KPMG

Funding models for the GB Electricity System Operator – Executive Summary

Prepared for National Grid

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26 March 2018

Important notice

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This version of the Report is an extract from the Executive Summary of the main Report and therefore does not represent a full and complete output of our work.

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Introduction

From April 2019, the NGET structure will be separated into discrete Electricity Transmission Owner (ETO) and Electricity System Operator (ESO) businesses.

In preparation for this fundamental change, new Electricity System Operator (ESO) incentive scheme will be set by April 2018 and specific ESO license duties and requirements identified.

Currently, National Grid is engaging with Ofgem in order to determine how the ESO should be regulated and funded in light of upcoming changes.

This provides an opportunity for more innovative regulatory and financing solutions other than rolling forward those used today.

In this context, National Grid sought KPMG's support in identifying the appropriate funding models for the ESO.

This report presents a range of considerations on a selected group of potential, viable funding models that can be seen as justifiable in light specific NG's ESO characteristics and regulatory objectives.

Context

— The upcoming separation creates a need to consider how the ESO is funded in order to ensure that the business post-separation is able to deliver on its license commitments and remain financially resilient.

— It is important that the new standalone business continues to be incentivised to deliver value for consumers, shareholders, and the industry at large, and to be innovative while remaining financeable. This needs to recognise that the highly dynamic energy sector is continuing to evolve at a rapid pace.

— Since SOs are asset-light and service-based organisations, this means that unlike for traditional, asset-heavy utilities, the RAB is a poor proxy for the total value of the business or as the basis to set SOs' tariffs. The SOs also adds significant value to the sector at large and its customers, and can influence the cost base of the rest of the value chain.

— Examining benefits and drawbacks of the funding models corresponding directly to the ESO characteristics should help National Grid and Ofgem decide on the preferred model that would meet the needs and objectives set by the company, the Authority, industry, customers and consumers.

Scope

— Define the key characteristics of the business and their implications for funding models.

— Develop a viable set of potential funding models.

— Define criteria for the assessment and the assumptions behind them.

— Carry out the assessment using the defined assessment criteria and applying them to each of the funding models through combination of qualitative and quantitative methods.

— Consider the pros and cons of each model through the lens of the criteria that Ofgem and other stakeholders will apply, including costs of separation and stand-alone viability and financeability, and what the impact on bills will be, as well as in terms of financial and risk implications for the ESO.

— Identify a preferred model (or models) and demonstrate why it is in the best interests of consumers and the industry as well as meeting shareholder expectations.

Executive summary—potential funding models for consideration

A wide range of potential funding models has been considered for NG ESO. After an initial pre-selection, we have focussed on six models set out below that have the potential to meet the criteria for an appropriate funding model with the NG ESO.

- The models presented below have been selected based on consideration of a number of categories of different criteria, including business characteristics, industry and customer characteristics, regulatory principles and consumer requirements, consistency with regulatory precedents and financeability.
- Some of the proposed models, if implemented, would represent a step-change from the existing regulatory framework for NG SO, but can be justified as appropriate models for a separate ESO business.

Capital based, variant of the current model	Margin-based, typical of asset light reg co's	Tailored solution, based on the CMA	Constructive engagement based	Contingent returns based	Mutual fund
ROCE(C) Return on Capital Employed (and committed) Model R	**Margin-based Model** M	**Layered / Hybrid Model** L	**Commitments Model** C	**Performance Model** P	**Not For Profit Model** Z
Ex-ante multi-year price control with fixed totex allowances. Baseline profitability based on several layers of capital employed and committed to the business. 3 tranches of capital recognised corresponding to RAV, PCG and working capital.	Ex-ante multi-year price control with fixed totex allowances. Baseline profitability and headroom based on pre-set margins. 2 margins: 1) Margin on controllable costs (EBIT margin) 2) Smaller margin on pass through costs.	Ex-ante multi-year price control with fixed totex allowances. Layers of remuneration based on RAV*WACC, Margin on pass-through costs. Allowance for PCG. Potential for premium if incentives or other future elements are asymmetric.	Price control based on commitments derived from constructive engagement. PC sets initial tariffs and a precautionary price cap; tariffs can be adjusted year on year by the ESO within the precautionary cap. Initial tariff basket is informed by existing charges, constructive engagement.	Ex-ante multi-year price control with fixed totex allowances. No baseline equity profitability but allowances for the cost of fixed debt and working capital. Enhanced incentives not fully symmetric, skewed towards positive performance.	A not-for-profit model which creates different expectation around equity returns. This type of model is not currently under consideration by the business or by Ofgem and therefore has not been analysed in this report.

