it would be premature to change the notional dividend yield assumption, as options (that affect downward pressure on gearing) are 'still under consideration', the underlying premise remains that the 'future of gas networks is less certain with the expectation that customers move away from gas over time'.[17] Furthermore, Ofgem has confirmed its intention to further accelerate the depreciation of new assets for GD.[18] Our observation that this will put the dividend yield of gas networks under upward pressure in order to enable the return *of* capital to shareholders still holds.

2.12 In line with the arguments developed in our previous report, we observe that there are significant drivers of the upward pressure on the dividend yield of gas networks in RIIO-3 and beyond,

[17] Ofgem (2025), 'RIIO-3 Draft Determinations – Finance Annex', 1 July, para. 1.6.
[18] Ofgem (2025), 'RIIO-3 Draft Determinations – Finance Annex', 1 July, para. 3.119.

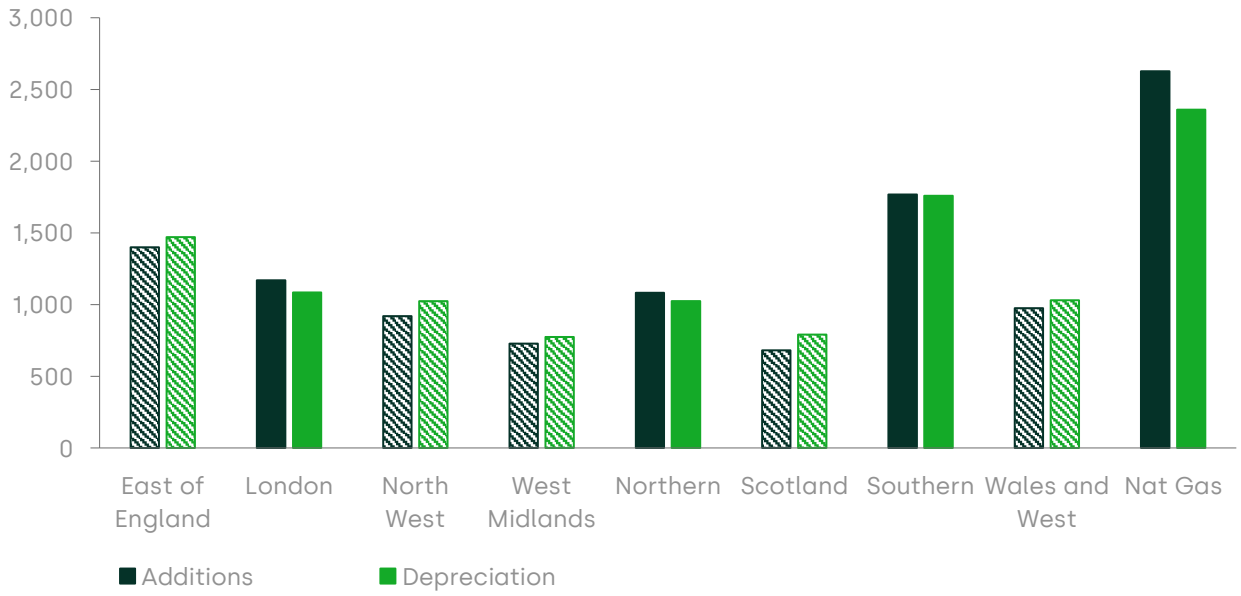
which Ofgem has given insufficient weight to in RIIO-3 DD. These are summarised below.

2.13 First, from a dividend policy perspective, cash not being used to fund profitable investment programmes (that would increase the value of the business) should be returned to shareholders, subject to financial resilience requirements being otherwise met.[19]

2.14 In that regard, we note that the outlook for the gas sector over RIIO-3 is that gas networks are still proposing significant investments in their RAV, but that these investments will not lead to significant RAV growth relative to the investment programmes implemented in the electricity transmission sector, for example. Indeed, Ofgem's projections of nominal RAV for the gas sector show that additions to the RAV (i.e. investments) over RIIO-3 will be below depreciation for five GDNs (in nominal terms).[20] For the other GDNs, additions to the RAV will be less than 10% higher than depreciation in nominal terms, and only 11% higher for National Gas.[21] This is shown in Figure 2.1 below.

[19] One objection to higher dividend payments could be that they should be balanced against financial resilience requirements. Indeed, dividend payments reduce available cash and increase gearing, and the risk might be that companies could no longer meet debt obligations and maintain adequate credit ratings if dividend payments are too high. In that regard, we consider that Ofgem's strengthened financial resilience framework—including stricter credit rating requirements, dividend lock-up triggers and AOR certificate—is designed to safeguard against excessive dividend distributions that could threaten financial stability. See Ofgem (2025), 'RIIO-3 Draft Determinations – Finance Annex', 1 July, paras 6.15–6.26.
[20] Ofgem (2025), 'RIIO-3 Draft Determinations – Finance Annex', 'Appendix 3 – Financial values for the GDNs', 1 July, pp. 171–180.
[21] Ibid.

Figure 2.1 RAV additions and depreciation allowance in RIIO-3 (£m, nominal)



Note: The solid bars indicate the networks for which CAPEX additions are above depreciation allowances.
Source: Oxera analysis based on Ofgem's BPFMs.