Executive summary: business characteristics

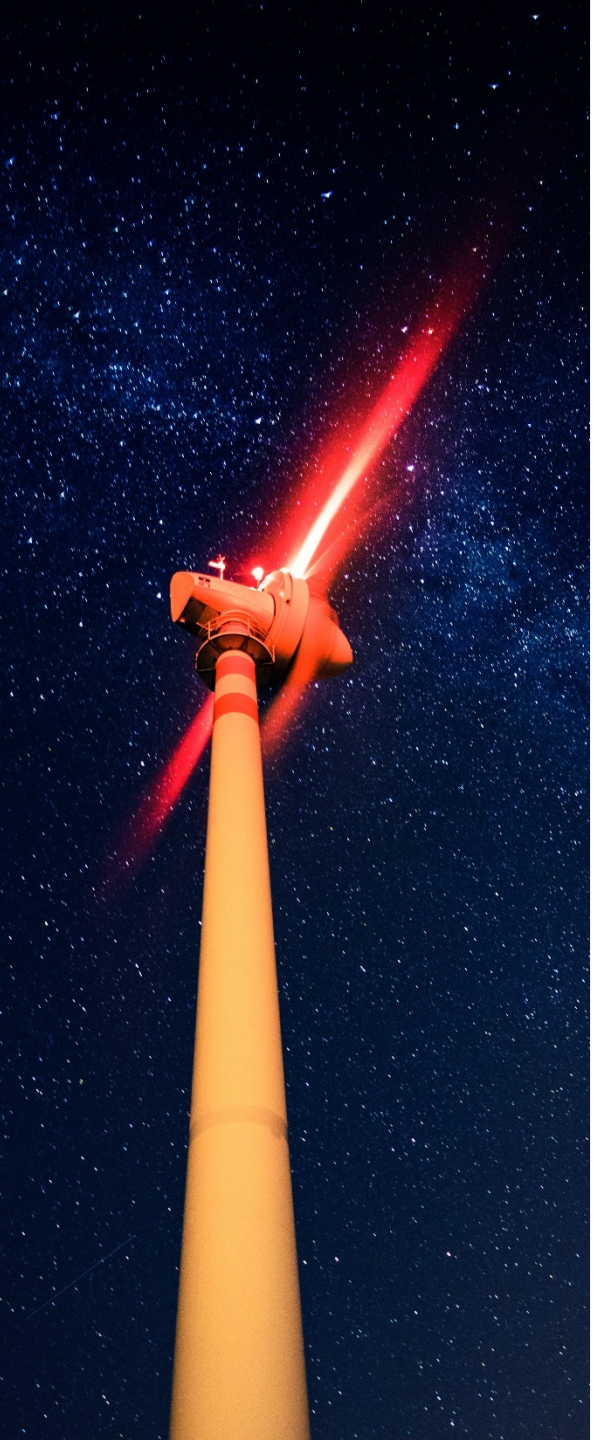
Business characteristic of ESO	Commentary and potential implications
High operational gearing/asset light	Operational gearing is significantly higher for the ESO than for typical regulated network utilities. For typical regulated utilities the financial buffer provided by returns on assets is sufficient to absorb the most likely downside shocks; this is not the case for the ESO and this exposure to risk needs to be addressed by each model.
High performance driven returns	The incentive package for the ESO is significantly higher than for traditional utilities when compared to either assets or operations. This leads to an unusual situation where the incentive package becomes the dominant feature of the remuneration framework.
Significant exposure to cash flow volatility through role as collection agent of industry revenues	These risk drivers are likely to result in increased uncertainty and variation around pass through costs, which could increase exposure to shortfalls in revenue to fund balancing payments. The ESO is bearing risks, such as the collection agent function risks, which are unrelated to its (low) asset base and this characteristic would need to be addressed by the financial framework. Any debt required e.g. an RCF to manage the exposure to cash shortfalls would introduce significant volatility to the gearing of the ESO.
Small RAV based on limited investment in tangible assets with short asset life	Capital programmes can include significant one-off projects. These in combination with short asset lives can lead to volatile returns derived from the RAB resulting in high variability of returns under an approach based on remuneration of the RAB.
Intangible assets	The ESO's business characteristics and hence risks are closer to companies that rely on intangible assets such as know-how, have limited infrastructure assets, and occupy a pivotal position in the market system.
Exposure to rapid industry changes and evolution of the market	While the whole energy sector is going through a rapid evolution, this will be particularly felt in the ESO, where not only are all the wider sector changes felt, but more specifically, new ways of working and potentially new expectations may be experienced. In practice exposure to market developments requires significant flexibility, in particular around the treatment of costs, as short term investments may be required to drive value for consumers.

*From RIIO databook Nov 17 iteration, all in 2009/10 prices

Executive summary—unique features of each model

This slide identifies the unique features of each potential funding model at a generic level. The following slide sets out a specific version or "strawman" for each model in more detail, which forms the basis of our assessment.

ROCE(C)	• Basis for expected returns is the total capital determined to be required to run the business • Flexible around how capital is defined and can be used with multiple tranches of capital • Tranches of capital could include RAV as well as committed and available contingent forms of capital such as guarantees or working capital (over and above the capital employed) • Adheres to the principle of financial capital maintenance and remuneration of invested capital • Can be combined with incentive mechanisms • Consistent with CMA's preferred approach to remunerating utilities • Perceived by market as low risk and well trodden path for regulators
Margin	• Links allowed returns to scale of operations, i.e. flows not stock • Conceptually, it approximates total profitability, but allows for deviations • Flexible around what margin is used and can be decomposed into multiple activities with different margin • Can be based on allowed or out-turn numbers • Return *of* capital invested is allowed for separately (if the margin does not include depreciation) • Can be combined with incentive mechanisms providing steady financial buffer
Layered	• Identifies clearly separable business activities before considering corresponding layers of funding • Delineated business activities and risks require differentiated regulatory treatment • Specification of layers of remuneration is a reflection of this way of thinking about the ESO business • Flexible around how different activities are defined and what types of treatment/remuneration are used • Might require formal or informal in-the-round cross check on overall profitability • Risk of double counting so important to ensure no overlap between layers/activities • Can be used with incentives, though these need to be calibrated against individual layers
Commitments	• Onus of regulatory settlement is reversed: moves away from Regulator's explicit determination of allowances with target outcomes to a focus on binding outcomes and negotiation of required revenues • Regulatory settlement based on ex-ante commitments, can be combined with precautionary cap on tariffs • Requires emphasis on constructive engagement with customers and consumers to agree outcomes. Potential for tariffs to be negotiated with customers • Degree of financial discretion and flexibility sits with company, but scrutiny of financials still occurs • Move away from ex-ante allowances creates need for ex-post review
Performance	• Primary focus is on delivery of outputs and specific regulatory incentive mechanisms linked to revenue • Basis for expected returns is around pre-defined scale of incentives linked to performance against outputs • Onus shifted towards outcomes not cost allowances • Requires a comprehensive contract and associated metrics alongside a performance monitoring regime • Doesn't necessarily involve a baseline remuneration but it may require so for financeability reasons • Differs from commitments in terms of the more conventional regulatory approach—i.e. Regulator developing specific ex-ante allowances and more limited business flexibility