2.15 Given the functioning of the regulatory model, lower—or even negative—RAV growth in future price controls hinders the ability of regulated gas networks to sustain high dividend growth rates in the future. In this context, financial theory (e.g. dividend growth models) suggests that the dividend yield of gas networks should increase in RIIO-3 compared to RIIO-2.[22]

2.16 Taking this line of reasoning further, the dividend yield of regulated networks should evolve in line with expected RAV growth. Specifically, as RAV growth flattens and the expected growth rate of dividends tends to zero, the dividend yield would be expected to tend towards the allowed return on equity.

[22] For example, the Gordon Growth Model (GGM) posits that, assuming a constant dividend growth rate, the price of a stock is calculated as follows: $P_0 = {}^{D_1}/_{(k-g)}$, where P_0 is the share price in period zero, D_1 is the expected dividend per share in period 1, k is the cost of equity and g is the constant dividend per share growth rate. This formula can be rewritten as ${}^{D_1}/_{P_0} + g = k$, where ${}^{D_1}/_{P_0}$ is the expected dividend yield of the company in period 1 (see Brealey, R.A., Myers, S.C. and Allen, F. (2010), *Principles of Corporate Finance*, 10th edition, McGraw-Hill/Irwin, pp. 81–82). If high dividend growth rates cannot be sustained (i.e. if g cannot be kept high in perpetuity), the GGM suggests that, in order to maintain the equality for a given cost of equity, the dividend yield should increase.

2.17 If RAV growth eventually becomes negative (which is the case, in nominal terms, for some GDNs in RIIO-3, as discussed above), suggesting that capital should be returned to shareholders, dividend distributions would need to cover the remuneration of capital (i.e. the return *on* equity capital) as well as its return to shareholders (i.e. the return *of* equity capital). In practice, given the functioning of the regulatory model, this means that the dividend yield would tend to exceed the cost of equity allowance.

2.18 We note that the statements above hold true even before considering the impact that further accelerating the depreciation of the GDNs' RAV would have on the distribution of dividends, which we discuss below.

2.19 From a regulator's perspective, ensuring that the dividend yield assumption is consistent with the growth prospects of the sector is therefore critical to ensuring investability—i.e. the ability of the sector to attract and retain equity capital. Indeed, ensuring this consistency would demonstrate that the regulatory settlement reflects investor expectations, which are themselves informed by, among other things, the lifecycle of the sector.

2.20 Mature or declining sectors with limited growth opportunities typically distribute more cash as dividends, rather than reinvest it in the business, while growing sectors retain more earnings to fund expansion, subject to potential minimum distribution expectations from their shareholders. These principles mean that regulators should adopt flexible dividend assumptions that reflect sector-specific dynamics (subject to minimum investor expectations).

2.21 Then, with regard to accelerated depreciation, we note that such regulatory depreciation policies specifically aim to return the RAV to investors faster than under the status quo depreciation policy (i.e. increase the return *of* capital), in order to allow investors to recover invested capital faster, reducing exposure to asset-stranding risk.

2.22 To effectively reduce the exposure to asset stranding risk, it is helpful to think about accelerated depreciation policy and dividend distribution policy, within the context facing gas networks in RIIO-3. If accelerated depreciation is not accompanied by higher dividend distributions to facilitate the

actual return of capital to shareholders, Ofgem's hypothesis that such policies reduce asset stranding risk would not materialise in practice, meaning that the risk would remain unmitigated. An alternative to a higher base dividend yield assumption would be that such distributions could be operationalised by a specific additional dividend assumption (distinct from the base dividend yield assumption) that would aim to return capital to shareholders, as proposed by Ofgem in the BPFM guidance.[23] In this context, the additional dividend assumption should not be implemented as a *special dividend* distribution subject to a gearing trigger, but rather as an additional *recurring dividend* reflecting the impact of accelerated depreciation, as we explain in section 2.2 below.

2.23 Furthermore, from a cash management perspective, further accelerating depreciation increases the cash available for distribution in the short to medium term. This puts additional upward pressure on the gas networks to increase payments to shareholders, in order to avoid the additional cash generated by further accelerated depreciation being inefficiently trapped on their balance sheets and depressing their gearing ratios, potentially reducing the internal rate of return on the invested equity below the allowed return on equity.

2.24 To summarise, there are at least two sources for the upward pressure on gas network dividends:

- the low or negative RAV growth scenarios for some gas networks, which imply limited expectation of growth in the future and the implied need to distribute returns on capital in the current period—as a result, the dividend yield should tend to the allowed return on equity;
- the accelerated depreciation, which would not be as effective as a risk mitigant without it being operationalised via increased dividend distributions that would allow equity capital to be returned to investors, to reduce their exposure to the asset stranding risk.

2.25 Given these dynamics, and given that we have not seen evidence from Ofgem contradicting the logic outlined in this section, we consider that maintaining the dividend yield

[23] Ofgem (2024), 'RIIO-GD/T3 BPFM Guidance v7', 30 September, para. 1.14.

assumption of the gas sector at the 3% level used in RIIO-2 is no longer appropriate, and that the regulator should adopt a higher dividend yield assumption for RIIO-3.