Executive summary—outline of 'strawman' models

ROCE(C)	• Ex-ante multi-year price control with fixed totex allowances • Baseline profitability based upon; RAV*WACC; PCG; and working capital • Could also argue for risk capital committed or employed given incentives package • WACC reflects high operational gearing • Capex (as % of totex) is added to the RAV and depreciation collected • Outperformance on totex allowances possible • Recognition for PCG costs and working capital facility as part of capital employed
Margin	• Ex-ante multi-year price control with fixed totex allowances • Two margins; margin on controllable costs (EBIT margin); and second (smaller) margin on pass through costs, both ex-ante • Capex (as % of totex) is added to RAV and depreciation collected • Outperformance on controllable opex allowances possible • PCG and working capital facility not explicitly remunerated, covered by margin on pass-through
Layered	• Ex-ante multi-year price control with fixed totex allowances • Layers of remuneration based on analysis of which ESO activities and associated risks can be separately identified and require different funding treatment include: RAV*WACC, WACC adjusted upwards for high operational gearing; margin on pass-through costs; allowance for PCG costs incorporating any form of additional support (e.g. cross guarantee if not in margin); potential for premium if incentives or other future element are asymmetric • Capex (as % of totex) is added to RAV and depreciation collected • Outperformance on controllable opex allowances possible
Commitments	• Price control confirms commitments, initial tariffs set by NG ESO and a precautionary price cap, i.e. tariffs are not fully deterministic • Tariffs can be adjusted by the ESO within the precautionary cap, moving away from an ex-ante framework • The initial price control can be reopened by regulator or the ESO, otherwise is rolled over • Commitments are reviewed at agreed time intervals • Initial tariff basket is a negotiated settlement informed by existing charges, constructive engagement, proof of need and value for money set out in ESO's business plan • Commitments are agreed through constructive engagement process and signed off by the regulator • Regulator might require ex-post profitability check despite the precautionary cap • Ex-post review annually where regulator can claw back demonstrably inefficient spend or over-charging • Incentive mechanisms are incorporated into commitments, scrutinised through CE and any revenue implications are subject to precautionary cap
Performance	• Ex-ante multi-year price control with fixed totex allowances • No baseline equity profitability but returns based on incentive mechanisms • Incentives not fully symmetric, skewed towards positive performance • Allowance for cost of debt including working capital • Capex is added to the RAV and depreciation collected • Outperformance on totex allowances possible • Allowance for PCG costs

Executive summary—philosophy of the models

Existing framework under RIIO-1 – This is the traditional regulatory model based on the return of and return on capital. The philosophy is that investors need to be rewarded for the risk associated with deploying capital into the business. The capital is fully deployed and on the balance sheet and it assumes that the value of the business is fully correlated with the value of the RAV. The costs of running the business are determined up front and set as hard allowances.

ROCE(C) – This is an extension of the traditional regulatory model based on the return of and return on capital. The philosophy is that investors need to be rewarded for the risk associated with deploying capital into the business. The capital can be fully deployed and exist on the balance sheet or can be a committed facility but it assumes that the value of the business is fully correlated with the value of the capital layers associated with the business. The costs of running the business are determined up front and set as hard allowances.

Margins – this is a typical services model where the value of the business is not linked with the value of the capital deployed, since the assets of the business do not meet the accounting tests to be defined as capital, eg professional services where the assets of the business are intellectual property and expertise. The philosophy is that investors need to be rewarded for the risks associated with the operations of the business since intangible assets such as the experience and expertise of employees is reflected in the costs of those people. The costs of running the business are determined up front and set as hard allowances.

Layers – This model seeks to recognise that for businesses with a wide range of different type of activities and risks, a single method of remuneration is potentially too blunt an instrument. It breaks down the business into its constituent parts, looking at layers of capital, business activities and risks and remunerates each separately. The philosophy is that as the business is an amalgamation of separable activities, the sum of the parts of these activities provides the remuneration for the business overall. The costs of the running the business are determined up front and set as hard allowances.

Commitments – This model seeks to move away from setting hard allowances for costs to setting more binding outputs. This can be thought of as the difference between a contract where the price is set on a time and materials basis eg the customer pays the actual cost of delivery (though based on an up front estimate and on pre-agreed rates), vs a fixed fee contract. The Commitments Model takes the former approach, where through constructive engagement, if customer expectations change over the duration of the contract, this can be easily accommodated, hence allowing a greater degree of flexibility. It also avoids the need for the contractor to price in all risks up front since the customer will only pay for those risks that eventuate. The pre-agreed rates and estimates can be based on any of the other models, though the layers is a particularly strong fit since the decomposed nature aligns well with the necessary granularity required for this approach. The philosophy of this model is therefore a more de-regulated approach based on a more commercial arrangement with an informed buyer (through the constructive engagement process). All the other models retain the detailed regulatory contract where the regulator assumes that role on behalf of customers.

Performance – This model disconnects the level of profitability from the size of the business, both in terms of capital deployed and operations, instead seeking to remunerate purely on levels of output achieved. This makes it similar it some ways to the Commitments Model, however the Performance Model retains the detailed regulatory contract approach where hard allowances are set up front. By focusing purely on incentive mechanisms it requires even more careful calibration and regulatory effort because the regulator directly determines all outcomes. In fact, compared with more classical regulatory models focused on capital plus incentives it requires greater regulatory effort because the regulator takes more on themselves in terms of regulating specific outcomes and identifying desirable behaviours. If calibrated correctly, the Performance Model can be targeted and therefore effective at remedying market failures.