2.26 Indeed, maintaining the assumption of a dividend yield that is insufficient could undermine investability across sectors by signalling to investors that expected returns may not materialise when growth prospects are limited.

2.2 Ofgem's proposal for a special dividend allowance

2.27 Notwithstanding the fact that Ofgem has not substantiated an implementation plan for its proposal to allow for the payment of special dividends if gearing were to reach a certain level, we consider that this proposal would be insufficient to ensure that the regulatory framework adequately reflects the changing economic circumstances of the gas sector in RIIO-3 and subsequent price controls.

2.28 From a distribution policy perspective, special dividends are different from regular dividends in that they are intended to be, as their name suggests, non-recurring. They are generally the result of excess cash being temporarily available for distribution, for example due to a temporary increase in operational performance, or because of a non-recurring cash inflow (e.g. following a divestment) for which there is no alternative investment opportunity. Crucially, this means that investors should not interpret special dividends as a signal for future long-term performance.[24]

2.29 As discussed in section 2.1, the evolution of the economic context and the regulatory environment of the gas sector in RIIO-3 and beyond will result in more cash being available for distribution—whether due to the acceleration of the depreciation schedule of new assets,[25] or as a result of a higher cost of equity allowance than in RIIO-2[26]—and less investment opportunities to reinvest this cash.

[24] See p. 127 of Baker, H.K., Mukherjee, T.K. and Powell, G.E. (2005), 'Distributing excess cash: the role of specially designated dividends', *Financial Services Review*, **14**, pp. 111–131.
[25] Ofgem (2025), 'RIIO-3 Draft Determinations – Overview', 1 July, p. 13.
[26] The RIIO-3 cost of equity allowance currently under consideration for gas networks is 6.04% (CPIH-real, at 60% gearing), compared with the 4.55% CAPM-implied cost of equity calculated in the RIIO-2 final determinations and adopted after the Competition and Markets Authority (CMA) considered the outperformance wedge adjustment erroneous. See Ofgem (2025), 'RIIO-3 Draft

2.30 Given the structural nature of these evolutions, it is very likely that they will have a recurring and lasting impact on the financials of the gas networks over RIIO-3, and potentially beyond. This is confirmed by Ofgem's own financial modelling, which suggests that the funds from operations generated by gas networks will constantly exceed net CAPEX cash flows over RIIO-3.[27]

2.31 Crucially, this means that the increase in cash available for distribution over RIIO-3 is not the result of a transitory, conjunctural or one-off event that would result in excess cash being temporarily available for distribution. From a distribution policy perspective, this means that it would be more adequate to distribute excess cash to shareholders through higher recurring dividend payments than through special dividends. Indeed, this would be more consistent with the structural nature of the evolutions discussed in this report.

2.32 Various academic papers have identified a link between dividend policies and excess cash.[28] These papers show that the distribution of special dividends typically indicates current excess performance rather than expected improvement in long-term performance. In other words, special dividends can be considered as a method (and as a signal) to distribute non-recurring cash flows or temporary excess cash. In contrast, the literature indicates that when companies expect a structural increase in both earnings and cash flows they are more likely to increase regular dividends rather than pay special dividends.

2.33 Given that, as discussed in section 2.1, the lack of RAV-expanding programmes and accelerated depreciation will generate excess cash over RIIO-3 and beyond (independently from the options still under consideration by Ofgem), the special dividend mechanism proposed by Ofgem is not appropriate to manage the excess cash generated by gas networks.

Determinations – Finance Annex', 1 July, table 20 and Ofgem (2021), 'RIIO-2 Final Determinations – Finance Annex (REVISED)', 3 February, table 13.

[27] Ofgem (2025), RIIO GD3 BPFM_Draft Determinations_Jun25, 'FinancialStatements' tab, rows 135 to 140 and 149 to 152, columns AU to AY. The exception is 2028 for National Gas, where CAPEX is £1.6m higher than funds from operations.

[28] See, for example, Baker, H.K., Mukherjee, T.K. and Powell, G.E. (2005), 'Distributing excess cash: the role of specially designated dividends', Financial Services Review, **14**, pp. 111–131; or Guary, W. and Harford, J. (2000), 'The cash-flow permanence and information content of dividend increases versus repurchases', *Journal of Financial Economics*, **57**:3, pp. 385–415.

2.34 Indeed, from a cash management perspective, the use of a gearing threshold mechanism for triggering special dividend payments leads, in the specific economic and regulatory context in which gas networks operate, to trapping cash on their balance sheets until the gearing threshold is met.

2.35 This is because both the economic context and the new regulatory mechanisms proposed by Ofgem put significant downward pressure on the gearing of gas networks. This pressure is likely to be permanent. In this context, a gearing threshold mechanism for the special dividend essentially translates into gas networks waiting for their gearing to reach the trigger threshold before being able to pay a special dividend, with cash building up on their balance sheets in the meantime.

2.36 Related to the observations about accelerated depreciation, we also observe that there will be an effect on cash balances for the notional company from Ofgem's approach to semi-nominal cost of debt allowances in RIIO-3.[29] While accelerated depreciation relates specifically to the return of capital, Ofgem's movement from a real cost of debt basis to a semi-nominal WACC basis would also tend to increase the cash available for distribution in RIIO-GD/GT3, relative to a real cost allowance in RIIO-GD/GT2, for the notional company.

2.37 In the context of the special dividend approach that Ofgem may take, we consider that a key question (unresolved in the current state of Ofgem's proposal) is the adequate definition of the level of the gearing threshold that would trigger such distributions.

- If the gearing threshold is set high—i.e. if the degree of deviation between the notional gearing and the gearing threshold that would trigger special dividends is low—then it is likely that special dividends would be paid often. This could be to the point that special dividends would become undistinguishable from regular dividend payments, which would make the existence of a special dividend mechanism irrelevant. As outlined above, special dividends can be considered as a means of distributing non-recurring cash

[29] Ofgem (2025), 'Consultation - RIIO-3 Draft Determinations - Finance Annex', para. 2.12.

flows or temporary excess cash. Therefore, frequent distribution of special dividends indicates a consistent generation of excess cash flows or excess cash, which cannot be considered as non-recurring.

- If the gearing threshold is set low—i.e. a high degree of deviation between the notional and threshold gearings would be required to trigger special dividends—then cash could inefficiently accumulate on the balance sheets of the regulated networks before the gearing threshold is reached, triggering the distribution of a special dividend to bring gearing back to the notional level.

2.38 In our previous report, we discussed that the two main ways in which shareholders realise returns from their investments are dividends and share price appreciation.[30] In particular, share price appreciation is achieved by reinvesting cash into the business (causing an increase in the value of the business) instead of distributing it to shareholders.

2.39 Therefore, Ofgem's proposal for a special dividend mechanism with a gearing trigger would not lead to an efficient use of cash and, consequently, an efficient dividend policy. The optimal dividend policy depends on whether it is more economically efficient for the business to distribute cash generated from its activities to shareholders or to invest this cash in profitable projects. On the one hand, if there are profitable opportunities, it can be more efficient to reinvest cash within the business rather than distribute it to shareholders. On the other hand, in the absence of profitable opportunities, it is recommended that cash be distributed to shareholders, as they may be able to make better use of it. Any gearing threshold mechanism would assume an artificial constraint on the company's dividend policy.

[30] Oxera (2024), 'Gas distribution networks' dividends in RIIO-GD3. Prepared for GB gas distribution networks', 3 December, section 2.1.

3 Empirical analysis of dividend payments by European gas and electricity networks

3.1 This section provides an update of the analysis on dividend trends across European gas and electricity networks that was included in our previous report.[31] As before, we examine two aspects: dividend yields and payout ratios, and the relationship between dividends and RAV growth. The aim is to determine whether the key trends previously identified continue to hold, or have shifted.

3.2 This update adds data from 2024 to the analysis in our previous report. The table below outlines the sample of the assessed networks, which remains the same as in the previous report.[32]

Table 3.1 Network companies sample for dividend analysis

Company	Primary sector	Primary location(s)
Gas networks		
Enagás	Gas transmission	Spain
Italgas	Gas distribution	Italy
Snam	Gas transmission	Italy
Electricity networks		
Elia	Electricity transmission	Belgium and Germany
Red Eléctrica	Electricity transmission	Spain
REN	Electricity transmission	Portugal
Terna	Electricity transmission	Italy

Note: For the purpose of this analysis, we are classifying REN as an electricity transmission network operator primarily, although we note that the company is also a gas transmission and distribution network operator. According to REN's 2024 accounts, EBITDA generated by its electricity activity are almost twice as high as that generated

[31] Oxera (2024), 'Gas distribution networks' dividends in RIIO-GD3. Prepared for GB gas distribution networks', 3 December, section 4.
[32] Ibid.

by its gas activity. See REN, 'Results Report 2024', p. 9, available at: https://www.ren.pt/media/qmkl1tjh/ren-results-report-12m24.pdf.
Source: Oxera analysis.

3.1 Dividend yields and payout ratios

3.3 We start by assessing dividend yields (in section 3.1.1) before moving on to assessing payout ratios (in section 3.1.2).[33]

3.1.1 Dividend yields

3.4 In this analysis, we define the dividend yield as a ratio of the dividend payment over market capitalisation, i.e. the market value of equity capital.