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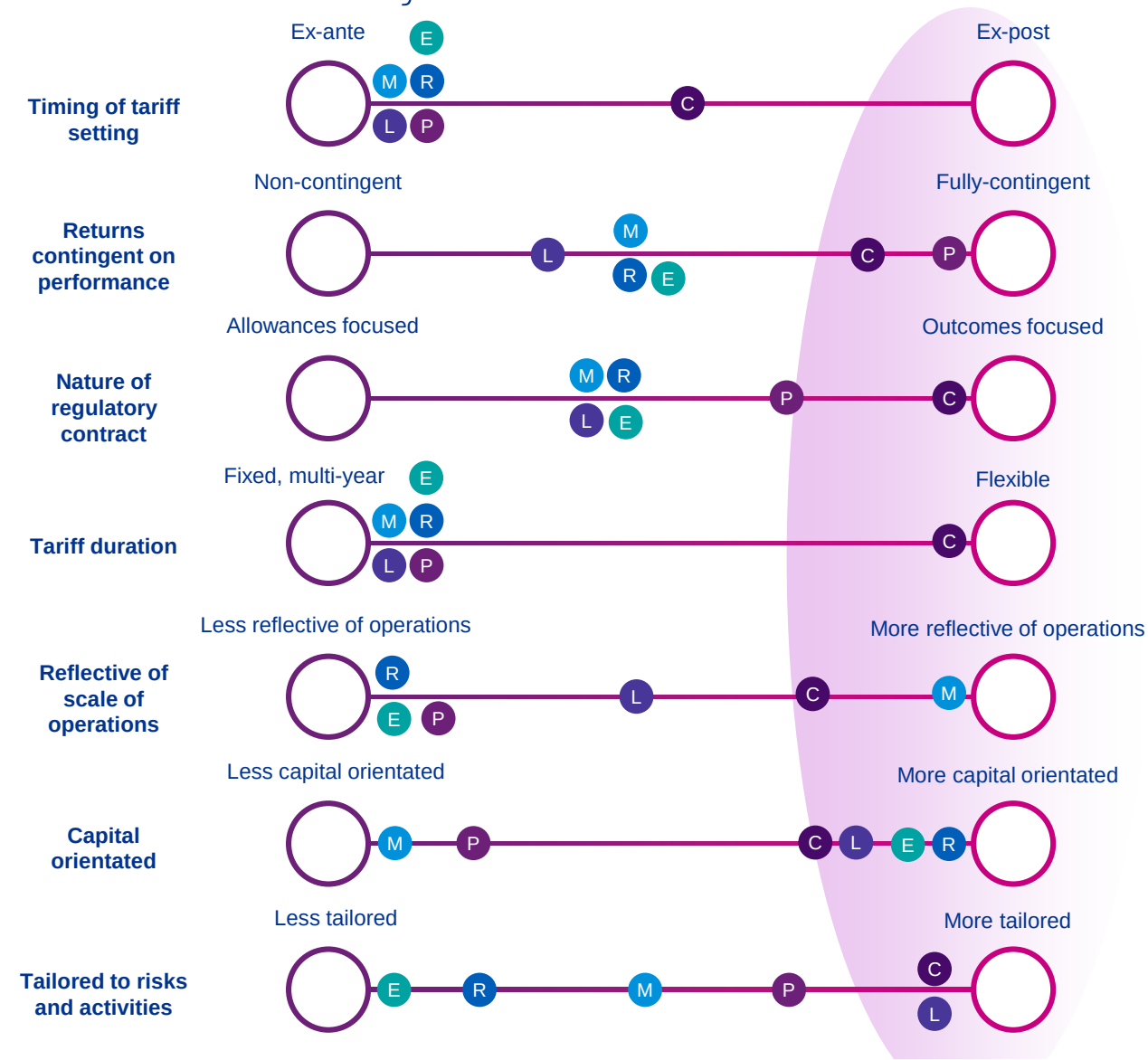
Executive summary—illustration of models' features in relative terms



The Commitments Model sees tariffs agreed up front but does have an element of ex-post review. The others are ex-ante.

The incentives package is the dominant feature in all the models, but the Performance Model is fully contingent.

The Commitments Model has the hardest focus on outcomes. The significant incentives package makes all the models outcomes focused.

The Commitments Model has flexibility on tariff duration, all the other models are for fixed period price controls.

The Margins Model is explicitly designed to be reflective of operations. The Commitments Model implicitly recognises operations, and the Layered Model partially reflects it.

The ROCE(C) Model is explicitly focused on capital. The Layered Model has a significant capital layer and the Commitments Model implicitly recognises capital layers.

The Commitments and Layered models are fully bespoke and tailored. The Performance Model does not recognise a number of activities.

Executive summary—the role of incentives

The role of incentives for the ESO is unique in regulated businesses in terms of their relative scale and importance for value add for customers.

- Financial incentives where appropriately structured and calibrated can encourage the ESO to act in the interests of customers and consumers and drive innovation over and above business as usual activities in response to the incentives package.
- For example, the ESO has the ability to influence wider energy supply chain costs, particularly in areas such as system balancing, but in order to do so needs to make sizeable investments in Opex and Capex terms at its own risk, sometimes at short notice. The potential to realise consumer value in this area is currently recognised through the BSIS scheme that runs until the end of March 2018, which encourages the SO to reduce balancing costs.
- **The ESO business typically requires many, often unplanned short term investments in intangible assets, resources and systems in response to market developments, which can be remunerated through incentive mechanisms.**
- Where such investments are not provided for ex-ante, **the scale of the incentive package would need to be large enough to be able to pay-back the investments within the period over which the incentive package applies**.
- This can lead to an unusual situation where the incentive package becomes a dominant feature of the remuneration framework and it is in consumers' interests for this to remain so. It also creates a somewhat unique situation where **baseline profitability is unlikely to be able to cover the downside risk of the incentive package.**
- Baseline returns are likely to be required to gain access to debt financing (depending on calibration) and also to provide a financial buffer in order to allow the business to make investments and take on risks, but might be secondary in scale to the performance-based returns.
- The funding models assessed in this report do not prescribe all financial flows of the ESO. Specifically, the funding models do not prescribe the parameters of the incentive package and rewards/penalties derived from incentives are excluded from our assessment of baseline profitability and implied financial headroom.
- **The funding models need to be consistent with and able to support the scale and structure of incentives as part of an integrated, holistic package** and allow the business to be able to pursue value adding activities which ultimately are rewarded through incentives. All the models, depending on calibration, could meet this test.
- The natural follow on from ensuring that the models do not prevent the incentives from functioning is determining which models best facilitate the pursuit of value-adding activities and seek to drive value for the industry and consumers. This will be principally picked up in the 'industry and customer characteristics' assessment.

Key criteria for consideration

There are a number of fundamental factors that should be considered in determining the appropriate funding model for the ESO. We have selected five broad categories of assessment criteria to be considered as part of the evaluation.

The following slides present the high level assessment under each of the **five broad categories** of relevant criteria considered.

1. Business characteristics

Considers whether the model is aligned with the licensed activities and risks of the business

Demonstrates whether the model can be tailored to reflect business, risks and incentive characteristics

2. Industry and customer characteristics

Considers whether the model is aligned with the evolving needs of the industry and customers, demonstrating that it will be fit for purpose in the future and that the ESO can create value for the industry by influencing other network costs

3. Regulatory principles and consumers

Considers whether the model meets the regulator's requirements, best practice methods and duties

Considers whether the model creates value for consumers

4. Precedents

Considers whether the model is aligned with recent CMA and other regulatory precedents

5. Financeability

Considers whether the model allows the business to access capital markets and earn a reasonable return

Presents quantitative assessment whether the business could be financeable under the specific funding model

Executive summary—overall conclusions (1/4)

The ESO presents an a different and unique funding challenge compared with traditional, asset-heavy utilities.

- It is **asset light, with high operational flows** and a significant reliance on intangible capital in the form of engineering expertise.
- Unlike many regulated networks, it does not predominantly create value through investment in physical assets and **exhibits more characteristics of a service provider** than those of an infrastructure provider.
- It is a relatively small business in terms of its own cost base, but **the ESO has material influence on the costs of the wider value chain**, for example on balancing costs, on evolving market operation, through initiatives such as 'power responsive', and potentially in future network design. This means from a consumer value perspective, it should be focused on driving savings in external costs to a greater extent than minimising its own costs and this is reflected in the scale of the incentives package.
- There is clear benefit in consumers paying for a high quality ESO since the increase in internal costs can be more than offset by the savings in external costs.
- This presents a significant challenge from a regulatory funding perspective. The unique features of the business mean that **the funding model must take account of the ESO's business characteristics in a more bespoke way** and therefore a roll forward of the standard regulatory model will be insufficient to meet this test.
- In addition, there are very few peers – there are only 3 for-profit system operators globally – making benchmarking difficult and increasing the likelihood of abnormal returns.
- **While there are clear benefits to industry and consumers from a more separate ESO (e.g. reduced conflicts of interest), there is an associated cost to both industry and consumers to achieving this**. Moving the management of risks such as the working capital timing risk to the ESO which does not have the balance sheet or equity buffer to cope with it creates additional cost. However, these should be considered in the context of the potential value a standalone ESO is able to derive for the wider industry and the relatively low cost base of the ESO itself.
- In summary, the ESO is an amalgamation of various business characteristics, which complicates the design of the regulatory framework. It demonstrates a number of the characteristics of a professional services organisation, e.g. engineering expertise and system management; the characteristics of a clearing house, e.g. collecting revenues and passing them on to recipients; and also characteristics of more capital intensive industries, e.g. constructing and maintaining a asset base.

Summary of approach

A wide range of potential funding models have been considered as part of this analysis across five criteria categories and 18 criteria

Criteria categories

1. The model is aligned with the licensed activities and risks of the business
2. The model is aligned with the evolving needs of the industry and customers
3. The model meets the regulator's requirements, best practice methods and duties and is in line with consumer interests
4. The model is aligned with recent CMA and other regulatory precedents
5. The model allows the business to access capital markets and earn a reasonable return

Executive summary—overall conclusions (2/4)

The overall conclusions of the relative assessment of the potential funding models are set out below. The conclusions are structured by order of preference based on the detailed assessment and the extent to which each model is in the best interests of consumers and the industry as well as meeting shareholder expectations.

The Margins-based Model seeks to determine baseline profitability with reference to the scale of the operations of the business.

- From a business characteristics perspective, returns derived from a margin are a better proxy for the scale and activities of the business than the capital employed, but it is a relatively general and 'crude' measure of profitability, though the use of two margins reduces this.
- The Margin Model has the advantage of being a relatively simple and transparent measure that could fund a financeable business through a single mechanism.
- However, a key issue for the Margins Model is there is no clear corporate finance theory for determining the appropriate margin (unless it can be shown to correspond to capital) and hence it can only be calibrated through benchmarking rather than derived bottom-up.
- Further, a margin applied to industry revenues may have perverse incentives and discourage the ESO from seeking to reduce e.g. system balancing costs.
- The returns implied from the Margins Model can act as a check on overall remuneration for other funding models or for example to set a precautionary cap in the Commitments Model.

The ROCE(C) Model seeks to compensate the capital employed and committed to the business.

- This is the typical way of remunerating regulated infrastructure and builds upon the existing regulatory framework for the SO and is a well understood and tested approach, but this model when applied to the ESO also allows for recognition of additional layers of capital.
- The correlation of returns to the size of capital employed may be a poor fit for business activities since the pricing does not directly reflect the scale of economic activities (in terms of costs) but is focused on capital; however the model is likely to address a number of potential market failures including the avoidance of abnormal profits.
- From a financeability perspective, the levels of return may not be sufficient, particularly given the scale of the incentive package, unless significant additional capital is recognised beyond the RAV.
- The ROCE(C) Model implies relatively low cost flexibility for management of short-term investment requirements that allow the ESO to respond to market developments, but provides for financial headroom.

The Performance Model seeks to ensure that the ESO is principally focused on delivering value for the industry by making the equity returns contingent on delivery of outcomes which are of value to them.