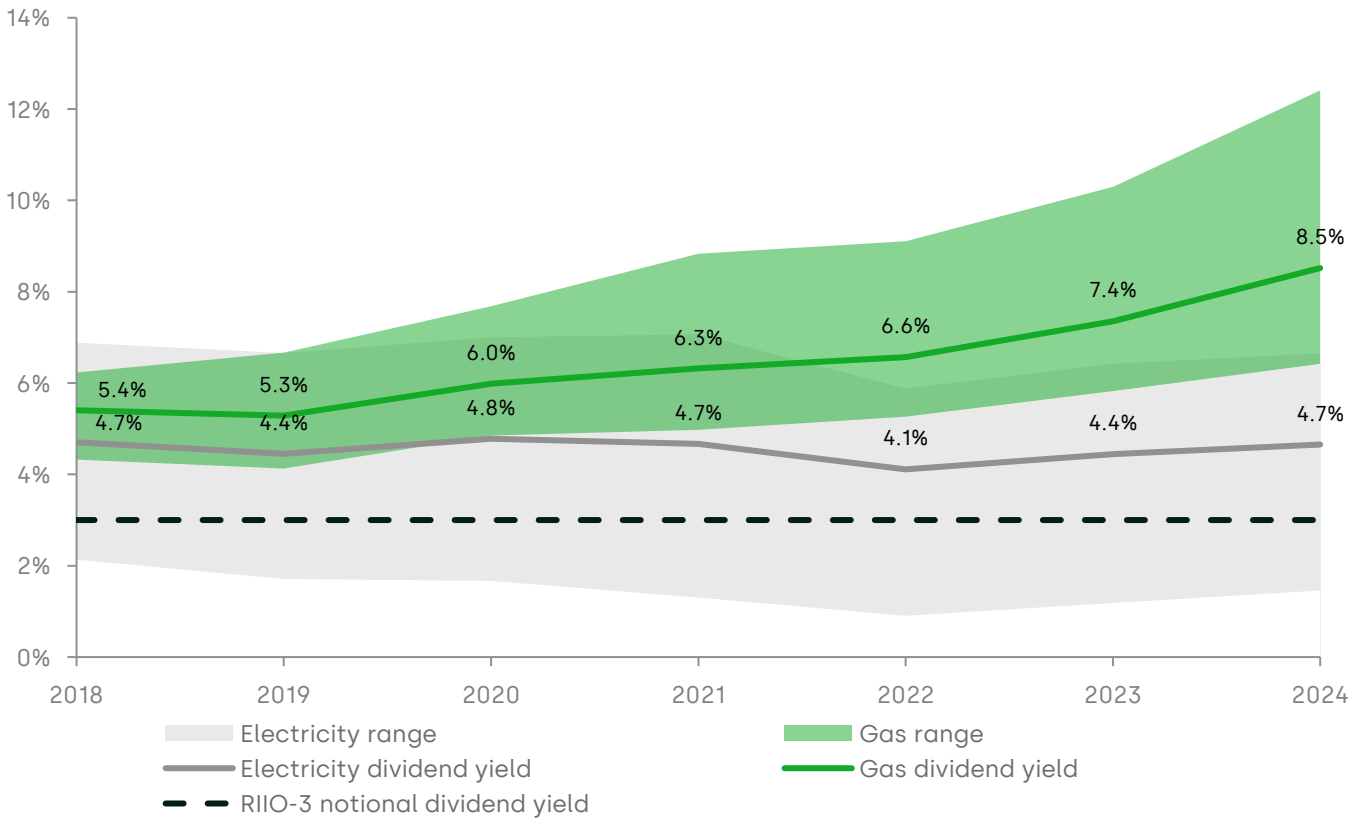
3.5 Our analysis—illustrated in Figure 3.1 below—shows that dividend yields for gas network operators ranged between **5.3% and 8.5%** over the period 2018–24, while electricity networks saw yields ranging from **4.1% to 4.8%** over the same period.

3.6 Crucially, compared to our previous analysis, the dividend yields of European gas networks have continued to increase, rising steadily from **5.3% in 2019 to 8.5% in 2024**. Meanwhile, the dividend yields of electricity networks have remained broadly stable, with only modest fluctuations around the **4.1% to 4.8%** range.

3.7 On average across the sample, the dividend yield has been consistently higher for gas than for electricity networks, and the gap has widened in recent years.

[33] In our analysis, we do not adjust the dividend yield and dividend payout metrics to account for differences in gearing between the different companies in the sample and that of the notional company. We consider that the impact of gearing on dividend metrics is uncertain (for example, firms can target specific payout ratios that do not vary with gearing, even though highly geared companies will tend to be more constrained in their ability to pay dividends).

Figure 3.1 Dividend yield of European listed gas and electricity networks



Source: Oxera analysis based on Refinitiv data.

3.8 These patterns remain aligned with the theoretical framework discussed in section 2, reinforcing the view that gas network investors are now expecting a higher dividend yield given the (future) growth prospects of the sector.

3.1.2 Payout ratios

3.9 We define the payout ratio as the share of net income distributed to shareholders in the form of dividends over a given financial year.

3.10 As shown in Figure 3.2 below, gas network companies continued to report higher average payout ratios than electricity networks from 2018–24.

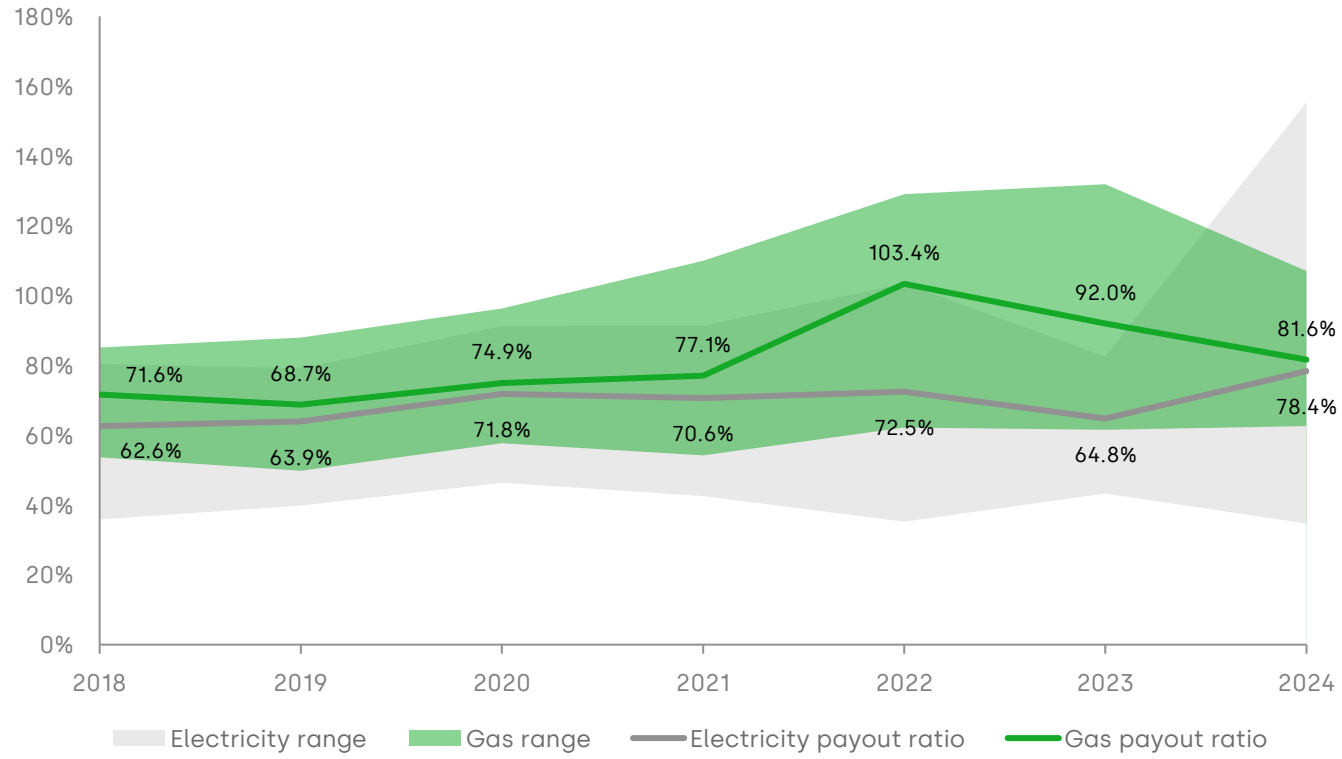
3.11 In recent years, gas networks' payout ratios have remained elevated, although have moderated slightly from their peak. The average payout ratio reached **103.4% in 2022**, declined to **92.0% in 2023**, and stood at **81.6% in 2024**. These values are still well

above the earlier range observed between 2018 and 2021 **(68.7–77.1%).**

3.12 For electricity networks, the payout ratio stood at **78.4% in 2024**, up from **64.8% in 2023**, and broadly in line with earlier years **(62.6–72.5%)**. The overall gap between the sectors narrowed slightly in 2024 but still reflects a trend of generally higher payouts among gas networks, consistent with patterns observed in dividend yields.

3.13 These results further support the hypothesis that gas networks may need to distribute a larger share of earnings as dividends compared to electricity networks—particularly when viewed in the context of recent dividend distribution patterns.

Figure 3.2 Payout ratio of European listed gas and electricity networks



Note: Enagás is the only company heavily affected by an extraordinary item (impairment losses on disposals of financial instruments in 2024). Therefore, we have excluded extraordinary items for Enagás from the net income in 2024. See Enagás (2024), '2024 Financial Statement', p. 2, available at: https://www.enagas.es/content/dam/enagas/en/files/accionistas-e-inversores/informacion-economico-financiera/cuentas-anuales-auditadas-e-informe-de-auditoria/2020/ccaa-consolidadas-2024-en.pdf (accessed 19 August 2025).
Source: Oxera analysis based on Refinitiv data.

3.2 Dividend payments in the context of asset growth

3.14 To put the dividend payment practices into context, we have added the data on the growth rates of fixed assets (as a proxy for RAV) of the networks into our analysis.[34] Figure 3.3 and Figure 3.4 below, show the trends in dividend yield, payout ratio, and fixed assets growth.

3.15 Electricity networks have consistently demonstrated stronger fixed asset growth than gas networks over the past several years. This trend continued in 2024, with electricity networks again showing strong investment activity and significant asset base expansion.