- On one level, this creates a strong alignment between the business and industry characteristics, economically desired outcomes, and the funding model as it focuses the business uniquely on these targets in order to earn returns.
- However, limited or no baseline remuneration and hence equity buffer means there is limited margin for error which could actually create a risk averse business that is unable to take the risks necessary to deliver the higher benefit value accretive products for customers and consumers.
- The model is also likely to struggle to meet financeability criteria since even with positively skewed incentives baseline equity return and hence financial headroom is zero and the incentive downside could impede the capability to service debt.

Executive summary—overall conclusions (3/4)

The Layered Model seeks to consider each of the business activities, risks and capital layers separately and specifically, selecting a bespoke funding solution for each rather than trying to choose a single, business-general tool.

- This ensures, as long as there is no overlap between layers, that there is also a low probability of abnormal profits meaning consumers are assured of a value for money service. It should also ensure that that the business is capable of being financeable.
- It is a robust and arguably the most accurate methodology for pricing returns and is fully aligned with the recent CMA precedent for SONI, but it is also a relatively complicated model.
- Effectively, the Layered Model should aim to ensure that the financial headroom provided by the baseline funding is sufficient for the business to access financing (a rigorous analysis by layer is required to avoid abnormal returns), while the incentives package can provide the impetus for the business to drive value in the wider industry.
- There could potentially be a layer in this model that provides a cost buffer for certain activities to reflect the likelihood of short term investments being required in response to market developments, which would provide additional cost flexibility to the ESO compared to models predicated on capital employed or margins.

The Commitments Model puts the onus of the development of the regulatory contract on customer engagement to specify commitments as outcomes and outputs and away from the regulator setting the ex-ante allowances based on costs.

- Given the ESO's relatively low internal cost base, but high degree of influence on the costs of the wider value chain, this model can be seen as strongly aligned with driving value for the industry and the characteristics of the business.
- The move away from hard ex-ante revenue caps and cost allowances also means that rather than having to price in every plausible risk into allowances, additional costs can be charged only if they occur. Given the potentially wide range of risks and high potential requirements for short term investments in response to market developments, a model with a degree of built-in cost flexibility may be a more efficient outcome for consumers than providing an equity buffer up front.
- The model is also the most aligned to customer and consumer interests. As outcomes are the most binding element of the contract, the business is likely to be focused on delivery of these.
- Given the relative scale of the ESO, any changes in its own cost base (which would be capped) only have a relatively minor impact to the overall bill costs. Combined with the incentive package, this can ensure that the focus is on value-additive activities, while internal costs are held to account through a robust constructive engagement process.

Executive summary—overall conclusions (4/4)

Each funding model assessed could potentially comprise a workable solution for the ESO. The Layered and Commitments models are the two which appear to be the most appropriate at this stage.

There are a number of key features that underpin this conclusion:

- They are aligned to the characteristics of the business as both allow all the bespoke elements of the ESO to be recognised rather than relying on a single component as a proxy.
- The Commitments Model in particular is aligned to the industry needs, since it focuses primarily on outcomes rather than allowances.
- The Commitments Model is also aligned to consumer interests and regulatory principles due to its inherent flexibility, particularly around treatment of costs.
- The Layered Model has a strong regulatory and CMA precedent from the SOs in ROI & NI.
- They are the most financeable models, based on preliminary assumptions - though it should be noted that the scale of the incentives package means that no model is likely to provide sufficient headroom to cope with the potential downside of the incentives package.

What would change this outcome?

- It may be possible to adjust the Performance Model such that it delivers such an expected mean positive result that it can provide the confidence to lenders that enables it to be financeable and provide enough of a buffer to allow the business to not be risk averse when investing in value adding activities.
- The license requirements to hold a credit rating, operate on an arms length basis and not be cross-subsidised create a narrow field of play when coupled with the business characteristics, especially the incentive package. Relaxing some of these license requirements could also make the Performance Model more attractive, or indeed the Margins Model.

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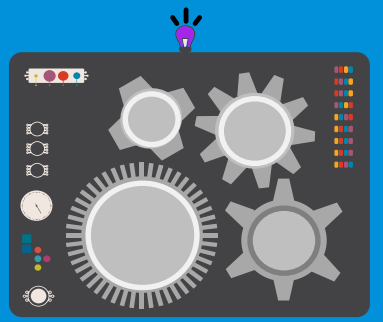
Appendix

PRIVATE AND CONFIDENTIAL



Key criteria for consideration: business characteristics

The criteria for assessment of different models are set out below

1. Business characteristics

Compatibility with ESO's business characteristics

Assessing whether each model recognises all economic activities and associated risks. The regulatory regime should recognise and remunerate relevant risks arising from all licensed activities. While different regimes inherently focus on a single framework as the basis of remuneration, which by definition may miss certain elements, the framework which recognises the greatest proportion is more closely aligned to the underlying characteristics of the business

Allows for management of uncertainty

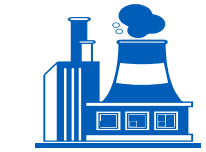
Assessing how each of the models would flex with changes to the scale of and risks inherent in existing business activities

Reflective of risk exposures

The regulator must ensure that the regulated company is able to bear the risks that are allocated to it by the regulatory framework. It follows that the financial headroom provided by the allowed profit and the other financial resources committed to the business need to be sufficient to absorb a range of downside outcomes. The price control must enable the ESO to secure financial resources and 'price in' the risks it will be exposed to in order to remain financeable