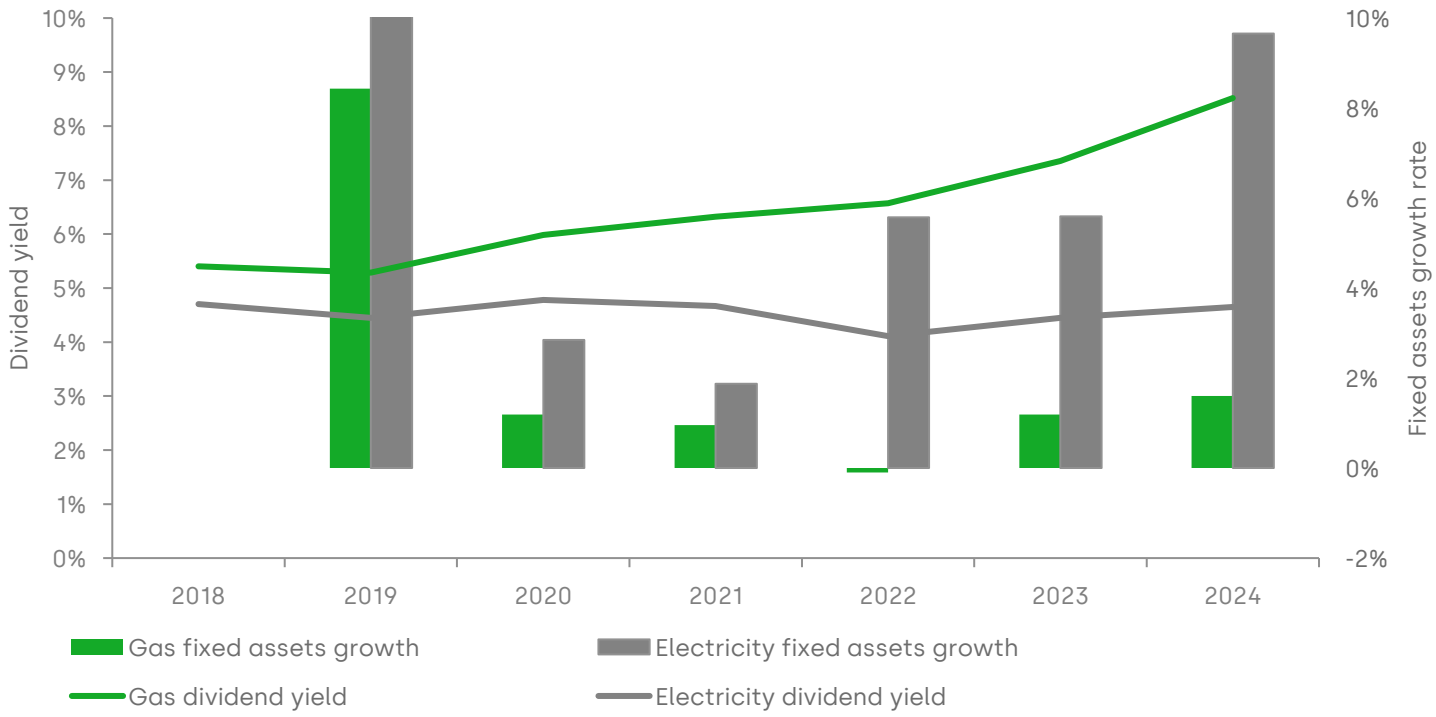
3.16 This pattern helps to explain the divergence in dividend behaviour between sectors. Electricity networks, with stronger asset expansion, have generally maintained more stable dividend yields, whereas gas networks—experiencing slower asset growth—have shown steadily increasing yields.

3.17 Growth in gas network fixed assets remained limited in 2024, following very low or even negative growth in earlier years (e.g. 2022). As previously highlighted in section 2, a slower rate of asset expansion may reduce reinvestment needs, creating stronger incentives to return earnings to shareholders through higher dividends.

3.18 The same relationship is also reflected in the payout ratio trends. While electricity networks' payout ratios remain aligned with their relatively steady asset growth, the higher and more volatile payout ratios among gas networks are consistent with their flatter asset base trajectory.

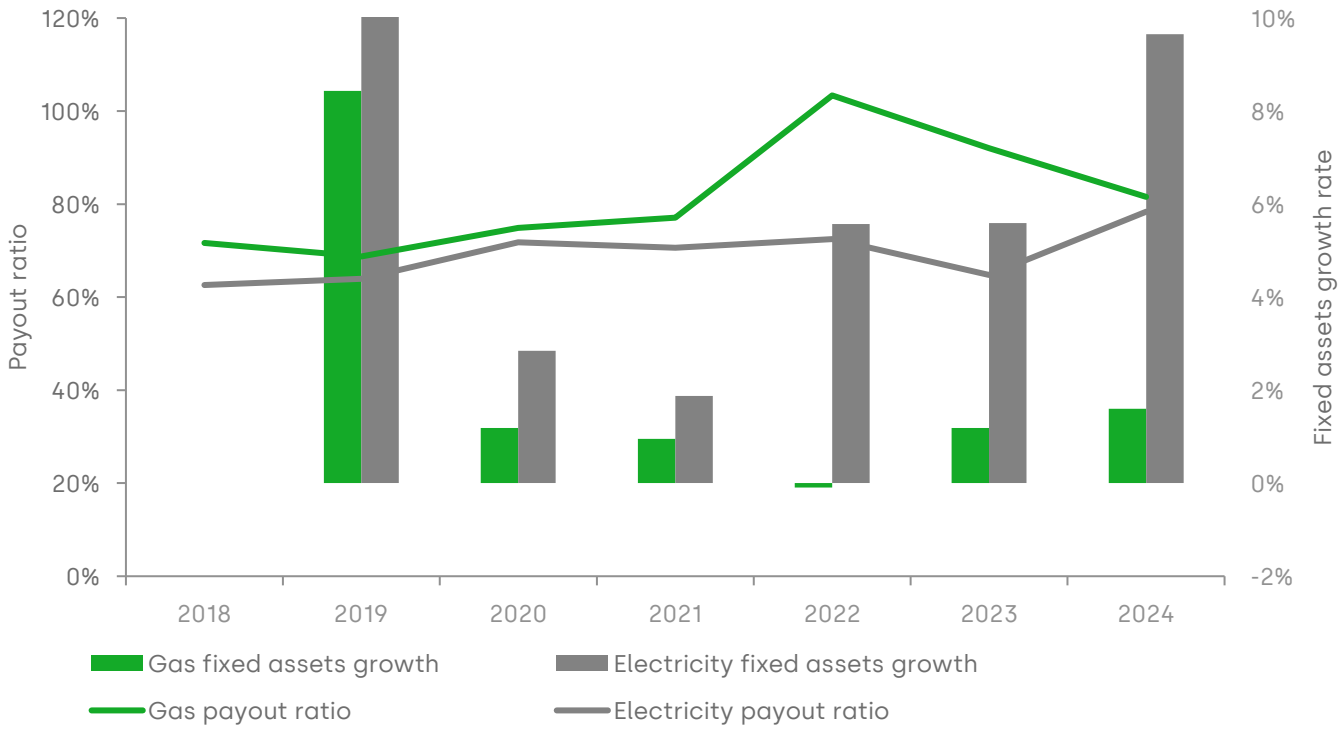
[34] Fixed assets are approximated by the 'Property, Plant & Equipment – Net' metric in Refinitiv. Proxying RAV growth by property, plant and equipment growth implicitly assumes that a net increase in the book value of property, plant and equipment assets happens proportionately to a net increase in the value of the RAV.