Key criteria for consideration: industry and customer characteristics

The criteria for assessment are set out below

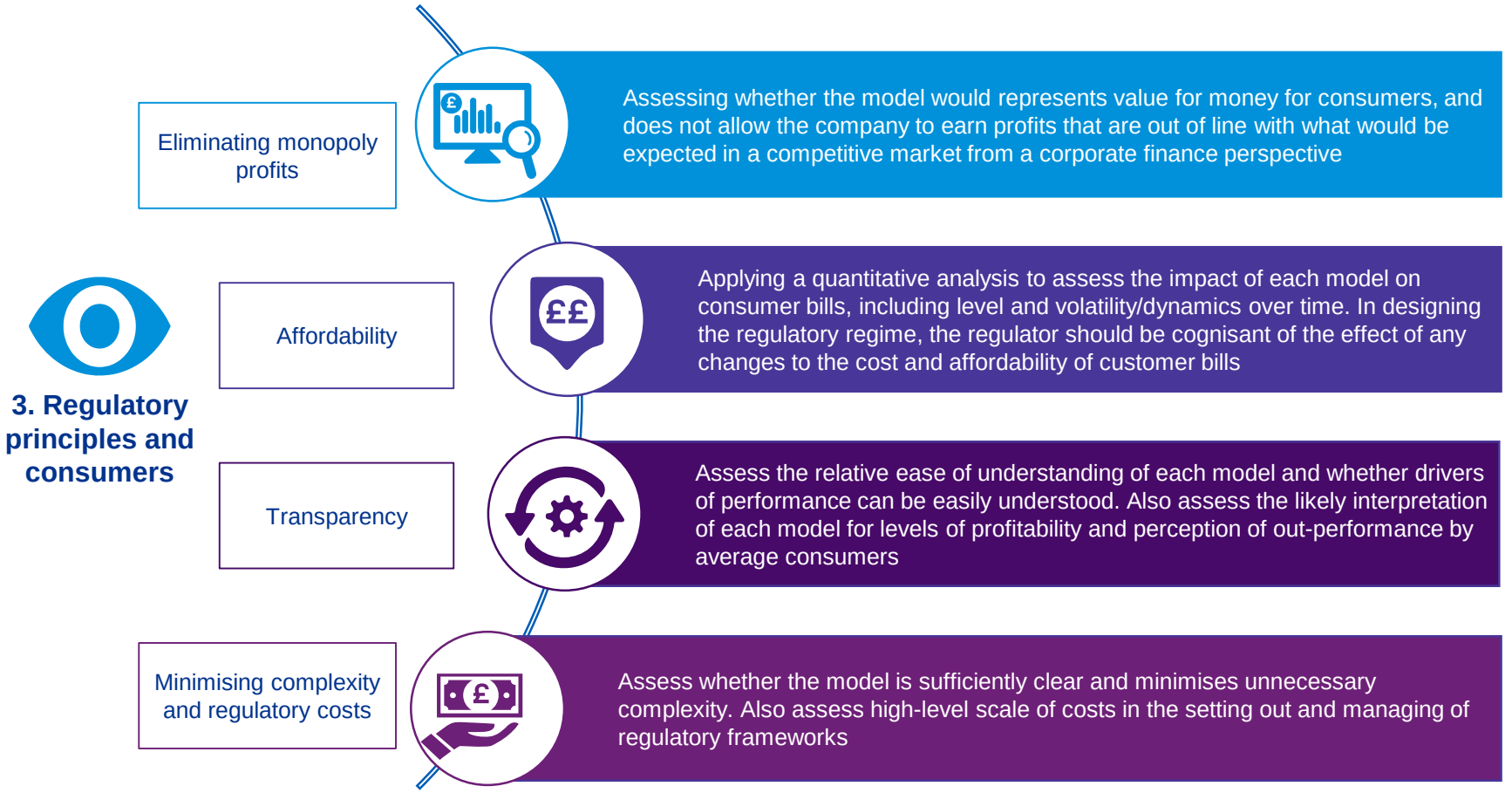


2. Industry and customer characteristics

Incentivising performance and creating value for the industry	Assessing the implicit and explicit incentives in each of the models. The regulatory framework should incentivise the firm to undertake activities that generate real value for customers, as they would in a competitive market
Value for customers	Evaluating if industry/sector value is created by assessing the approach to investment, innovation, long-term action planning and facilitating competition in each of the models
Financial and business flexibility	Assessing how each of the models would be able to flex with changes in the industry environment, such as changing licensed activities, evolution of the sector, etc. and the scope for constructive engagement with industry within each model

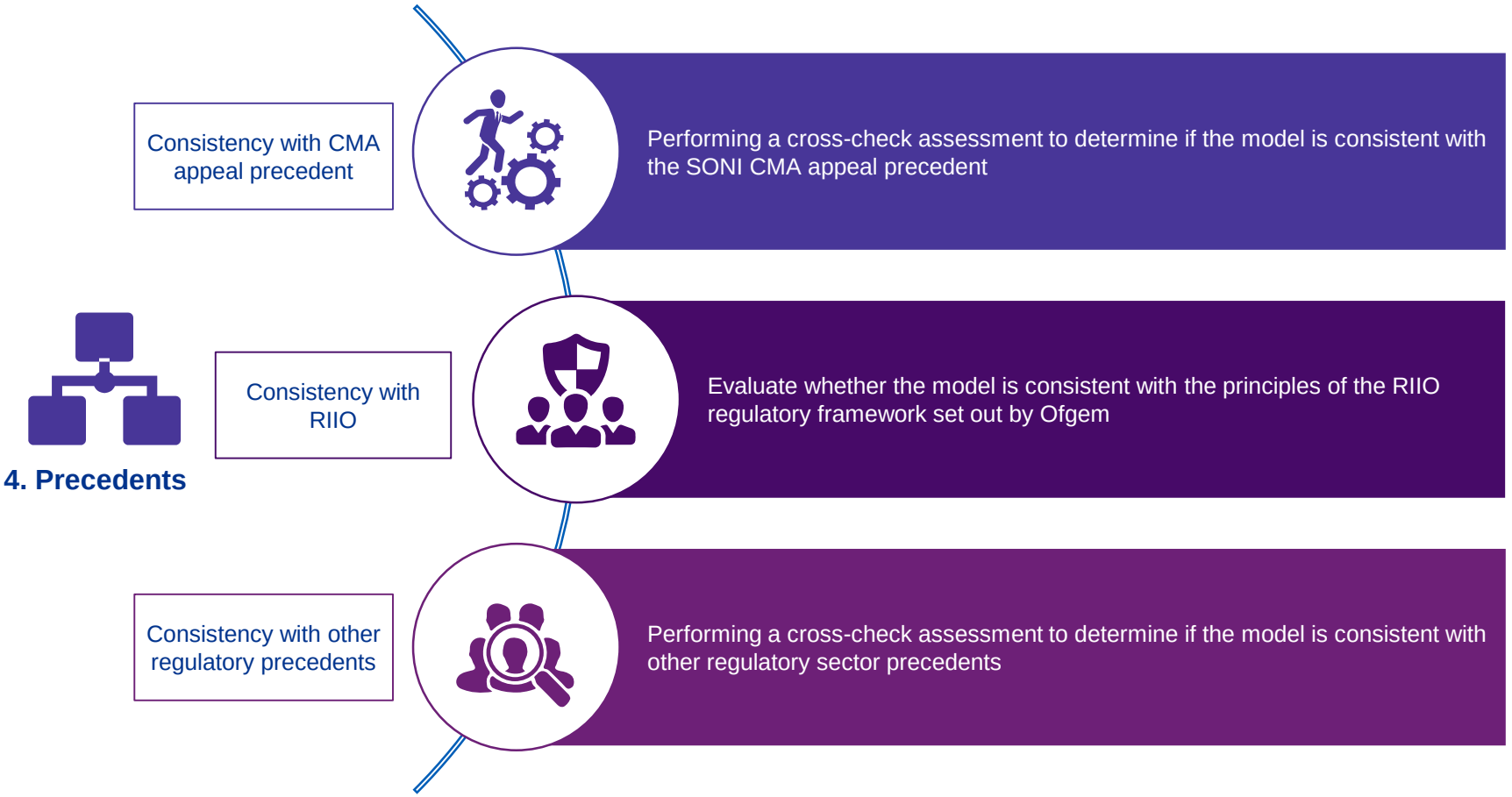
Key criteria for consideration: regulatory principles and consumers

The criteria for assessment are set out below



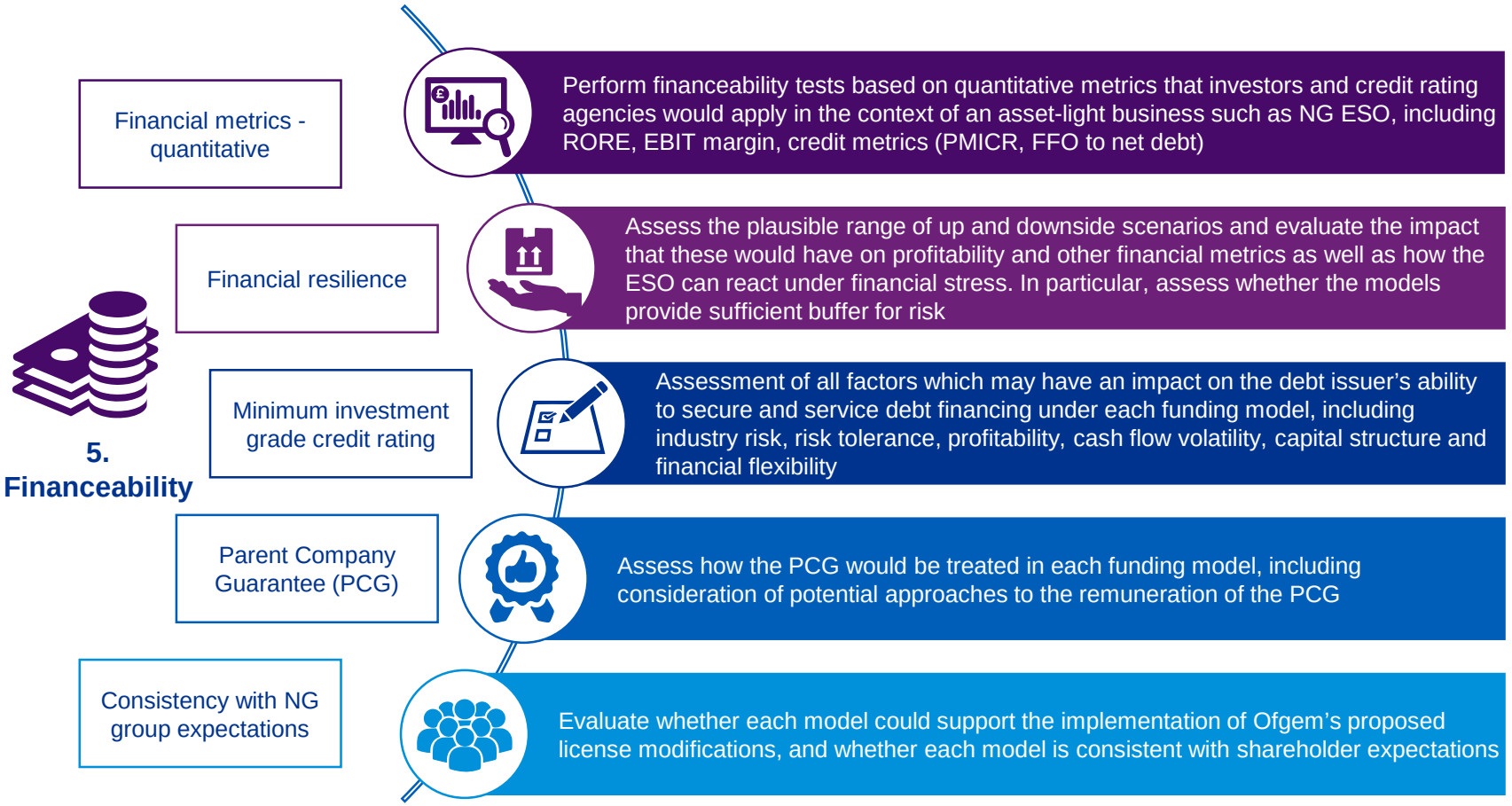
Key criteria for consideration: precedents

The criteria for assessment are set out below



Key criteria for consideration: financeability

The criteria for assessment are set out below



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