Figure 3.3 Dividend yield and fixed assets growth



Note: The fixed assets growth rate in 2019 for electricity networks is higher than shown by the bounds on this chart (it is at 5,581%) because of REN increasing its fixed assets substantially.
Source: Oxera analysis based on Refinitiv data.

Figure 3.4 Payout ratio and fixed assets growth



Note: The fixed assets growth rate in 2019 for electricity networks is higher than shown by the bounds on this chart (it is at 5,581%) because of REN increasing its fixed assets substantially.
Source: Oxera analysis based on Refinitiv data.

3.19 The updated analysis continues to support the relationship between lower asset growth and higher dividend distributions.

3.20 As highlighted in earlier sections, asset growth for gas networks is expected to be lower in RIIO-3 than it will be for the electricity sector. This may reinforce the need for divergence between dividend policies in the two sectors and the need for higher dividend distribution in the gas sector, relative to the position Ofgem has set out in the RIIO-3 DD.

4 Conclusion

4.1 In this report, we have assessed Ofgem's proposed combination of the notional dividend yield assumption (the 'base' yield of 3%) and the special dividend mechanism for RIIO-3 in terms of their adequacy in light of the evolving economic context and regulatory environment affecting the operations of gas networks in RIIO-3 and beyond.

4.2 We conclude the following.

- Independently from the options 'still under consideration' by Ofgem (which could affect downward pressure on gearing in the gas sector), it is clear that reduced investment need scenarios and accelerated depreciation will generate excess cash on a recurring basis over RIIO-3 and beyond.
- Any increased cash flow from depreciation allowances would tend to depress gearing; therefore, in the absence of steady asset growth, dividend yields would need to increase in order to maintain gearing levels.
- As a consequence, in the current environment, Ofgem's 3% notional dividend yield assumption would not enable the return *of* shareholder capital. A credible policy for dividend distribution as a means of returning capital to shareholders, is required alongside other measures (such as accelerated depreciation) towards mitigation of asset stranding risk.
- Moreover, the 3% notional dividend yield assumption would be insufficient to enable the return *on* capital, as part of the return is expected to be recovered in future periods, expressed in expected growth in assets and dividends, which are absent in low-growth scenarios for the gas networks.
- The use of a special dividend allowance would be inconsistent with the typical purpose of special dividends: while the reasons for the need for this special dividend allowance are structural and long-term, the allowance is by definition non-recurring.
- Furthermore, the gearing-triggered mechanism proposed by Ofgem to assess whether gas networks may be allowed to distribute special dividends, which is still to be defined, may result in an inefficient use of cash that could reduce

the internal rate of return on equity below the allowed cost of equity and therefore worsen project investability.

4.3 In light of the above, as discussed in our previous report, we recommend that Ofgem ensures consistency across the different elements of the regulatory package, the economic context, and shareholders' expectations by allowing for an increase in the required dividend yields in its financeability and investability assessments, to ensure adequate calibration of the regulatory package. As a minimum, the dividend growth model suggests that the assumed yield should be set at the level of the allowed cost of equity in the absence of steady RAV growth, or above it if the RAV is expected to decline. Any addition on top of the allowed cost of equity may enable the return *of* capital. Moreover, it would be appropriate for dividend payments to be recurring and operationalised in a way that would avoid any cash being trapped on the balance sheet—i.e. suboptimal cash management.

4.4 Our updated analysis on dividend trends across European gas and electricity networks, considering 2024 data, is consistent with that presented in our previous report. In particular, European gas networks, experiencing relatively slow asset growth, have shown steadily increasing dividend yields over time. This supports our conceptual arguments for higher dividend yield in the gas sector, relative to the position Ofgem has set out in the RIIO-3 DD.

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